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1031Insider

February 2013

1031 Exchanges are Even More Valuable Now!

Earlier this year many articles were written listing all of the tax changes that occurred at the beginning of 2013. That is not the purpose of this article. Instead we will review those changes that directly impact investment properties and discuss how 1031 exchanges are even more valuable to investors than they were before.

On January 1, 2013 two new tax laws which adversely affect many investors took effect: a new tax and an increase in the tax rate on capital gains. The new tax was part of The Affordable Healthcare Act. It imposes a 3.8% tax on certain investment income (including capital gains) on taxpayers whose **Adjusted Gross Income** exceeds $200,000 for single filers and $250,000 for married couples filing jointly. In addition, The American Taxpayer Relief Act raised the top long-term capital gain tax rate from 15% to 20% for some taxpayers. The 20% top rate applies to the extent a taxpayer's **Taxable Income** exceeds $400,000 for single individuals and $450,000 for married couples filing jointly. It should be noted that these two taxes apply to different levels of income. Taxable Income is a smaller amount and results after a taxpayer's deductions and exemptions are subtracted from the Adjusted Gross Income. Accordingly, the Healthcare tax will impact more taxpayers than if it applied to "Taxable Income".

To illustrate the application of these taxes, let's look at an example. Assume that Ted Taxpayer (married and filing jointly) has no other income other than the proceeds from a commercial property he plans to sell in 2013 for $3,000,000. He bought the property 10 years earlier for $1,500,000, put $200,000 of capital improvements into the building and took depreciation deductions totaling $600,000.

Ted's adjusted tax basis in the building is $1,100,000: $1,500,000 (Purchase Price) + $200,000 (Capital Improvements) - $600,000 (Accumulated Depreciation). Assuming his closing costs will be $200,000 he will have a capital gain of $1,700,000: $3,000,000 (Sale Price) - $200,000 (Closing Costs) - $1,100,000 (Adjusted Tax Basis).

Since Ted is selling the property in 2013, he will pay three types of federal taxes: depreciation recapture, capital gain and a tax on investment income. He has a capital gain of $1,700,000; of this $600,000 is depreciation recapture tax and the balance of $1,100,000 will be taxed at the applicable capital gain rates. Ted's taxes will be computed as follows: recapture tax on the depreciation taken ($600,000 x 25% = $150,000); and capital gain tax on the balance of $1,100,000 ($450,000 @ 15% = $67,500 and $650,000 @ 20% = $130,000). In addition, as a result of the Healthcare Act, he will pay tax on the investment income in excess of $250,000 ($1,450,000 x 3.8% = $55,100). **Consequently**, Ted will pay $83,600 (26.5%) more in federal taxes than if he had sold the property in 2012.

However there is good news. If Ted does a 1031 exchange, he can defer all three taxes: depreciation recapture, capital gain and the new healthcare tax. In summary, Ted has more reasons to do a 1031 exchange in 2013 instead of recognizing his gain and paying taxes: 83,600 reasons to be exact. Although 1031 exchanges have always been very beneficial to investors, they are even more valuable now!

We at IPX1031® pride ourselves on not only being the industry leader in service and security, but we also strive to help our clients and their advisors keep current on tax issues pertaining to §1031 exchanges and applications for them. We aim to be your complete information resource. For more information about us or our complimentary monthly webinars on 1031 exchanges, visit our website at www.ipx1031.com.