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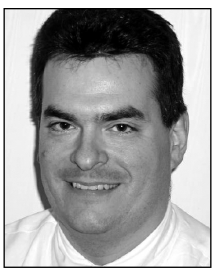
Capital Gains Tax Complexity Thrives in Sales and Exchanges

By Thomas J. Moylan

The decision whether or not to enter into a 1031 Exchange often depends on the amount of taxes that can be deferred.



If the real estate is being sold at a loss, then the taxpayer would probably be better off not exchanging, as losses are not recognized in 1031 Exchanges. Taxpayers who will realize a gain should determine how much tax will be due if they decide to pay the tax and forego the opportunity to enter into a 1031 Exchange.

The general rule, familiar to most taxpayers, is that net long-term capital gains for noncorporate taxpayers for assets held more than 12 months are taxed generally at a maximum rate of 15 percent – 5 percent for the 10 percent and 15 percent bracket taxpayers. Short-term gains, i.e. assets held less than 12 months, are taxed at the taxpayer's highest ordinary income tax rates.

A more complex set of rules comes into play when the asset sold is depreciable real estate. This is so because a maximum rate of 25 percent will apply to what's called "unrecaptured Section 1250 gain" and a maximum rate of 15 percent will apply to the balance of the gain. Unrecaptured Section 1250 gain refers to the portion of gain that is eligible for capital gain treatment even though it is attributable to previously allowable depreciation. A further complication is that the portion of the gain that is unrecaptured Section 1250 gain depends, as shown below, on when the property was placed in service.

For real estate placed in service after 1986, all depreciation deductions allowable before the sale of the real estate give rise to unrecaptured Section 1250 gain. Thus, if a taxpayer sells, at a gain of $200,000, a building on which $90,000 of depreciation deductions were allowable to him through the time of sale, $90,000 of the gain is unrecaptured Section 1250 gain that will be taxed at a rate of 25 percent. The remaining $110,000 of the gain will be taxed at a rate of 15 percent.

Prior to the enactment of the Revenue Enhancement Act of 2002, long-term capital gains in Massachusetts were divided into six classes based on the length of time that the capital asset had been kept prior to sale or exchange. Capital gains taxes ranged from 5 percent for capital assets held more than one year and up to two years, 4 percent if held more than two years and up to three, and so on; with no tax on the gain from the sale or exchange of capital assets held more than six years. As a result of the enactment of the act, long-term capital gains realized in calendar year 2002 before May 1, are taxed pursuant to the old formula described above, whereas long-term capital gains realized in calendar year 2002 on or after May 1 are taxed as ordinary income at 5.3 percent.

The Massachusetts Supreme Judicial Court has recently held, however, that the 2002 law change that increased the tax rate on long-term capital gains effective May 1, 2002, is unconstitutional. According to the court, the act violates the uniformity requirement of Article 44 of the Amendments to the Massachusetts Constitution because two different tax rates would apply to the same class of property during calendar year 2002. The case was remanded for a determination of the applicability date in view of the declaration of unconstitutionality of the mid-year effective date.

On the federal side, the Internal Revenue Service has issued temporary and proposed regulations explaining how to depreciate property acquired in exchange for like-kind property under code Section 1031. The regulation's basic approach is to divide the replacement property into the depreciable exchanged basis, i.e., the remaining basis of the relinquished property carried over to the replacement property, and the depreciable excess basis, i.e., the additional consideration to acquire the replacement property. Where the properties share the same recovery class and depreciation method, the depreciable exchanged basis is written off over what's left of the relinquished property's recovery period; and the depreciable excess basis is in effect treated as a separate property with a recovery period that begins anew. ■

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