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Numbers can be deceiving: Long-term gains on commercial property

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I was recently discussing the candidates for Most Valuable Player (MVP) in the American League with a colleague. Baseball is a game of numbers and discussions about the success of any player is often settled by reviewing their statistics. However, this was one of those rare instances where we both agreed that this years' MVP race should be based more on intangibles than statistics. Derek Jeter, the shortstop for the New York Yankees, is having an MVP year without being near the league leaders in "home runs" and "runs batted in" which are usually staples of this award. Many sport aficionados agree that Jeter's clutch performance and leadership, combined with his league leading batting average are sufficient to earn this award. Numbers can be deceiving in baseball and they can often be as deceiving in commercial real estate. Take for example the 5% capital gains tax figure that we often hear about. Once you research the capital gains tax, you will quickly realize that 5% may be just as deceptive.

We must differentiate between a short-term and long-term capital gain which is determined by the holding period or length of time that you own the property. A short-term gain on the sale of a property occurs when the holding period is twelve months or less. Similarly, a long-term gain has a holding period of more than twelve months. Short-term capital gains are taxed as ordinary income based on your income tax bracket (as determined by the taxable income on your federal tax return). This article will focus on long-term gains on commercial property as recent legislation has reduced this rate substantially.

On May 28, 2003, President Bush signed "The Jobs and Growth Tax Relief Reconciliation Act of 2003" which temporarily (until 2008) reduced the maximum long-term capital gains tax rate from 20% to 15% , the lowest level since the Great Depression. Taxpayers in low income tax brackets (10% and 15%) would be subject to a lower capital gains rate of 5% through 2007 and a special 0% rate effective in 2008.

On May 17, 2006 President Bush signed the "Tax Increase Prevention and Reconciliation Act." The new law extended through 2010 the favorable federal income tax rates for long-term capital gains. Therefore, the special 0% rate for individuals in the lowest two tax brackets will remain at the current 5% level through 2007 and then drop to 0% for 2008 through 2010. It's not even a presidential election year, so this sounds too good to be true. However as my father always tells me; if it is too good to be true, it probably isn't true.

As mentioned above, the 5% and special 0% rates will only apply if you are in the lower income tax brackets. However, the amount of the capital gain is included in the tax bracket calculation. Let's take a look at this legislation in a "real-life" example:

A married couple sells a commercial property that they have owned for 4 years for a $50,000 capital gain. They currently have $80,000 in gross income and have one child so they will receive personal exemptions of $9,900 ($3,300 for each plus the child). Assuming they take the standard deduction of $10,300, their taxable income would be $59,800 which put them in the 15% tax bracket ("caps out" at $61,300 for 2006). If you multiply the $50,000 capital gain by 5%, the capital gain tax would be $2,500. However, the calculation is not that easy. The first $1,500 of the capital gain ($61,300 less $59,800) would be taxed at 5% and the remaining $48,500 would be taxed at 15% resulting in an effective rate of 14.70% or $7,350. If the couple had taken depreciation deductions on the commercial property, their gain up to the depreciation would be taxed at a maximum rate of 25% and the remaining under the general rule. Also, most states do not have separate capital gains tax rates so the capital gains would be considered ordinary income subject to the state income taxes rates. Either way, you are looking at a much higher rate than 5%.

There are various alternatives that you can select to minimize a large capital gain and the associated tax impact. Seller based financing under the installment sales method can defer the capital gain over time and a Section 1031 like-kind exchange could defer the capital gains indefinitely (see my article from the July 26, 2005 publication). Always consult with a CPA or tax professional to see if the above options are viable for your situation.

In baseball and commercial real estate, numbers can be deceiving, therefore make sure to fully research the topic at hand.

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