1031 Exchanges And Taxes

Those Taxes You Pay By Not Doing A 1031 Exchange Can Be Much Higher Than You Expect

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Many of my readers know that I specialize in finding replacement properties for investors who are selling real estate and completing tax-deferred 1031 exchanges. My article this month will focus on the tax consequences of NOT doing a 1031 exchange.

When Paying Taxes, it is Not "Just 20%"

Sometimes investors are told to "just pay your taxes – it's only 20%." I remind these investors that's only one of the *many* taxes due upon sale of a property. For instance; remember that the state of California will charge their capital gains tax (9.3%) on top of that. Additionally, your *accumulated depreciation* (all the depreciation you have taken during your ownership) will be taxed at 25% by the Feds plus California's 9.3% again. With the addition of "Obamacare," we also have an additional 3.8% that is charged on your capital gain as "investment income." So "only 20%" is really "only" 29.3% PLUS 36.3% PLUS 3.8%.

So Does That Mean My Tax Will Be Somewhere Around 35%?

No! Recently, I sat down with a client who wished to take $100,000 out of his exchange for some "spending money." (He exchanged most of his equity, replaced all of his debt, and had some cash left over.) When we did the math, he found that his tax due would be $47,000 on that $100,000. How did we end up with 44%? Remember that we need to pay tax on our accumulated depreciation – and that's not money we're getting in our pocket today. *That is* how 29.3% and 36.3% and 3.8% can equal 47% of your earnings.

What if I Am Selling a Property at Zero Profit?

A new client recently came to me with a property that he's selling for zero gain. He bought this property in 2007, and is selling now to be done with it. He and his wife bought the property in 2007 for $1,250,000 and they will be selling for a little bit more this year – but expenses from the sale will make their net sales price $1,250,000 – exactly what they paid. The husband said "that means I don't need to do a 1031 exchange because I won't owe taxes, right?" Wrong. In the case above, he will likely pay zero capital gain and zero Obamacare tax; but he still owes his depreciation recapture tax at 25% Federal + 9.3% California. So, I pulled out my calculator and did the math: With a 70%/30% improvements to land ratio, depreciated over 39 years, (this was a commercial, rather than apartment, property), they should have taken ($1,250,000 X 70%) ÷39 = $22,436 depreciation every year. Over 7 years of ownership, that equals $22,436 X 7 = $157,052 of accumulated depreciation. 25% + 9.3% of that is $52,869 of taxes due – not an insignificant sum.

Uh, Oh. So What If I Am Selling for a Big Profit?

Well, if you are selling for a big profit; congratulations! Now – you've got much more to gain, or save, through a 1031 exchange – and much more to lose by not doing one. Let's say that you bought an apartment building in 1995 for $1 million, and that you sold it today for $3 million. (We'll say that you bought it in the same month that you sold it to keep the math easy.) This leaves you with a $2 million capital gain. $1,000,000 depreciated over 27.5 years with a 70%/30% improvements to land ratio will yield $27,273 of depreciation annually. That amount, over 19 years, grew to a total of $518,182. To estimate your taxes; 29.3% of a $2 million capital gain is $586,000. 34.3% of your $518,182 accumulated depreciation is $177,736 and your 3.8% "Obamacare" tax on the capital gain is $76,000. This gives you a total tax due of $839,736 to pay from your $2 million of proceeds. That's 42% of your proceeds – certainly not a "low capital gains rate of 20%;" right?

Avoiding This Through 1031 exchanges

The big downside, of course, to paying out 42% of your sales proceeds is that now you'll need to earn it back. After paying your 42% tax above from your $2 million proceeds, you are left with (rounded) $1,160,000. To make it back to $2 million, you'll need to earn 72% on your money! Remember that the next time your stockbroker says "just pay the taxes, and I'll earn it back for you." If you earn 36% per year on your money, (highly unlikely), it will still take you two years just to get back even! By the way, that "I'll earn it back for you" line is a favorite of stockbrokers. Remember that, and don't let your friends fall prey to it. Friends don't let friends pay unnecessary taxes!

All These Taxes Disappear Upon Your Death

For quite some time, I have described the 1031 exchange as a way to defer your capital gains and accumulated depreciation taxes forever. My investors defer, defer and defer these taxes with exchanges every time they sell. When they die, they go to "taxpayer heaven" and these taxes disappear. My investor's heirs win because they inherit a larger estate that hasn't been diminished by large tax bills with every sale. More importantly – my investors themselves win because they keep more of their principal growing and earning income for them when they are around to enjoy it.

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