

Case Study

Selling Investment Real Estate and Cashing out vs. Deferring Tax via 1031 Exchange

Case Study #1 Bill and Mary Miller are in their mid-seventies and have owned a 10-unit apartment building in La Jolla for 30 years. The Millers are tired of dealing with property managers, tenants, repairs, and all the other challenges of owning direct real estate. They are considering selling their property and investing the proceeds into a fixed income portfolio with their financial advisor. They purchased the property for \$500,000 30 years ago and have invested an additional \$50,000 in capital improvements. They could sell the property today for \$3,000,000 and would pay \$180,000 in closing costs. The following is an analysis of the potential tax consequences of simply selling the property and cashing out versus deferring capital gains taxes via tax deferred 1031 exchange. The Millers are in the highest federal tax bracket and live in California.

The 4 Steps in Calculating Tax Liability

1. Calculate Cost Basis
2. Calculate Taxable Gain
3. Determine Applicable Tax Rates
4. Calculate Tax Liability

Calculate Cost Basis

Purchase Price	\$500,000
Capital Improvement	+ \$50,000
Depreciation	- \$500,000
Adjusted Cost Basis	= \$50,000

Calculate Taxable Gain

Sales Price	\$3,000,000
Closing Costs	-\$180,000
Adjusted Basis	-\$50,000
Capital Gain	\$2,770,000

Determine Tax Rates

Federal Capital Gains	20%*
Depreciation Recapture	25%*
Medicare Tax	3.8%*
CA Income Tax	11.3%**

*Tax rates may vary depending on income levels and may change in the future.

**CA Income tax only applies in California.

Calculating Tax Liability

Federal Capital Gains	\$454,000
Depreciation Recapture	\$125,000
Medicare Tax	\$105,260
CA Income Tax	\$313,010
Tax Due	\$997,270

Cash Out vs. Tax Deferred 1031 Exchange:

Cash Out		1031 Exchange	
Net Sales Price	\$2,820,000	Net Sales Price	\$2,820,000
Federal Cap Gain	\$454,000	Federal Cap Gain	0
Recapture	\$125,000	Recapture	0
Medicare	\$105,260	Medicare	0
CA Income	\$313,010	CA Income	0
Total Tax	\$997,270	Total Tax	0
Net Equity	\$1,822,730	Net Equity	\$2,820,000
Income (5%)*	\$91,136	Income (5%)*	\$141,000

*Based on a hypothetical annual yield from a hypothetical investment portfolio.
Not guaranteed