2013

Brief Tax Update

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INTRODUCTION

The 2012 American Taxpayer Relief Act ("Tax Act") is a sweeping tax package that includes a permanent extension of the Bush tax cuts for most taxpayers, revised tax rates on ordinary income and capital gain income for high-income individuals, modification of the estate tax, and permanent relief from the Alternative Minimum Tax ("AMT") for individual taxpayers, as well as numerous other tax changes and surcharges.

This article will briefly summarize some of the more problematic changes and those that specifically affect real estate investors.

OVERVIEW OF THE 2012 TAX ACT

Here is a look at the key elements of the Tax Act:

Individual Tax Rates

The 10%, 15%, 25%, 28%, 33% and 35% tax brackets enacted under President Bush were made permanent, which means that, for most Americans, the tax rates remain the same for tax years beginning 2013. However, a new tax bracket of 39.6% was introduced for taxpayers as follows: $225,000 for married filing separate, $400,000 for single filers, $425,000 for head of household filers, $450,000, which are inflation adjusted for tax years after 2013.

Estate Tax Rates

The exemption for estate, gift and generation-skipping transfers of $5,000,000 was made permanent for tax years beginning in 2013, and will be indexed for inflation. Accordingly, for 2013, the estate tax exemption is $5,250,000. However, the Tax Act also increased the top estate, gift and generation-skipping transfer tax bracket from 35% to 40%.

Capital Gain Tax Rates

For tax years beginning in 2013, the capital gain tax rates will be:

- 0% if the taxpayer's Adjusted Gross Income ("AGI") is below the 25% individual tax bracket; or
- 15% if the taxpayer's AGI is between the 25% and 39.6% individual tax brackets; or
- 20% if the taxpayer's AGI is in the new 39.6% individual tax bracket.

These capital gain tax rates do <u>not</u> include the Medicare surcharge of 3.8%. Taxpayers that qualify for the 3.8% tax rate would add this to the capital gain rates outlined above. So, effectively, the top capital gain tax rate is now 23.8% beginning in 2013.

Cost Recovery

The Tax Act extended the increased expensing limitations and treatment of certain real property as Section 179 property. It also extends and modifies the bonus depreciation provisions with respect to property placed in service after December 31, 2012 for tax years ending after that date.

Medicare Surcharges

The Medicare surcharges were part of the Patient Protection and Affordable Care Act, more commonly known as Obamacare, which was adopted in 2010. The healthcare reform legislation included two (2) Medicare surcharges, both of which became effective in 2013. I'm covering these surcharges in this article even though they were not part of the Tax Act because they can have a direct impact on the sale of real estate.

Medicare Surcharge on Earned Income

There is now a 0.9% Medicare surcharge on earned income (i.e. income from salary and wages). The surcharge applies to salaries and wages as well as to self-employment income when total earnings exceed $200,000 for single taxpayers and $250,000 for married taxpayers.

Medicare Surcharge on Net Investment Income

The more troublesome Medicare surcharge is the 3.8% tax on net investment income. While there have been many claims that most taxpayers will not get hit with the Medicare surcharge, if it does hit you then it means that you have already paid exceptionally high income taxes and/or capital gain taxes and are now going to get hit with an additional 3.8% tax. Income tax, capital gain tax, penalty, or surcharge, whatever you call it – it hurts.

The Medicare surcharge, also referred to as the Obamacare tax, went into effect on January 1, 2013. It applies to single taxpayers and heads of household who have Modified Adjusted Gross Income ("MAGI") of more than $200,000 and to married taxpayers who have MAGI of over $250,000. The surcharge is based on:

- Investment income such as interest income or dividend income
- Capital gains from the sale of investment real property
- Capital gains from the sale of your primary residence in excess of the $250,000/$500,000 tax free exclusion under Section 121
- Capital gains from the sale of other investments
- Passive rental income
- Royalties
- Annuities

This surcharge is assessed on the smaller of the taxpayer's net investment income or the excess of their MAGI over the taxpayer's applicable threshold (i.e. $200,000 or $250,000).

For example, let's assume that a married couple has MAGI of $300,000. Their excess would be $50,000 ($300,000 minus their threshold of $250,000). Let's further assume that their net investment income is $25,000. The lesser of the two is $25,000, so they would pay an additional tax of $950.00 ($25,000 multiplied by 3.8%).

1031 Tax Deferred Exchanges

Fortunately, you can still defer depreciation recapture, capital gain and Medicare surcharge taxes by structuring a 1031 Tax Deferred Exchange. The Treasury Department ruled in the beginning of 2013 that you can defer the Medicare surcharge through a 1031 Exchange. This may present a tax planning opportunity even for those taxpayers that did not want to structure a 1031 Exchange. It could help them "manage" their income down by deferring some of the income through a 1031 Exchange in order to avoid the Medicare surcharge.