Buying Discounted Property

Examine the After-Tax Benefits of a 1031 Exchange

1031 Knowledge

Taxpayers should consider potential taxes on a future sale before making a decision to buy or sell. For real estate investments, there are three tax scenarios which could apply to a sale: (i) short-term gains at ordinary income tax rates (ii) the long-term capital gains tax rate and the net investment income tax (NIIT) when applicable, or (iii) deferral of state and federal taxes through a 1031 exchange. The foregoing is a bit of a simplification, but provides a simple analytic framework to illustrate the tax impact of various real estate sale scenarios. To understand these classifications and the corresponding tax rate structures more thoroughly, review Ordinary Income vs. Capital Gain Taxation.

Let's look at a taxpayer who purchases two distressed properties at a significant discount (either a short-sale seller or a lender who has already foreclosed on property that secured a non-performing loan). For this example, assume the properties are purchased for $140,000 each, a 30% discount from the fair market value of $200,000 each. Also assume the taxpayer is in the top federal tax bracket and pays state taxes at a rate of 10%. If the taxpayer sells both properties immediately after they are acquired, the taxpayer will realize a before-tax return of $92,000 (assuming no repairs and approximately 7% for commissions and closing costs; 2 x $60,000 = $120,000 minus $28,000 closing costs). So, let's analyze the after-tax dollars that will remain after the sale and consider the potential impact of a 1031 exchange to evaluate the best investment strategy. As demonstrated below, taxpayers who exchange have a much better after-tax return on investment, resulting in considerably greater purchasing power and more wealth accumulation.

ANALYZING THE AFTER-TAX IMPACT
Ordinary Income Tax Rate: 49.6% (39.6% federal, plus 10% state)
Taxes Owed: $45,632 in combined state and federal ordinary income taxes.
Equity Remaining to Reinvest: $46,368

A MORE TAX EFFICIENT SOLUTION: 1031 EXCHANGES
Tax Rate: 0%
Taxes Owed: $0
Equity Remaining to Reinvest: $92,000

Taxpayers purchasing discounted property may want to consider purchasing some of these properties in a separate legal entity, such as a limited liability company (LLC), that will hold property for investment purposes. By segregating real estate assets that are held for investment from other assets that may be flipped for an immediate profit, an active real estate investor can preserve the opportunity to complete 1031 exchanges on the property held longer term and held for investment purposes. By doing so, the taxpayer can get the best of both worlds by generating immediate cash flow selling the property shortly after purchasing, and building long-term equity by holding some properties acquired for investment purposes.

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