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A 92-year-old solution for real estate investors facing higher taxes in 2013: 1031 exchanges

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The familiar adage, "It's not how much you make, but how much you keep" rings truer than ever for real estate investors in 2013. 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.

Under the American Taxpayer Relief Act of 2012, the top capital gain tax rate has been permanently increased to 20% (up from 15%) for single filers with incomes above $400,000 and married couples filing jointly with incomes exceeding $450,000. In addition, the new IRC Section 1411 3.8% Medicare surtax on net investment income, which includes capital gains, results in an overall rate for higher-income taxpayers of 23.8%-a staggering 58% increase from 2012 tax rates! While these minimums refer to adjusted gross income, given the cost of living in the Northeast, most selling real estate investments in the Tri-State area will have income exceeding these amounts and thus be subject to the higher rates.

Four Steps Involved in

Determining Capital Gain Taxation

Absent the tax deferral benefits of a 1031 exchange, below is a summary of the five ways investors in the Northeast will be taxed on the sale of an investment property:

Depreciation Recapture: Taxpayers will be taxed at a rate of 25% on all depreciation recapture.

Federal Capital Gain Taxes: Investors owe Federal capital gain taxes on the remaining economic gain depending upon their taxable income. Since 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.

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").

State Taxes: Taxpayers must also take into account the applicable state tax, if any, to determine their total tax owed. Some states have no state taxes at all, while other states, like New York and New Jersey, have a rate ranging from 6-8% generally.

Local Taxes: In addition if the property is situated or the taxpayer resides in New York City or one of the boroughs, there is a local tax on capital gains of 3.8% which needs to be included in calculating the total tax due and which is also able to be deferred if a IRC Section 1031 is performed.

1031 Exchanges Help Investors

Defer the New 3.8% Medicare Surtax

Under recently proposed regulations, REG-130507-11, taxpayers have received proposed guidance from the IRS that notes: "to the extent gain from a like-kind exchange is not recognized for income tax purposes under Section 1031, it is not recognized for purposes of determining net investment income under Section 1411." [Â§1.1411-5(C)(i)(2)(ii)]. Although these regulations are not yet finalized, taxpayers may rely on the proposed regulations to be in compliance with Section 1411 until the effective date of the final regulations.

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 holding property for investment purposes to defer taxes that would otherwise be recognized upon the sale of investment property. Savvy investors use 1031 exchanges to redeploy their investment capital into better performing investment properties. An exchange provides a fantastic opportunity for investment property owners to defer all capital gain taxes that would otherwise be owed.

Scott Saunders is a senior vice president and Pamela Michaels, Esq., is an attorney and vice president of Asset Preservation, Inc., New York, N.Y.