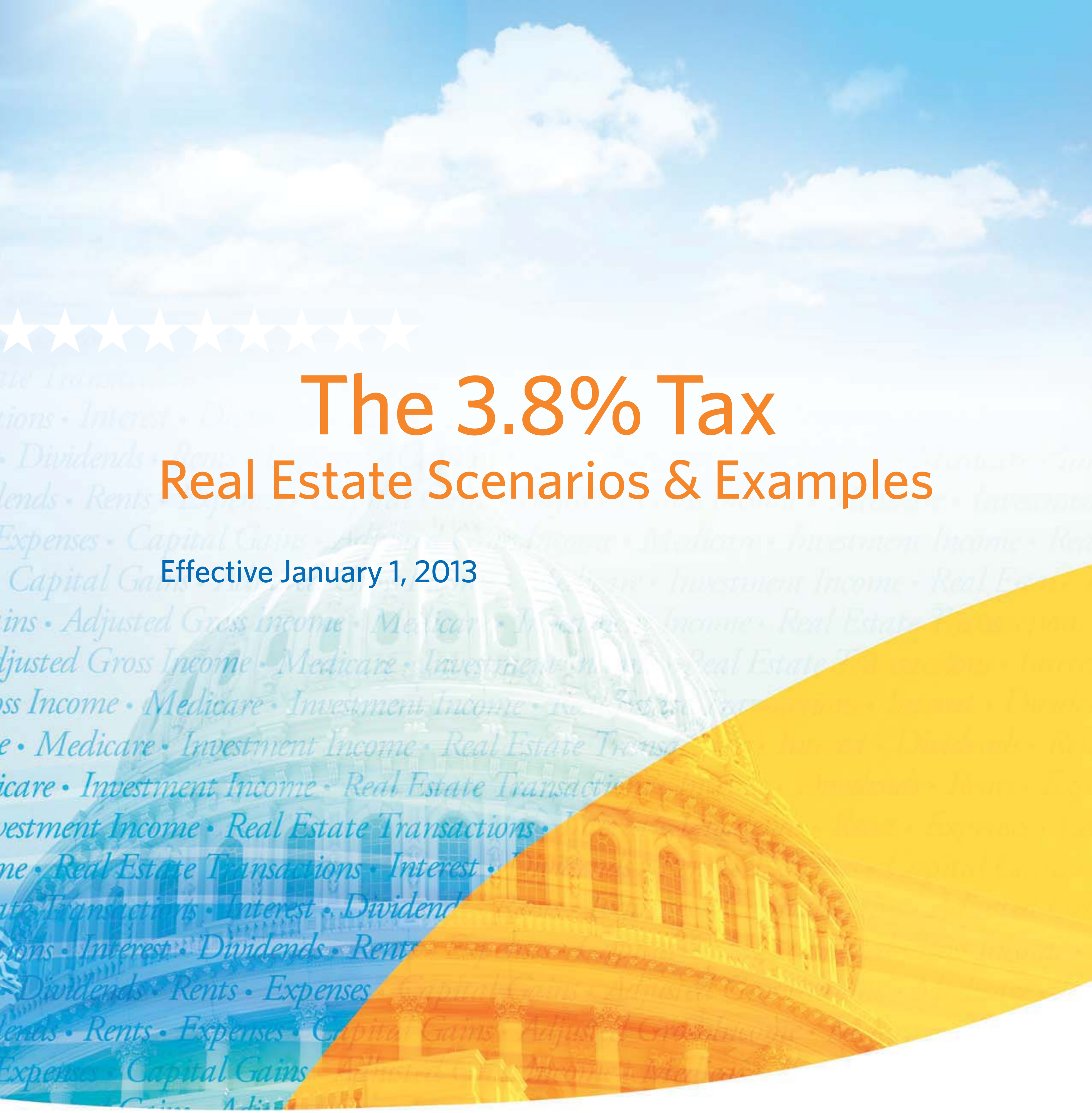

The 3.8% Tax

Real Estate Scenarios & Examples

Effective January 1, 2013

NATIONAL ASSOCIATION of REALTORS®

Intro

Beginning January 1, 2013, a new 3.8 percent tax on some investment income will take effect. Since this new tax will affect some real estate transactions, it is important for REALTORS® to clearly understand the tax and how it could impact your clients. It's a complicated tax, so you won't be able to predict how it will affect every buyer or seller.

To get you up to speed about this new tax legislation, the NATIONAL ASSOCIATION OF REALTORS® has developed this informational brochure. On the following pages, you'll read examples of different scenarios in which this new tax — passed by Congress in 2010 with the intent of generating an estimated $210 billion to help fund President Barack Obama's health care and Medicare overhaul plans — could be relevant to your clients.

Understand that this tax WILL NOT be imposed on all real estate transactions, a common misconception. Rather, when the legislation becomes effective in 2013, it may impose a 3.8% tax on some (but not all) income from interest, dividends, rents (less expenses) and capital gains (less capital losses). The tax will fall only on individuals with an adjusted gross income (AGI) above $200,000 and couples filing a joint return with more than $250,000 AGI.

New Tax Rate:

(0.038)

%

Applies to:

- Individuals with adjusted gross income (AGI) above $200,000
- Couples filing a joint return with more than $250,000 AGI

Types of Income: Interest, dividends, rents (less expenses), capital gains (less capital losses)

Formula: The new tax applies to the LESSER of

- Investment income amount
- Excess of AGI over the $200,000 or $250,000 amount

Example 1

Capital Gain: Sale of a Principal Residence

John and Mary sold their principal residence and realized a gain of $525,000. They have $325,000 Adjusted Gross Income (before adding taxable gain).

The tax applies as follows:

AGI Before Taxable Gain	$325,000	
Gain on Sale of Residence	$525,000	
Taxable Gain *(Added to AGI)*	$25,000	*($525,000 – $500,000)*
New AGI	$350,000	*($325,000 + $25,000 taxable gain)*
Excess of AGI over $250,000	$100,000	*($350,000 – $250,000)*
Lesser Amount *(Taxable)*	$25,000	*(Taxable gain)*
Tax Due	**$950**	*($25,000 x 0.038)*

NOTE: *If John and Mary had a gain of less than $500,000 on the sale of their residence, none of that gain would be subject to the 3.8% tax. Whether they paid the 3.8% tax would depend on the other components of their $325,000 AGI.*

Example 2

Capital Gain: Sale of a Non-Real Estate Asset

Barry and Michelle inherited stocks and bonds that they have decided to liquidate. The sale of these assets generates a capital gain of $120,000. Their AGI before the gain is $140,000.

The tax applies as follows:

AGI Before Capital Gain	$140,000	
Gain on Sale of Stocks and Bonds	$120,000	
New AGI	$260,000	
Excess of AGI over $250,000	$10,000	*($260,000 – $250,000)*
Lesser Amount *(Taxable)*	$10,000	*(AGI excess)*
Tax Due	**$380**	*($10,000 x 0.038)*

NOTE: *In this example, only $10,000 of their capital gain is subject to the 3.8% tax. If their gain had been smaller (less than $110,000), they would not pay the 3.8% tax because their AGI would be less than $250,000.*

Example 3

Capital Gains, Interest and Dividends: Securities

Harry and Sally have substantial income from their securities investments. Their AGI before including that income is $190,000. Their investment income is listed below.

The tax applies as follows:

Interest Income *(Bonds, CDs)*	$60,000	
Dividend Income	$75,000	
Capital Gains	$10,000	
Total Investment Income	$145,000	
New AGI	$335,000	*($190,000 + $145,000)*
Excess of AGI over $250,000	$85,000	*($335,000 – $250,000)*
Lesser Amount *(Taxable)*	$85,000	*(AGI excess)*
Tax Due	**$3,230**	*($85,000 x 0.038)*

Example 4

Rental Income: Income Sources Including Real Estate Investment Income

Hank has a "day job" from which he earns $85,000 a year. He owns several small apartment units and receives gross rents of $130,000. He also has expenses related to that income.

The tax applies as follows:

AGI Before Rents	$85,000	
Gross Rents	$130,000	
Expenses *(Including depreciation and debt service)*	$110,000	
Net Rents	$20,000	
New AGI	$105,000	*($85,000 + net rents)*
Excess of AGI over $200,000	$0	
Lesser Amount *(Taxable)*	$0	
Tax Due	**$0**	

NOTE: *Even though Hank's combined gross rents and day job earnings exceed $200,000, he will not be subject to the 3.8% tax because investment income includes NET, not gross, rents.*

Rental Income: Rental Income as Sole Source of Earnings – Real Estate Trade or Business

Henrietta's sole livelihood is derived from owning and operating commercial buildings. Thus, these assets are treated as business property and not as investment property. Her income stream is outlined below.

The tax applies as follows:

Gross Rents	$750,000	
Expenses *(Including depreciation and debt service)*	$520,000	
Net Rents	$230,000	
New AGI *(Net rental income)*	$230,000	
Excess of AGI over $200,000	$30,000	
Lesser Amount *(Taxable)*	$0	*(No investment income)*
Tax Due	**$0**	

Henrietta's rental income is from a trade or business so it is NOT treated as investment income. Thus, she is NOT subject to the 3.8% investment income tax.

NOTE: *The health care bill created a separate tax for high wage and self-employment business income. Thus, Henrietta IS subject to the new 0.9% (0.009) tax on earned income, because some portion of the net rents represents her compensation for operating the commercial buildings. See additional background below.*

For this example, assume that the total net rents are her sole compensation. The tax on this earned income would be as follows:

AGI	*$230,000*	
Excess of AGI over $200,000	*$30,000*	
Tax Due	*$270*	*($30,000 x .009)*

NOTE: *Depending on how Henrietta has organized her business (S Corp, LLC or sole proprietor), she might be able, for example, to pay herself $175,000, leaving the remaining $55,000 in the business in anticipation of making improvements the following year. In that case, because her AGI of $175,000 is less than $200,000, she will owe neither the unearned income tax (3.8%) nor the earned income tax (0.9%).*

Example 6

Sale of a Second Home with No Rental Use (or no more than 14 days rental)

The Bridgers own a vacation home that they purchased for $275,000. They have never rented it to others. They sell it for $335,000. In the year of sale they also have earned income from other sources of $225,000.

The tax applies as follows:

Gain on Sale of Vacation Home	$60,000	*($335,000 – $275,000)*
Income from Other Sources	$225,000	
New AGI	$285,000	*($60,000 + $225,000)*
Excess of AGI over $250,000	$35,000	*($285,000 – $250,000)*
Capital Gain	$60,000	
Lesser Amount *(Taxable)*	$35,000	*(AGI excess)*
Tax Due	**$1,330**	*($35,000 x 0.038)*

NOTE: *If the Bridgers rent the home for 14 or fewer days in the course of a year, the rental income is non-taxable and the results in the year of sale will be the same as shown above. If the rental period exceeds 14 days in any year, then the rental income (less expenses) will be taxable and AGI would include not only the capital gain, but also some amount that is depreciation recapture. (See next example.)*

NOTE: *If the second residence is SOLELY a rental property, it is treated as an investment property. See examples 7 and 8.*

Sale of an Inherited Investment Property (Residential or Commercial)

In 2010, Ethan inherited a four-plex investment property from his great aunt. She had used it for many years as an investment rental property in San Francisco. At the time of her death, the adjusted basis of the property was $10,000. During her period of ownership, she had taken $240,000 of depreciation deductions on it. Its fair market value was $900,000 when she died. Because there was no estate tax for 2010 and because carryover basis was in effect, Ethan's basis in the inherited property is also $10,000. The prior depreciation allowances carry over to him, as well. He continues to use the property as an investment rental property.

Ethan later sells the property for $1.2 million. He is single and reports Schedule C self-employment income of $180,000.

The tax applies as follows:

Gain on Sale	$1,190,000	*($1.2 million – $10,000)*
Depreciation Recapture	$240,000	*(From great aunt)*
Depreciation Recapture	$2,200	*(Ethan — approximate)*
Total Gain	$1,432,200	*($1.19 million + total depreciation recapture)*
Schedule C Income	$180,000	
New AGI	$1,612,200	*(Gain + Schedule C)*
Excess over $200,000	$1,412,200	
Lesser Amount *(Taxable)*	$1,412,200	*(AGI excess)*
Tax Due	**$53,664**	*($1,412,200 x 0.038)*

NOTE: *If Ethan had inherited the property in a year when stepped-up basis was in effect, his basis would have been $900,000. The capital gain in this example would have been only $300,000. Ethan would not have been responsible for his great aunt's depreciation recapture amount. His own depreciation recapture amount would have been based on depreciation allowances claimed on a basis of $900,000 rather than $10,000. Thus, while he would still have been liable for the 3.8% tax, the amount of tax would be substantially smaller.*

Example 8

Purchase and Sale of Investment Property (Residential or Commercial)

Ethan has purchased an investment property for $900,000. During his period of ownership, he takes $230,000 in depreciation deductions. He has also made some improvements to the property. At the time of sale, his adjusted basis in the property is $760,000. He subsequently sells the property for $1.2 million. In the year of sale, he is single and reports self-employment income of $315,000.

The tax applies as follows:

Gain on Sale	$440,000	*($1.2 million less adjusted basis of $760,000)*
Depreciation Recapture	$230,000	
Total Gain	$670,000	*(Gain on sale plus depreciation recapture)*
Schedule C Income	$315,000	
New AGI	$985,000	*($315,000 + $670,000)*
Excess AGI over $200,000	$785,000	*($985,000 – $200,000)*
Lesser Amount *(Taxable)*	$670,000	*(Capital gain)*
Tax Due	**$25,460**	*($670,000 x 0.038)*

NOTE: *The statute provides no guidance as to whether Ethan can defer the 3.8% tax by entering into a like-kind exchange when he sells the property. This question may be addressed in regulations at a later time, but for the present is not resolved.*

This new tax was never introduced, discussed or reviewed until just hours before the final debate on the massive health care legislation began. That legislation was enacted on March 23, 2010, more than a year after the health care debate began. This new tax was put forward after Congress was unable to agree on changes to current law that were sufficient to pay for the proposed changes to the Medicare program and increased subsidies to individuals and businesses.

The new tax raises more than $210 billion (over 10 years), representing more than half of the total new expenditures in the health care reform package. NAR expressed its strongest possible objections, but the legislation passed on a largely party line vote.

The new tax is sometimes called a "Medicare tax" because the proceeds from it are to be dedicated to the Medicare Trust Fund. That Fund will run dry in only a few more years, so this tax is a means of extending its life.

A second new tax, also dedicated to Medicare funding, is imposed on the so-called "earned" income of higher income individuals. This earned income tax has a much lower rate of 0.9% (0.009). Like the tax described in this brochure, this additional or alternative tax is based on adjusted gross income thresholds of $200,000 for an individual and $250,000 on a joint return. Like the 3.8% tax, this 0.9% tax is imposed only on the excess of earned income above the threshold amounts. An example and some analysis of this tax is presented in Example 5 of this brochure.

Another way of thinking about these new taxes is to think of the 3.8% tax as being imposed on a portion of the money that you make on your money — your capital (sometimes referred to as "unearned income"). The 0.9% tax is imposed on a portion of the money you make on your labor — your salary, wages, commission and similar income related to earning a livelihood.

Online FAQs

www.REALTOR.org/healthreform

These FAQs can answer most of the questions not covered in these examples. No separate brochure has been prepared on the 0.9% tax, as it has none of the complexity associated with the 3.8% tax.

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500 New Jersey Avenue, NW • Washington, DC 20001-2020 • 800.874.6500 • www.REALTOR.org