

THE 2003 CAPITAL GAIN TAX REDUCTION

"WHAT IT MEANS FOR REAL ESTATE INVESTORS"



Compliments of

On May 28, 2003 the President approved a \$350 billion tax cut that includes reductions in dividend and capital gain taxes. Long-term capital gain tax rates for investors in the top tax brackets are reduced to 15 percent from 20 percent. The rates are reduced to 5 percent for investors in the 10 percent and 15 percent brackets. The changes are retroactive to May 6, 2003.

Even with the lower capital gain rates, real estate investors should first determine their total tax liability before selling real estate. Often the impact of depreciation recapture at 25 percent, *plus* the combined federal and state tax owed result in a §1031 tax deferred exchange being a much better alternative. In fact, when analyzing the purchasing power of an exchange as compared to a sale, the value of tax deferral becomes even more dramatic.

EXAMPLE: Assume an investment property owner sells a rental property for \$700,000. The owner originally purchased the property for \$200,000. There is \$100,000 of debt and the property has been fully depreciated (assuming 80% of the property is depreciable). The investor has \$500,000 of capital gain plus \$160,000 of depreciation recapture. They are in the top federal tax bracket and their state tax rate is 5%.

Depreciation Recapture:

$$\$160,000 \text{ (depreciation recapture)} \times 25\% = \$40,000$$

Plus: Federal Capital Gain Tax:

$$\$500,000 \text{ (capital gain balance)} \times 15\% = \$75,000$$

Plus: State Taxes:

$$\begin{array}{r}
 \times 5\% = \underline{\$33,000} \\
 \$660,000 \times 5\% = \underline{\$33,000}
 \end{array}$$

$$\text{Equals: Total Taxes Owed in a Sale:} = \mathbf{\$148,000}$$

BENEFIT OF IRC §1031: The major benefit of an exchange is not the actual savings but the purchasing power provided by this tax savings! The example below analyzes the value of a new property that could be acquired in an exchange versus a sale. The comparison assumes an investor makes a 25 percent down payment and finances 75 percent of the property (75 percent loan-to-value ratio.) As this comparison illustrates, the investor who performs a §1031 exchange acquires \$592,000 more real estate than the investor who sold and paid taxes!

Sale

Equity:	\$600,000
- Taxes Owed:	<u>\$148,000</u>
After-Tax Equity:	\$452,000
	_____ x 4
New Property:	\$1,808,000

Exchange

Equity:	\$600,000
- Taxes Owed:	<u>\$ 0</u>
After-Tax Equity:	\$600,000
	_____ x 4
New Property:	\$2,400,000

ADDITIONAL §1031 EXCHANGE BENEFITS

- Maximize return on investment
- Preservation of equity
- Increased cash flow from larger properties



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