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To exchange or not to exchange, that is the question - by John Starling

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When you sell business or investment property and you have a gain, you generally have to pay tax on that gain. IRS Code Section 1031 provides an exception and allows you to postpone paying tax on the gain if you reinvest the proceeds in replacement property as part of a qualifying exchange. The code effectively allows you to grow your wealth much faster than normal. Gain deferred in a like-kind exchange under Code Section 1031 is tax-deferred because the exchange transaction itself is not taxed if you buy replacement property of equal or greater value.

So how do you decide whether to sell and exchange or not exchange?

The basic question you need to answer is…How much is my tax liability if I don't exchange? This will be critical to your final decision.

Computing Tax Basis on Investment Properties

Your real estate's tax basis is what you paid for the property and all of its capital improvements. This is usually different from the property's original purchase price. The property's tax basis comes into play when the property sells because taxes get calculated on the difference between the tax basis and the final selling price minus your cost of sale. Investors, though, must pay attention to a property's basis for the entire time that they own it because depreciation taken over the years of ownership gets deducted from the basis in the property for tax computing purposes when you sell. Depreciation is defined as a reduction in the value of an asset that occurs over time as the asset gets older or as wear and tear occurs. The IRS allows you to deduct depreciation each year from income received from the property allowing you to pay less tax on the income from the property than you would on ordinary income. So, to clarify, the net adjusted basis after deducting depreciation taken during the time of ownership gets subtracted from the sales price of your property being sold minus cost of sale (closing cost) to determine your profit. Here's an example you can use to help you calculate your profit to determine your potential tax due: You take the original purchase price that you paid for the property and in our example we will use $500,000 as the purchase price of the property you acquired. Also let's say at the time you purchased the property you added capital improvements that cost $50,000. Capital improvements aren't maintenance and repair expenses such as cosmetic paint and or replacing worn out carpet. Think about anything that will add value like an addition or remodeling. For depreciation we are using 27.5 years straight line depreciation (commercial property is depreciated over 39 years). Now let's say you decide to sell after 10 years. We take the purchase price plus the cost of improvements and divide it by 27.5 years. This is the allotted amount of depreciation per year you would have written off your rental income over the holding period. In our example, the property was valued at $550,000 (land $100,000 and improvements $450,000). You can't depreciate land so we divide the $450,000 by 27.5 years, giving us depreciation of $16,364 per year. In our example, we depreciated 10 years. So our adjusted basis is 386,360.

$500,000	original purchase price
+ $50,000	capital improvements
$550,000	
– $163,640	Depreciation
$386,360	Adjusted basis

Calculating the Gain

For our example let's say you sold your property for $1.2 million at the end of the 10th year. Take your sales price and subtract the closing costs and the adjusted basis. Our sales price was $1.2 million and let's say the closing costs are $80,000 and we already calculated the adjusted basis above as $386,306 so you get $733,640 in taxable gain.

$1,200,000	sale price
– $80,000	closing cost
– $386,306	Adjusted basis
$733,640	taxable gain

Calculating the Tax Due

First you start with the amount of depreciation taken which in our example was $163,640 and multiply by 25% to get the unrecaptured depreciation tax; then subtract the depreciation from the taxable gain and multiply that amount by 20% to get the Capital Gains Tax (as our buyer was in the highest income bracket); then take the taxable gain and multiply by 3.8% to get the federal NIIT tax; and finally take the taxable gain and multiply by 5.1% to get the Massachusetts state tax; add these all together to determine the total tax liability to you of $221,304.

$40,910	Unrecaptured Depreciation Tax – 25%
$114,000	Capital Gain Tax – 20% (highest bracket)
$27,878	NIIT (net investment ncome tax) – 3.8%
$38,516	NC State Tax – 5.25%
$221,304	Total Tax

Should you sell and pay the $221,304.00 tax or exchange? Would you rather pay this amount to the

IRS or reinvest it to grow your wealth faster?

In the next article let’s talk about what happens when you own a duplex, live in one unit and rent the other and you decide to sell…Can you receive your IRS code 121 primary residence exemption of up to $500,000.00 in profit tax free and use code 1031 exchange to take the remaining profit without paying any tax? Look for us in future NEREJ publications.

*Northern Bank, including its subsidiary Northern 1031 Exchange, LLC does not provide tax, legal or accounting advice, nor can we make any representations or warranties regarding the tax consequences of your exchange transaction. We strongly encourage you to seek appropriate professional advice regarding your specific facts and circumstances.

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