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Taxpayers Beware: Zero Profit Doesn't Mean Zero Capital Gains Taxes

In this difficult market, many taxpayers are selling property in short sales or other transactions with no profit. Unfortunately, what many taxpayers do not understand is that property may be sold with no profit, but still be subject to significant taxable capital gain. How is this possible? It is possible simply because gain results not just from appreciation in value, but also results from depreciation deductions taken during ownership of the property, gain deferred from previous transactions, and from borrowing against appreciated equity in a declining market. These adverse taxconsequences can be avoided by engaging in a Section 1031 taxdeferred exchange.

How to Determine Gain

The formula to determine taxable gain is: Sales price less adjusted basis[1] = taxable gain

Three Situations Resulting In No Profit, But Taxable Gain

1. Depreciation Recapture If a taxpayer takes depreciation deductions, those deductions reduce the taxpayer's basis, thereby resulting in gain.

Example: Taxpayer acquires investment property A for $200,000. Taxpayer's basis is therefore $200,000. During taxpayer's ownership, taxpayer takes $138,500 of depreciation deductions, thereby reducing taxpayer's basis to $61,500. Taxpayer sells Property A for $180,000.00. Even though taxpayer sells the property for $20,000 less than what he originally purchased it for, he still has a taxable gain of $118,500 ($180,000-$61,500=$118,500) which will result in approximately $41,500 in federal and state taxes. This adverse tax result can be avoided by exchanging the property in a tax deferred exchange rather than selling the property.

2. Carryover Gain If a taxpayer sells property previously acquired in an exchange – at no profit or even at a loss – the taxpayer may still be faced with significant taxable gain.

Example: Taxpayer originally acquired Property A for $20,000. Taxpayer disposed of Property A in a tax deferred exchange for $100,000 and acquired Property B for $150,000, thereby deferring taxes on $80,000 of gain. Taxpayer's adjusted basis in Property B is $70,000 ($150,000 purchase price-$80,000 carryover gain=$70,000). Taxpayer now proposes to sell Property B for the same price as he purchased it for – i.e. $150,000. Although Taxpayer is not making a profit on this transaction, he will still have significant federal and state taxes of approximately $28,000 on his gain of $80,000.

3. Excess Borrowing If a taxpayer borrows against appreciated equity in their property, tax consequences can also result if the property thereafter declines in value and the taxpayer is forced to sell the property for little or no profit.

Example: Taxpayer acquired property A for $1,000,000, paying $200,000 cash and borrowing $800,000. Taxpayer's basis is $1,000,000. During Taxpayer's ownership, the property appreciates in value to $1,400,000, enabling Taxpayer to refinance the existing loan of $800,000 with a new loan of $1,120,000. Taxpayer now sells, but since property values have declined, his selling price is $1,120,000. Although Taxpayer will receive no cash from the sale, he will still have taxable gain of $120,000 ($1,120,000-$1,000,000=$120,000), with combined federal and state taxes of $42,000.

As illustrated by the foregoing examples, sales of property that yield little or no cash can still result in taxable gain. Before selling in a down market, taxpayers and their advisors should first determine the taxpayer's basis in the property to be disposed of and thoroughly discuss upfront the potential tax consequences. Taxpayers can avoid any of the tax consequences noted in these examples by engaging in a IRC §1031 tax deferred exchange.

[1]Basis = Original purchase price
Adjusted Basis = Basis plus improvements less depreciation

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