How to Determine Capital Gain Tax

1031 Knowledge

The familiar adage, *"It's not how much you make, but how much you keep"* rings truer than ever for taxpayers. Capital gain taxes increased significantly for high earners in 2013, and many face an additional 3.8% net investment income tax (NIIT) on passive investment income like capital gains. Fortunately, IRC Section 1031, a provision which has been in the tax code since 1921, provides critically needed tax relief.

Under the American Taxpayer Relief Act of 2012, the top federal capital gain tax rate was increased to 20% (up from 15%) for single filers with incomes above $400,000 and married couples filing jointly with incomes exceeding $450,000. In addition, IRC Section 1411 added a new 3.8% NIIT on net investment income, which includes capital gains.

Four Steps Involved in Determining Capital Gain Taxation

Absent the tax-deferral benefits of a 1031 exchange, below is a summary of the four ways taxpayers will be taxed on the sale of an investment property:

1. **Depreciation Recapture:** Taxpayers will be taxed at a rate of 25% on all depreciation recapture.

2. **Federal Capital Gain Taxes:** Taxpayers owe federal capital gain taxes on the remaining economic gain depending upon their taxable income. Since a higher federal capital gain tax rate of 20% has been added to the tax code, taxpayers exceeding the $400,000 taxable income threshold for single filers and married couples filing jointly with over $450,000 in taxable income will be subject to the higher tax rate. The previous federal capital gain tax rate of 15% remains for taxpayers below these threshold income amounts.

3. **New Medicare Surtax Pursuant to IRC Section 1411:** The Health Care and Education Reconciliation Act of 2010 added a new 3.8% tax on "net investment income." This 3.8% NIIT applies to taxpayers with "net investment income" who exceed threshold income amounts of $200,000 for single filers and $250,000 for married couples filing jointly. Pursuant to IRC Section 1411, "net investment income" includes interest, dividends, capital gains, retirement income and income from partnerships (as well as other forms of "unearned income").

4. **State Taxes:** Taxpayers must also take into account the applicable state tax, if any, to determine their total tax owed. Some states have no state taxes at all, while other states, like California, have a 13.3% top tax rate.

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