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Tax, tax and more tax for real estate investors

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Preparing for Higher Taxes
on Investment Income

Many investors in the Northeast own real estate which is again appreciating. Section 1031 exchanges are likewise on the rise. But what many investors do not realize is that beginning as soon as 2013, gain and other income on the sale of real estate investments may be taxed at even higher rates at the Federal level due to the new Medicare tax and other taxes scheduled to go into effect in 2013. These taxes are in addition to the state and local taxes imposed in the Northeast on capital gains from the sale of real estate and other investments.

The new Medicare tax, which Congress passed as part of the Health Care and Education Affordability Reconciliation Act of 2010, was recently upheld by the Supreme Court. The Medicare tax will impose a 3.8% tax on the net investment income of joint filers with adjusted gross income over $250,000, and single filers with adjusted gross income over $200,000.

The new Medicare tax applies to adjusted gross income (the figure on the bottom of the front page of IRS Form 1040), which includes interest, dividends, capital gains, wages, retirement income and income from partnerships and small businesses. It appears the tax will also apply to dividends, rents, royalties, interest (except municipal bond interest), short and long-term capital gains, the taxable portion of annuity payments, income from the sale of a principal residence above the $250,000/$500,000 exclusion, gain from the sale of an investment property or a second home, and passive income from real estate and investments in which the taxpayer does not materially participate.

Other Potential Tax
Increases in 2013

In addition to the new Medicare tax discussed above, the "Bush-era Tax Cuts," which went into effect in 2001, are scheduled to expire at the end of this year. If the Bush-era Tax Cuts are allowed to expire due to inaction by Congress, the federal capital gain tax rate will increase to 20%, and the highest marginal tax rate for ordinary income will increase from 35% to 39.6%.

The Combined Effect of the Tax Increases on Real Estate Investors

Future tax rates remain uncertain. But taking into account the imposition of the new 3.8% Medicare tax, and the uncertainty regarding the Bush-era Tax Cuts, on January 1, 2013 taxpayers could face one of three scenarios:

1) If Congress extends the Bush-era Tax Cuts, the top federal tax rate on long-term capital gains will increase from 15% to 18.8%;

2) If Congress lets the Bush-era Tax Cuts expire, the top federal tax rate on long-term capital gains will increase from 15% to 23.8%, and the top tax rate on dividends will nearly triple to 43.4%; or

3) If Congress extends the Bush-era Tax Cuts, but not for all tax brackets, this will result in a

combination of the above two scenarios, and the top federal tax rate on long-term capital gains will likely rise for higher earners, but not for all tax brackets.

Using Section 1031 to Preserve Wealth

Given the likelihood of increasing taxes, investors seeking to preserve wealth would be well advised to consider the benefits of a Section 1031 exchange if considering a real estate sale. Despite the above described potential tax increases, Section 1031 continues to provide investors with the ability to defer all federal, local and state taxes on the sale of appreciated real estate. As a result of the new laws described above, Section 1031 is likely to become an increasingly powerful tool for real estate investors.

As a "Qualified Intermediary" as defined in the Section 1031 regulations, Asset Preservation, Inc. is not able to provide legal or tax advice. Accordingly, you should review the details of your specific transaction with your own legal or tax advisor.

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