

1031 Exchange

FOCUS

SECTION 1031 OF THE INTERNAL REVENUE CODE IS ONE OF THE GREATEST WEALTH BUILDING TOOLS AVAILABLE TO INVESTORS



> Calculating Capital Gains Taxes

Internal Revenue Code Section 1031 allows investors to defer the payment of capital gains taxes when selling investment property.

Many property owners are familiar with the “Terrible T’s” in real estate: termites, tenants and trash. Often the “Terrible T’s” become so burdensome that investors decide they want out of real estate altogether. At that point however, investors become all too familiar with another “Terrible T” — Taxes!

Federal taxes increased for high income earners in 2013 and owners who decide to sell an investment property are likely subject to the following Federal tax rates (based on modified adjusted gross income):

<u>Individual</u>	<u>Married</u>	<u>Capital Gains</u>
<200K	<250K	15%
200-400K	250-450K	15%
400K+	\$450K+	20%

In addition to increased federal capital gains tax rates, The Health Care and Education Reconciliation Act of 2010 added a 3.8% Medicare Surtax on capital gains. The 3.8% surtax only applies to individual taxpayers with income over \$200K or joint taxpayers with income over \$250K.

State taxes may also apply depending on which state the property is sold in. For property sold in CA, the state tax typically ranges anywhere between 9.3% - 13.3%, depending on income levels.

Calculating the tax bill upon the sale of a property requires a firm understanding of some basic principles. The first thing to understand is how to calculate the Adjusted Basis.

Formula	Example
Net Purchase Price	\$500,000
(Depreciation)	(\$100,00)
<u>+ Capital Improvements</u>	<u>+ \$25,000</u>
Adjusted Basis	\$425,000

Once the Adjusted Basis is figured, calculating the gain is simple:

Formula	Example
Net Sales Price	\$1,000,000
<u>(Adjusted Basis)</u>	<u>(\$425,000)</u>
Gain	\$575,000

Tax computations can then be made by using the applicable tax rates:

Tax	Formula
Federal Capital Gain	20% * (Gain - Depreciation)
Medicare Tax	3.8% * Gain
CA State Tax	9.3% * Gain
Depreciation Recapture Tax	25% * Depreciation

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