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**Will the Recent Tax Changes Have a Major Impact
on Your Real Estate Investments?**

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Will the Recent Tax Changes Have a Major Impact on Your Real Estate Investments?

- **Increase in Individual Income Tax Rates**

- The 2012 Act increases the maximum marginal individual tax rate of 35% to 39.6% for individuals having taxable income over \$400,000 and for married couples filing joint returns having taxable income of over \$450,000.

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- **Increase in Individual Income Tax Rates**

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Tax Rate	Single	Married Filing Joint
10%	Up to \$8,925	Up to \$17,850
15%	\$8,926 – \$36,250	\$17,851 – \$72,500
25%	\$36,251 – \$87,850	\$72,501 – \$146,400
28%	\$87,851 – \$183,250	\$146,401 – \$223,050
33%	\$183,251 – \$398,350	\$223,051 – \$398,350
35%	\$398,351 – \$400,000	\$398,351 – \$450,000
39.6%	Over \$400,000	Over \$450,000

Will the Recent Tax Changes Have a Major Impact on Your Real Estate Investments?

- Capital Gains Tax and Tax on Dividends

- If Congress had taken no action, the maximum marginal tax rate on capital gains would have increased from 15% to 20% and the maximum marginal income tax rate on dividends would have dramatically increased from 15% to 39.6%.

Will the Recent Tax Changes Have a Major Impact on Your Real Estate Investments?

- Capital Gains Tax and Tax on Dividends

- The 2012 Act establishes a maximum marginal income tax rate on capital gains and on dividends of 20% for high income taxpayers (individuals having taxable income over \$400,000 and for married couples filing joint returns having taxable income over \$450,000).

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- **Phase Out of Itemized Deduction and Personal Exemptions**

- The limitation on itemized deductions has been reinstated, so that higher income taxpayers (with adjusted gross income, or “AGI,” of \$250,000 for individuals or \$300,000 for joint returns) must reduce the amount of their itemized deductions by 3% of the amount by which the taxpayer’s AGI exceeds the applicable threshold (i.e., \$250,000 or \$300,000, as the case may be).

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- **Phase-Out of Itemized Deduction and Personal Exemptions**

- ❖ Based on the income level, itemized deductions can be reduced by up to 80%.
- ❖ Itemized deductions related to real estate might include principal residence and second home mortgage interest and real estate taxes.

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- **Phase Out of Itemized Deduction and Personal Exemptions**
 - The “phase-out” of personal exemptions has been revived, so that the total amount of exemptions of a taxpayer are reduced by 2% for each \$2,500 by which such taxpayer’s adjusted gross income exceeds the applicable threshold (i.e., \$250,000 or \$300,000, as the case may be).

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- **End of Payroll Tax Holiday and Increase in Wage Base for FICA and Self-Employment**
 - Another change made by the 2012 Act is the end of the so-called payroll tax holiday that was in effect for 2011 and 2012.

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- **End of Payroll Tax Holiday and Increase in Wage Base for FICA and Self-Employment**
 - The Social Security wage base will rise from \$110,100 in 2012 to \$113,700 in 2013.

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- **Additional Medicare Tax on Employee Wages and Self-Employment Income**
 - The ACA raises the hospital insurance (Medicare) portion of the FICA tax and the self-employment tax from 2.9% to 3.8% beginning January 1, 2013.
 - Applies to employee wages and net earnings from self-employment in excess of \$200,000 for individual filers (\$250,000 for joint filers).

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- **Additional Medicare Tax on Employee Wages and Self-Employment Income**
 - Once these thresholds are exceeded, there is no cap on the amount of wages or self-employment income to which the Medicare portion of the FICA tax and the self-employment tax are subject.

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- **New 3.8% Tax on Net Investment Income**
 - The ACA imposes a new 3.8% tax on the “net investment income” of individuals having modified adjusted gross income of over a threshold amount (\$250,000 in the case of taxpayers filing a joint return and over \$200,000 for other individual taxpayers) (the “**NII Tax**”).

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- **New 3.8% Tax on Net Investment Income**
 - ❖ The NII Tax, if it applies, is in addition to the regular income tax.
 - ❖ NII Tax also applies to estates and trusts.

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- **New 3.8% Tax on Net Investment Income**
 - ❖ NII Tax does not apply to S corporations, partnerships or LLCs, but such entities must report each owner's share of applicable net investment income on the owner's Form K-1.
 - ❖ NII Tax applies to the lesser of "net investment income" or the taxpayer's modified gross income above the threshold.

Will the Recent Tax Changes Have a Major Impact on Your Real Estate Investments?

- **New 3.8% Tax on Net Investment Income**
 - Net Investment Income includes Portfolio Income, Other Business Income and Net Gains; but does ***not*** include such income items if the income item derived in the ordinary course of a business that is active (not passive) as to the taxpayer for such tax year (“**Active Business Exception**”).

Will the Recent Tax Changes Have a Major Impact on Your Real Estate Investments?

- **New 3.8% Tax on Net Investment Income**
 - ❖ Portfolio Income is gross income from interest, dividends, annuities, royalties and rents (unless such items fall within the Active Business Exception).
 - ❖ Other Business Income is income from a trade or business in which the taxpayer is passive.

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- **New 3.8% Tax on Net Investment Income**
 - ❖ Net Gains means the net gain from the sale or disposition of property that does not meet the Active Business Exception.

Will the Recent Tax Changes Have a Major Impact on Your Real Estate Investments?

- Rental Activities of Real Estate Professionals
 - Even if a real estate professional actively participates in the rental activity, the rental income and gain on sale is subject to the NII Tax ***unless the rental activity rises to the level of a trade or business.***

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- Examples:

- Rentals. To avoid NII Tax, the rental activity must be a trade or business **and** the taxpayer must actively participate.

- ❖ Trade or business of renting.

Taxpayer is a member (treated as a “partner” for tax purposes) in a limited liability company (“**LLC**”); the LLC owns several commercial buildings and provides various services (security, repairs, etc.) for tenants in the building. The taxpayer is the manager of the LLC and actively participates. Likely, not subject to NII Tax.

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- **Rentals.** To avoid NII Tax, the rental activity must be a trade or business *and* the taxpayer must actively participate.

- ❖ **Investment Real Estate.** Doctor is the sole member of an LLC, which owns one commercial rental property rented to one tenant on a triple net basis with no services provided. Subject to NII Tax.

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- **Operating income of Passthrough Entity.**
 - ❖ Taxpayer is a shareholder of an S corporation, which operates a hardware store; taxpayer works full-time in running the hardware store. The store generates an operating profit. Because the S corporation owner actively participates, his share of S corporation income is not subject to NII Tax.

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- **Net Gains from sale of property.**
 - ❖ Doctor (from prior example) who owns one commercial real property (which did not constitute a trade or business property in which the doctor actively participated) decides to sell the real property. Sale of investment real estate - subject to NII Tax.

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- **Net Gains from sale of property.**
 - ❖ LLC (from prior example) owning several commercial properties decides to sell them all. Sale of real property used in a trade or business is subject to NII Tax for the LLC's passive owners, but is not subject to NII Tax for the LLC's active owners.

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- **NII Tax only applies to income/ gains otherwise subject to tax.**
 - ❖ Gain not recognized in a like-kind exchange is not subject to NII Tax.
 - ❖ Any ***excluded*** gain on sale of residence is not subject to NII Tax.

Will the Recent Tax Changes Have a Major Impact on Your Real Estate Investments?

- **NII Tax only applies to income/ gains otherwise subject to tax.**
 - ❖ For sales on the installment method, NII Tax for the tax year applies to that portion of the gain recognized in the tax year.

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- Use of related landlord/tenants for holding real estate.
 - ❖ Example: Doctor operates medical practice through a professional association (“PA”). Dr. (and/or family) forms an LLC, partnership or S corporation (“Passthrough Entity”) to buy real estate needed for the medical practice. PA leases the real estate from the Passthrough Entity.

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- **Use of related landlord/tenants for holding real estate.**
 - ❖ If the rental income of the Passthrough Entity exceeds its expenses, rental income is the result. Does this cause the 3.8% Net Investment Income Tax to be due even with respect to a lease in which the taxpayer/the Doctor is both lessor and lessee?

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- **S Corporation Built in Gain Tax**
 - For regular corporations that convert to S corporation status, there is normally a 10-year period (“**Built-In Gain Period**”) during which, if the property is sold, the built-in gain as of the date of the S election is subject to corporate level tax.

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- **S Corporation Built in Gain Tax**

- Prior law reduced this period to five years for sales occurring in 2011. The 2012 Act extended the benefits of this 5-year Built-In Gain Period for sales occurring in 2012 or 2013.

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- **S Corporation Built in Gain Tax**

- ❖ If the five-year period has been met, consider the sale of S corporation real estate or other assets in 2013 to avoid corporate level tax.
- ❖ Use of installment sale to create 2013 sale.

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- Like-Kind Exchanges
- Discharge of Debt on Personal Residence

Will the Recent Tax Changes Have a Major Impact on Your Real Estate Investments?

- **Favorable Rates for Long Term Capital Gains.**
 - The status of an asset, such as real estate, as a capital asset or not a capital asset remains significant for individuals at most income levels.

Will the Recent Tax Changes Have a Major Impact on Your Real Estate Investments?

- **Favorable Rates for Long Term Capital Gains.**

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<u>Individual Income Level</u>	<u>Ordinary Tax Rate</u>	<u>Long Term Capital Gain Rate</u>	<u>Spread</u>
\$183,251 - \$398,350	33%	15%	18%
\$398,351 - \$400,000	35%	15%	20%
Over \$400,000	39.6%	20%	19.6%

Will the Recent Tax Changes Have a Major Impact on Your Real Estate Investments?

- Capital Asset

- To receive favorable long-term capital gain treatment, the real estate must be a capital asset held for more than one year.

- ❖ Capital Asset. IRC Section 1221 provides that a “capital asset” is “property held by the taxpayer,” but does ***not*** include “property held by the taxpayer ***primarily for sale to customers in the ordinary course of his trade or business.***”

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- **Dealer Property.**

- As noted above, “property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business” is specifically excluded from the definition of a “capital asset.” Such property is commonly referred to as “dealer property.”

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- **Dealer Property.**
 - The characterization of real property as either a capital asset or dealer property is one of the most frequently litigated issues in the tax law

Will the Recent Tax Changes Have a Major Impact on Your Real Estate Investments?

- **Dealer Property.**
 - ❖ Established Factors involved in the determination of whether real property is dealer property.

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- **Dealer Property v. Non-Dealer Property.**
 - Installment Reporting
 - Like-Kind Exchanges
 - Losses

Will the Recent Tax Changes Have a Major Impact on Your Real Estate Investments?

- **Take Away Points.**
 - Tax rate spread between ordinary income and capital gain remains high. Characterizations of real property as dealer or non-dealer still a key tax issue.
 - ❖ If a gain, characterization as non-dealer property is most favorable.
 - ❖ If a loss, characterization as dealer property yields the most desired result.

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- **Take Away Points.**
 - In addition, NII Tax is effectively a tax increase on rental income and on gains from the sale of real property with respect to a taxpayer who does not materially participate.
 - Regarding the NII Tax, a key issue with rental real estate - does it rise to the level of a trade or business?

Will the Recent Tax Changes Have a Major Impact on Your Real Estate Investments?

- **Take Away Points.**
 - If you have an S corporation with real property which in 2013 has satisfied the 5-year Built-In Gain Period, consider a sale of the real property in 2013.
 - Like-kind exchanges and installment sales remain viable planning tools for real estate disposition.

Will the Recent Tax Changes Have a Major Impact on Your Real Estate Investments?

- **Take Away Points.**
 - For holding real property, passthrough entities, and in particular, LLCs, remain preferred over “C” corporations.
 - For operating businesses, passthrough entities, and in particular, “S” corporations, remain preferred over “C” corporations.

Will the Recent Tax Changes Have a Major Impact on Your Real Estate Investments?

- **Prospects for Reform.**

- The Camp Proposal.

- ❖ Changes to S Corporation Rules.

- ❖ Changes to Partnership Rules.

- ❖ New Unified Passthrough Entity Rules.