

To Exchange Or Not To Exchange: Do Increasing Capital Gain Tax Rates Matter?

by Pamela A. Michaels, Asset Preservation, Inc



When considering whether to sell appreciated real estate, the tax consequences are generally a paramount concern. Surprisingly, many investors do not realize the tax consequences of a sale until after the property has been sold. At that point, the damage is done as a taxable event has occurred. The time to consider the tax consequences of a sale and whether to utilize a §1031 exchange as a means of

deferring one's capital gain taxes is prior to closing.

Most investors will incur long term capital gain taxes on the sale of appreciated property at the Federal level at a maximum rate of 15% and 25% on any depreciation taken during ownership. Most states, including NY and NJ impose a long term capital gain tax on the sale of appreciated real estate of between 6% and 8%. If the property is located within NYC or one of its boroughs, the sale is generally subject to an additional local capital gain tax of 3.8%. Thus, even presuming no depreciation recapture, many investors will incur total taxes of approximately 25–30% on the sale of appreciated real estate if they do not perform a §1031 tax deferred exchange.

Tax rates on capital gains are scheduled to increase from 15% to 20% in 2011. However, Senator Obama has stated he is in favor of having the capital gain tax rates increased immediately and would probably like to see them in the 20–25% range. Senator McCain said he would like to see the 2003 temporary rate reduction of 15% made permanent.

The Tax Reform Act of 1986 reduced the differential between capital gain taxes and ordinary income taxes. More recently, the Jobs and Growth Tax Relief Reconciliation Act of 2003 lowered the rates on long-term capital gains to 15% from 20% for taxpayers in the 25% bracket or higher and lowered the 10% rate to 5% for taxpayers in the 10% and 15% tax brackets. In 2008, the 15% rate remains the same but the 5% rate is reduced to zero. The Tax Increase Prevention and Reconciliation Act (signed into law on May 17, 2006) extends these rates through the end of 2010. In 2011, the capital gain rates are set to return to the old 20% and 10%.

Let's compare the after tax result for a taxpayer who sells today at the current 15% maximum rate versus the same taxpayer who elects to defer all capital gain taxes using a 1031 exchange. In each case, the taxpayer sells at a capital gain tax rate of 20% in the future.

Assume the following: A taxpayer is selling an investment property for \$1 million with \$200,000 remaining debt and \$800,000 equity; the taxpayer's adjusted cost basis is \$300,000 and his gain is \$700,000, of which \$200,000 is depreciation recapture (taxed at 25%) and \$500,000 (taxed at 15%) is the remaining economic gain; the taxpayer is in the top Federal tax bracket and their state tax rate is 7%. Also assume the after-tax sale proceeds are

reinvested into a mutual fund for 5 years yielding 8% simple interest and the exchange proceeds are reinvested into another investment property with a 25% down payment (75% LTV) and that the investment property appreciates an average of 6% for the next 5 years. Assume five years later the capital gain rate is 20%, the depreciation recapture is \$80,128 (\$320,515 at 25%; \$3,200,000 purchase price–\$700,000 deferred gain = \$2,500,000 / 39 years straight line depreciation of \$64,103/year x 5 years) and the state tax remains at 7%.

Scenario 1: Sell in 2008: \$174,000 owed in capital gains (\$50,000 depreciation recapture; \$75,000 Federal taxes; \$49,000 state taxes). Sell/Reinvest after-tax proceeds in a mutual fund: \$626,000 (\$800,000–\$174,000 taxes owed). 5 Years Later—Sell: \$876,400 in mutual fund assets (Assuming an 8% return—the S & P 500 historical average).

Scenario 2: Exchange in 2008: \$0 owed in capital gains (No taxes recognized under IRC §1031) Exchange/Reinvest \$800,000 gross proceeds in property: \$3,200,000 (4 x \$800,000). 5 Years Later : \$1,760,000 equity (\$4,160,000 in value–\$2,400,000 loan). Paying taxes at 20%: \$464,225 (\$4,160,000 sales price–\$2,500,000 cost basis = \$1,660,000 gain x applicable tax rates); \$80,128 depreciation recapture [assuming \$320,515 in depreciation x 25%]; \$267,897 Federal taxes [\$1,339,485 x 20%]; \$116,200 state taxes [\$1,660,000 x 7%].

The exchanger has \$419,375* more equity and almost a 48% better rate of return—even if paying taxes at a higher 20% rate—than the taxpayer who sells today and paid taxes at 15%. And this calculation does not even include the additional taxes that would be owed after the sale of the mutual fund. The above calculation also does not account for any local capital gain taxes that would be incurred on the sale of appreciated property in NYC and its boroughs. If such taxes are additionally taken into account, the benefits of exchanging now, rather than selling and reinvesting the equity in non real estate assets, are magnified as one's equity would only be depleted further by local taxes.

Tax deferral and reinvestment of the entire net equity into replacement property yields a better investment return—even if capital gain taxes rates increase to 20%. Even if we consider that the outcome of the current Presidential race may result in an increase of the Federal long term capital gain rates to 20%, economically, investors still fare much better by exchanging now, rather than cashing out.

* \$1,760,000 equity - \$464,225 taxes = \$1,295,775; After-tax equity 5 years later. \$1,295,775–\$876,400 = \$419,375

Pamla A. Michaels
Attorney and Northeast Division Manager
Asset Preservation, Inc.
Tel: 866-317-1031
pmichaels@apiexchange.com