

Calculating Your Capital Gain

Analyze the Benefits of a 1031 Exchange Before You Sell

1031

Knowledge

The real power of a 1031 exchange is not just the tax savings — it is the tremendous increase in purchasing power generated by this tax savings. With the advantages of leverage, every dollar saved in taxes allows a taxpayer to generally purchase multiple times more real estate when taking advantage of debt financing. Many taxpayers are surprised to discover that capital gain taxes are far higher than 15% or 20% federal tax rates. State taxes, which can be as high as 13.3% in some states, are added to the federal capital gain tax owed. In addition, depreciation deducted over the ownership period is recaptured and taxed at a rate of 25%. Finally, when applicable, some taxpayers may also have to pay an additional 3.8% net investment income tax on certain income over threshold amounts of \$200,000 for single filers and \$250,000 for married couples filing jointly. The net result is often a large percentage of a taxpayer's profits could be going directly to pay the four potential levels of taxation. Under the 4th calculation below, the net equity times four (assuming a 25% down payment and a 75% loan-to-value ratio) is the value of a replacement property a taxpayer could purchase after paying all capital gain taxes.

Under the 5th calculation involving a 1031 exchange, no taxes are recognized in the current tax year, leaving the full purchasing power of the entire gross equity to acquire more real property held for investment. In just one transaction, the taxpayer who chooses to exchange versus sell and pay capital gain and other taxes has the potential to acquire more investment property than a taxpayer who sells and will ultimately only retain the net proceeds after-taxes are paid.

COMPARE THE TAX SAVINGS OF AN EXCHANGE VS. A TAXABLE SALE

1. CALCULATE NET ADJUSTED BASIS

Original Purchase Price	_____
+ Improvements	_____
- Depreciation	_____
= <i>NET ADJUSTED BASIS</i>	_____

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2. CALCULATE CAPITAL GAIN

Sales Price _____
- Net Adjusted Basis _____
- Cost of Sale _____
= CAPITAL GAIN _____

3. CALCULATE TAXES DUE

Recaptured Depreciation (25%) _____
+ Federal Capital Gain (15% or 20%) _____
+ State Tax (when applicable) _____
+ Net Investment Income Tax (when applicable 3.8%) _____
= TOTAL TAX DUE _____

4. ANALYZE PURCHASE – NO EXCHANGE

Sales Price _____
- Cost of Sale _____
- Loan Balance _____
= GROSS EQUITY _____
- Taxes Due _____
= NET EQUITY _____
Net Equity X 4 = _____

5. ANALYZE PURCHASE - EXCHANGE

Capital Gain Taxes Due _____ 0 _____
Gross Equity = Net Equity _____
Gross Equity x 4 = _____

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