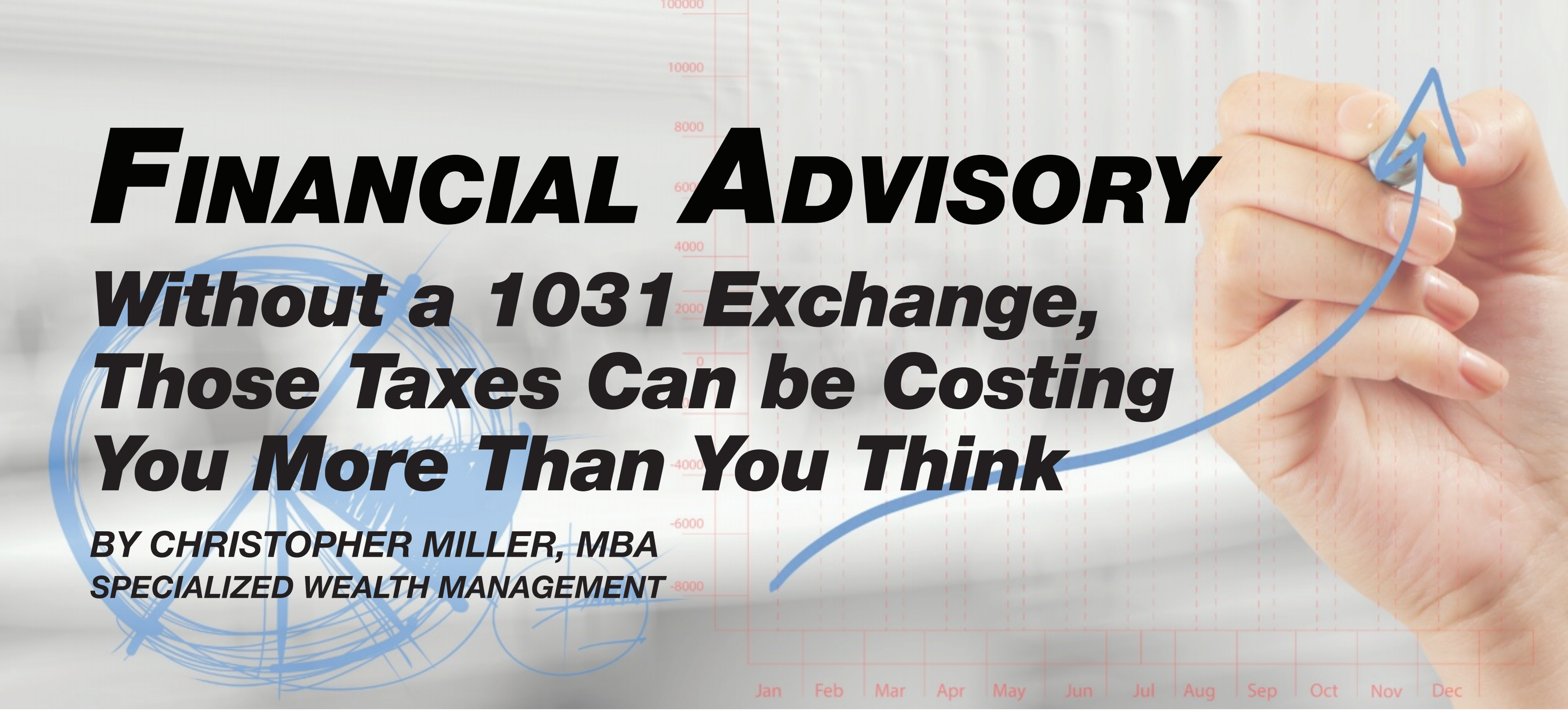

Financial Advisory

Without a 1031 Exchange, Those Taxes Can be Costing You More Than You Think

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I have written many times in the past about just how much damage taxes can do to your wealth building plans. It is an important topic that I think is worthy of a review.

Let's say that you bought 4 units in Orange County for $300,000 back in 1998, and that you sold them this year for $1,800,000. The IRS now uses a tax bracket system to divide your gains between the 15% and 20% rates. For this example, we will use 19% since the gain is so high. This gives us a Capital Gain of ($1,800,000 - $300,000 = $1,500,000) and a Capital Gains tax to the IRS of ($1,500,000 X 19% = $285,000.) That's not too bad, right?

That's not all there is. Remember that the state you live in will (if they have a capital gains tax) want "their share," too. California will charge a graduated rate that currently goes all the way up to 13.2%. Let's estimate this at 10%. So – your Capital Gain to California will be 10% of $1,500,000 or an additional $150,000.

ACCUMULATED DEPRECIATION

So far, our tax bill is $285,000 + $150,000 = $435,000. Next we need to pay accumulated depreciation taxes. All the depreciation benefits we enjoyed over the ownership period need to be paid back to the IRS at a 25% rate. Our depreciation benefits are based on our initial purchase price, the percentage of that price that is assigned to improvements value (since we can't depreciate land), and on a 27.5 year ownership period for residential rental property. Our purchase price was $300,000 and let's say that we estimated 80% of that value to be improvements value. Our annual depreciation would be ($300,000 x 80%) / 27.5 = $8,727. Since 1998 is 24 years ago, we have taken $8,727 x 24 = $209,454 of depreciation. Twenty five percent of this ($209,454 x 25% =) is an additional $52,364 going to the IRS.

Once again, California will want a part of this as well, with their same tax scale that tops out at 13.3%. Let's call this 10% as well and that's ($209,454 X 10%=) $20,945 going to California.

Christopher Miller is a Managing Director with Specialized Wealth Management and specializes in tax-advantaged investments including 1031 replacement properties. Chris' real estate experience includes work in commercial appraisal, in institutional acquisitions for a national real estate syndicator and as an advisor helping clients through over four hundred and fifty 1031 Exchanges. Chris has been featured as an expert in several industry publications and on television and earned an undergraduate business degree and an MBA emphasizing Real Estate Finance from the University of Southern California. Chris began his real estate career in 1998. Call him toll-free at (877) 313 – 1868.

"OBAMACARE TAX"

After all that, there's one more tax! The "Obamacare Tax," or Net Investment Income Tax is 3.8% of your capital gain. That is $1,500,000 x 3.8% = $57,000.

TOTAL TAXES DUE

That total of everything above is $285,000 + $150,000 + $52,364 + $20,945 + $57,000 = $565,309. So your sales proceeds of $1,800,000 is $1,234,691 after your are done paying what turns out to be ($565,309 / $1,500,000=) a 38% tax on your gain. This is why the 1031 Exchange is such a popular tool with real estate investors.

MISSING OUT ON INCOME POTENTIAL

If your next investment with those proceeds has the potential to pay 5% annual income, that could give you ($1,234,691 x 5%=) $61,735 of annual income. Had you deferred (potentially forever) that tax, your full $1,800,000 sales proceeds could be earning you $90,000 annually.

MISSING OUT ON GROWTH POTENTIAL

If your next investment, in addition to paying the above-mentioned annual income, appreciates at 4% per year, then your sales proceeds at your next sale could be $1,827,644. (Near where you used to be – and ready for another tax bite.) Had you deferred (again – potentially forever) your taxes the last time, your full $1,800,000 could grow to $2,664,439 upon sale in 10 more years. This is where the differences are much more noticeable: How much income can you earn on your next investment with $2.6 million of principal vs. $1.8 million? What will it look like for your heirs much further into the future?

I know that writing an article for rental property owners that stresses the importance of deferring taxes to preserve returns is preaching to the choir a bit, but we can all use a periodic review of real estate investment fundamentals. All these taxes can be deferred with a 1031 Exchange. How long are they deferred? As I always say: "potentially forever." All the deferred taxes from 1031 Exchanges will follow you until your death. When that occurs, your heirs will receive a stepped-up basis and those taxes will disappear forever. I and many of my clients plan to own our rental real estate and enjoy the income from it for the rest of our lives by completing 1031 Exchanges after every sale to maximize income and growth potential. Upon our deaths, all our capital gains and accumulated depreciation (and therefore the taxes due on them) will disappear, and our heirs will receive the full value of our life's work.

I hope this article can save you taxes and keep more of your equity working for you and your heirs. If you would like to discuss this more, my office number is (877) 313-1868.

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