



## The 2003 Capital Gains Tax (Not as Simple as You Thought) By Frank Gallinelli

As you surely know, the Jobs and Growth Tax Relief Reconciliation Act of 2003 (we wish they had called it the "If You Can Say It Then You Don't Have to Pay It" Act) lowered the rates on long-term gains effective May 6, 2003 and continuing through the end of 2008.

You probably read in the newspaper or heard on the evening news that the capital gains tax rate used to be 20% but now it has been lowered to 15%. Well, that's sort of true. There was a 20% rate and now there is indeed a 15% rate. But that's not the whole story -- the new rules aren't as simple as the sound-bites may have led you to believe. If you're a real estate investor, you need to know the rest of that story.

The capital gains tax rate that may apply to the sale of a real estate investment depends on three factors: the investor's tax bracket, the year of the sale and the length of time the investor has owned the property. You have to keep these factors sorted out in order to determine which of six different tax rates may apply to your gain in a particular year. This need is especially important for you as a real estate investor performing an income-property analysis. When you make such an analysis you're making a forecast about a property's future performance. You are almost certainly expecting to hold the property into some future year and to pay the tax that's appropriate for that year. One rate doesn't fit all.

One of your objectives in performing the analysis in the first place is to forecast an optimum time to sell. When do you achieve the best mix of cash flow, resale value and tax consequences; when does your IRR peak? To get those answers you have to match the right tax rates to the right years.

Short-term gains, where you have held the property for twelve months or less, are still taxed at your ordinary-income rate. Depending upon how the three factors -- tax bracket, year of sale and holding period -- line up, your long-term capital gains rate could be 0%, 8%, 10%, 15%, 18% or 20%. Keep in mind that depreciation must be also recaptured at ordinary income rates but not more than 25%.

The new capital gains rules may be more complicated than they need to, but we're not complaining. Tax relief for real estate investors is always welcome -- just don't get blindsided by simplistic explanations that don't tell the whole story.

[An important postscript: RealData has updated its Real Estate Investment Analysis software to handle the revised capital gains rules. (Updates are available to registered users, of course.) This is the fifth major tax law change since we began selling the program in 1982. As with previous versions, the program asks you for just your marginal tax bracket; it then does all the hard work, tracking other pertinent information year-by-year, selecting the appropriate capital gains rate for each year and performing the final calculations for you.

We were surprised to see several income-property programs that said they included the new rules but actually did nothing more than ask for a blanket "investor's capital gains rate." That might be all right for a one-year analysis (except that it would require the user to figure out the correct rate for that year), but it's really saying that one tax rate fits all investors for all years. Under the new code one blanket rate is just not applicable to sale forecasts for each of 10 or 20 future years. It's a recipe for error and perhaps some bad investment decisions. Again, beware of simplistic explanations.]