How to Calculate Your Potential Tax Benefits with a 1031 Exchange

If you are selling an investment or business use property, you should consider a 1031 exchange. Generally speaking, a 1031 exchange allows you to defer capital gains tax at the federal and state level, depreciation recapture tax, and net investment income tax when you sell an investment or business use real estate and reinvest those proceeds into another business or investment use property.

How to Calculate Capital Gains Tax

Many people ask, how is Capital Gains Calculated, the Capital Gains Tax Calculation is as follows:

Sales Price - the TOTAL of Original purchase price (cost basis) + improvements to the property + selling expenses = Total Capital Gains

Federal Capital Gains Tax = Total Capital Gains multiplied either 15% or 20% depending on your annual household Income. Currently for persons married filing jointly the 20% rate would begin on income of $517,001. Remember the sale of the property itself is considered part of the income.

State Capital Gains Tax = Total Capital Gains multiplied by your State Capital Gain Tax Rate which varies by state.

By adding the total of your Federal Capital Gains and State Capital Gains Tax you get your total Capital Gain Tax that would be owed if you did not complete a 1031 Exchange.

How to Calculate Depreciation Recapture Tax

Your tax liability doesn't stop there, without a 1031 exchange you will also be responsible for Depreciation Recapture Tax. How do you calculate depreciation recapture tax? First, we need to calculate the Depreciation taken on the property over the course of ownership.

Annual allowable depreciation is based off whether the property is residential or commercial, from there you need to know your original purchase price (cost basis), land value (value of the land minus building/structure value), and cost of improvements.

The calculation for annual allowable depreciation is as follows:

Original purchase price - land value + cost of improvements = Total Depreciable Value

Annual Allowable Depreciation = Total Depreciation Value divided by either 27.5 (residential) or 39 (commercial)

Once you know your Annual Allowable Depreciation, you can calculate the Depreciation Recapture Tax you would be liable for without a 1031 exchange.

The calculation is as follows:

Annual Allowable Depreciation multiplied by the total years you have owned the property = Accumulated Depreciation

Accumulated Depreciation multiplied by 25% deprecation capture tax rate = total Depreciation Recapture Tax that will be due along with the capital gain tax to the IRS without a 1031 exchange.

Please consult your Tax Advisor for an accurate calculation based upon your specific situation.