

NEW TAX ON INVESTMENT INCOME
Effective January 1, 2013

Source: National Association of Realtors®
The 3.8% Tax: Real Estate Scenarios and Examples

Basics:

Tax Rate: 3.8% (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

Examples:

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)

Comment: 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 AGI.

Capital Gain: Sale of a Non-real Estate Asset

Barry and Michelle inherited capital assets that they have decided to liquidate. The sale of the assets generates a capital gain of \$120,000. Their AGI before the gain is \$140,000. They will pay the tax as follows:

AGI before capital gain	\$140,000
Gain on sale of assets	<u>\$120,000</u>
New AGI	\$260,000

Excess of AGI over \$250,000	\$10,000	(\$260,000 - \$250,000)
<i>Lesser</i> amount (Taxable)	\$10,000	(AGI Excess)
Tax due	\$380	

Comment: 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.

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 as follows:

Interest Income (Bonds, CDs)	\$60,000	
Dividend Income	\$75,000	
Capital Gains	<u>\$10,000</u>	
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)
<i>Lesser</i> amount (Taxable)	\$ 85,000	(AGI excess)
Tax Due	\$ 3,230	(\$85,000 x .038)

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.

AGI before rents	\$85,000	
Gross Rents	\$130,000	
Expenses (including depreciation)	<u>\$110,000</u>	
Net Rents	\$20,000	
New AGI	\$105,000	(\$85,000 + <i>net</i> rents)
Excess of AGI over \$200,000	\$0	
Taxable amount	\$0	
Tax due	\$0	

Comment: Even though Hank’s combined gross rents and day job earnings exceed \$200,000, he will not be subject to the 3.8% tax.

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. Her income stream is as follows:

Gross rents	\$750,000
Expenses (including depreciation)	<u>\$520,000</u>
Net rents	\$230,000
AGI (net rental income)	\$230,000
Excess of AGI over \$200,000	\$ 30,000
Taxable amount	\$0

Because Henrietta’s rental income is from a trade or business and therefore not treated as investment income, she is NOT subject to the 3.8% investment income tax.

Comment: Henrietta IS subject to the new 0.9 tax on *earned* income, however, because some portion of the net rents represents her compensation for operating the commercial buildings.

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)

Comment: Depending on how Henrietta has organized her business (S Corp, LLC or sole proprietor), she might be able 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%).

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 3.8% tax applies as follows:

Gain on sale of vacation home	\$60,000 (\$335,000 - \$275,000)
Income from other sources	\$225,000
AGI	\$285,000 (\$60,000 + \$225,000)
Excess of AGI over \$250,000	\$35,000 (\$285,000 – \$250,000)
Capital Gain	\$60,000
Taxable (Lesser) Amount	\$35,000
Tax Due	\$1330

Comment: 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 example below.)

Sale of an 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.

In 2015, Ethan sells the property for \$1.2 million. He is single and reports Schedule C income of \$180,000. The 3.8% tax will affect Ethan 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	
Schedule C Income	\$ 180,000	
Adjusted Gross Income	\$1,612,200	(Gain + Schedule C)
Excess over \$200,000	\$1,412,200	
Taxable Amount	\$1,412,200	
Tax Due	\$54,664	

Comment: 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 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. (Exclusive of any depreciation recapture amount, the tax due would be \$10,640. His capital gain would have been \$300,000.) *The results would be the same if Ethan had purchased the property for \$900,000.*