A 93 Year-Old Solution for Investors Facing Higher Taxes in 2014!
By Kathy Biewenga

The familiar adage, "*It's not how much you make, but how much you keep*" rings truer than ever for Southern California real estate investors in 2014. Not only have capital gain taxes increased significantly for high earners, but many investors below the top tax bracket face an additional 3.8% surtax on passive investment income like capital gains. Fortunately, IRC Section 1031, a provision which has been in the tax code since 1921, provides critically needed tax relief for California investors.

Section 1031 of the Internal Revenue Code allows an owner of investment property to exchange property and defer paying federal and state capital gain taxes and the 25% depreciation recapture. In order to benefit from this, the owner must purchase a "like-kind" property following the rules and regulations of the Internal Revenue Code. This allows investors to use all the sale proceeds to leverage into more valuable real estate, increase cash flow, diversify into other properties, reduce management and/or consolidate holdings.

A 1031 exchange is applicable when a property owner intends to SELL any property "held for investment" that is not their primary residence and then plans to BUY another "like-kind" property within 180 calendar days following the closing of the relinquished property. They must also identify a replacement property within 45 calendar days of the closing of escrow.

Before you consider a 1031 exchange, review the four steps in determining capital gain taxation to determine your total tax burden. A Qualified Intermediary, the entity that facilitates the exchange, holds the exchange proceeds and prepares the exchange documentation, can't provide tax advice so it's important to consult your tax advisor before closing escrow on any property held for investment so you understand the full tax ramifications if now exchanging. Here are the steps involved in determining taxes owed.

1) ***Depreciation Recapture:*** Taxpayers will be taxed at a rate of 25% on all depreciation recapture. (35% for personal property depreciation recapture)

2) ***Federal Capital Gain Taxes*:** Investors owe Federal capital gain taxes on the remaining economic gain depending upon their taxable income. A new higher capital gain tax rate of 20% has been added to the tax code; investors exceeding the $400,000 taxable income threshold for single filers and married couples filing jointly with over $450,000 in taxable income will be subject to the new higher tax rate. The previous Federal capital gain tax rate of 15% remains for investors below these threshold income amounts.

3) ***New Medicare Surtax Pursuant to IRC Section 1411:*** The Health Care and Education Reconciliation Act of 2010 added a new 3.8% Medicare Surtax on "net investment income." This 3.8% Medicare surtax applies to taxpayers with "net investment income"

who exceed threshold income amounts of $200,000 for single filers and $250,000 for married couples filing jointly. Pursuant to IRC Section 1411, "net investment income" includes interest, dividends, capital gains, retirement income and income from partnerships (as well as other forms of "unearned income").

4) ***State Taxes***: Taxpayers must also take into account the applicable state tax. In California taxpayers face steep state taxes that can be as high as 13.3%.

Despite these new tax increases, one aspect of the tax code provides real estate investors with a huge tax advantage. Section 1031 allows property owners who hold property for investment purposes to defer taxes that would otherwise be recognized upon the sale of the investment property. Property owners selling restaurants have the potential to exchange both the real property and personal property aspects of their restaurant operation. Savvy investors use 1031 exchanges to redeploy their investment capital into better performing investment property.

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