Cash-Out Now or §1031 Exchange:
A Look at the Potential Effects of Higher Capital Gain Rates on the Effectiveness of a §1031 Exchange

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With the Change Administration set to take the Executive Stage this month, the eyes of investors and their trusted advisors have focused on what effects the incoming president will have on the tax codes that so many have benefited from in the past and the rates of which determine the impact of those codes.

As a core business market, Blue Oak has heard many investors and tax professionals say that since it is clear that the Obama administration intends on increasing the capital gains rates, now is the time to sell investment real estate, elect not to do a §1031 tax-deferred exchange and "cash-out" while rates are low. But is that the right choice?

This article will attempt to look at the financial implications of that assumption through Bob and Linda's story.

The Bob and Linda Story

Bob and Linda have been offered $500,000 for their apartment building in Bloomington, Minnesota. They have a $150,000 mortgage on the property leaving them $350,000 in equity proceeds that they will receive at closing. The couple purchased the building for $300,000 ten years ago and has depreciated the property by $110,000 during that time giving them an adjusted cost basis of $190,000. If they choose to sell the building they will realize a $310,000 capital gain, of which $110,000 is depreciation recapture and $200,000 is the remaining economic gain.

While considering their options they determine the following tax-related facts about the possible sale:

Tax-Related Facts	
Original Purchase Price	$300,000
Mortgage Balance	$150,000
Offered Sales Price	$500,000
Depreciation	$110,000 (27 ½ Yr Depreciation Schedule = $300,000 ÷ 27.5 x 10 Years)
Adjusted Cost Basis	$190,000 ($300,000 - $110,000)
Capital Gain	$310,000 ($500,000 - $190,000)
Depreciation Recapture	$110,000 (taxed at 25%)
Economic Gain	$200,000 (taxed at capital gain rates: Fed 15% and Minnesota State 7.8%)
Total Tax Due	$73,100 ($27,500 + $45,600)

Their CPA suggests that they consider doing a §1031 Tax-Deferred Exchange explaining that by using this common tax strategy they are able to defer both the Federal (15%) and State (Minnesota = 7.8%) capital gain taxes as well as the depreciation recapture tax (25%). In this case, deferring the payment of $73,100 in taxes. However, the CPA explained, a §1031 exchange acts as a "tax snowball" allowing for the deferral of these taxes, not the elimination.

If Bob and Linda choose to sell the apartment building and exchange into another investment property and then over a period of time choose to sell that property using another §1031 exchange they will be accumulating the taxes due in all §1031 related transactions. When they finally choose to sell their final investment property in a string of §1031 exchanges and cash out the taxes will be due on all previous exchange transactions. The only way for Bob and Linda to eliminate the taxes associated with the string of investment property sales is to die. When the owner of a §1031 exchanged property dies his/her property transfers into their estate at a stepped up cost basis giving their heirs an opportunity to sell the property at the time of death and avoid paying any of the accumulated capital gain or depreciation recapture taxes. The value Bob and Linda receive in using the §1031 exchange strategy is the ability to reinvest 100 cents on every dollar they receive at closing from their sale and avoid, for the moment, paying almost 24% ($73,100 ÷ $310,000) of the investment's gain in taxes to the government.

With the chance of these rates increasing in the near future with the Obama Administration, Bob and Linda are considering not doing a §1031 exchange and cashing-out now while rates are low instead of exchanging into a tax-environment where rates are likely to go up and they will be stuck paying higher taxes at a future "cash-out" date.

Is this a good idea? Let's take a look at the bottom line. Assuming all else equal and that Bob and Linda do not have any immediate needs for the lump sum that will come to them upon the sale of this property and that no other tax considerations for their specific situation need to be considered, here are the facts:

	Cash Out Scenario
Sales Price	$500,000
Net Proceeds after Debt Payoff	$350,000
Economic Gain	$200,000
Capital Gain Tax (Fed 15% & MN 7.8%)	$45,600
Depreciation Recapture	$110,000
Depreciation Recapture Tax (25%)	$27,500
Total Taxes Due on Sale	$73,100
Net Reinvested Proceeds	$276,900
Assumed Avg. Rate of Return	8% (the S&P 500 historical average)
Value of securities portfolio in Dec 2013 (after taxes assuming 35% income tax rate)	$348,894 (simple return w/o compounding)

Now let's assume that Bob and Linda sell the property for $875,000 in 2013 and decided to cash-out and pay the 2013 federal capital gain rates of 25%.

	Cash-Out in 2013 at 25% Cap Gain Rates
2013 Sales Price	$875,000
2013 Adjusted Cost Basis	$390,000 (Purchase price $700,000 – Deferred gain $310,000)
2013 Economic Gain	$435,000 ($875,000 - $390,000 - $50,000)
2013 Capital Gain Tax (Fed 25% & MN 7.8%)	$142,680 ($435,000 x 32.8%)
2013 Depreciation Recapture	$160,000 ($110,000 on 1st 1031 exchange + $50,000 on 2nd property)
2013 Depreciation Recapture Tax	$40,000 ($160,000 x 25%)
Total Taxes Due on 2013 Sale	$182,680 ($142,680 + $40,000)
Mortgage Payoff	$350,000
Net Proceeds of Sale after Taxes	$342,320 ($875,000 - $350,000 - $182,680)
Net after tax income over 5 year period	$92,488
Value of 1031 Asset in 2013	$434,808 ($342,320 + $92,488)

As the above comparison shows, Bob and Linda have a net after tax asset value of $434,808 by doing a 1031 exchange in 2009 even when cashing out in a hypothetical 25% federal capital gains rate environment in 2013 and a $348,893 after tax asset value by cashing out in 2009 and reinvesting the proceeds into mutual funds for 5 years. Bob and Linda end up with $85,914 more in their pocket by using the §1031 Tax Deferred Exchange process, a 29% higher rate of return on their initial $300,000 investment. • CONTACT KAP@CONSULTKAP.COM FOR MORE INFO.