THE 3.8% TAX ON HOME SALES TO FUND NATIONAL HEALTHCARE: REAL ESTATE SCENARIOS & EXAMPLES

BEGINNING JANUARY 1, 2013, a new 3.8 percent tax on some home sales and 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 San Mateo County Association of REALTORS® has developed this informational handout. Included are examples of different scenarios in which this new tax - passed by Congress in 2010 with the intent of generating an estimated $210 billion over 10 years to help fund President Barack Obama's health care plan and Medicare overhaul - could be relevant to your clients. The revenue represents more than half of the total new expenditures in the health care reform package.

This health care bill ALSO created a separate tax for high wage and self-employment business income. This new, separate tax is 0.9% (0.009) tax on earned income.

Understand that this tax WILL NOT be imposed on all real estate transactions… a very common misconception within the industry. 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.

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 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 was presented as a means of extending the life of the Medicare Trust Fund.

Another new tax, also dedicated to Medicare funding, is imposed on the so-called "earned" proceeds on higher income individuals. This earned income tax has a much lower rate of 0.9% (0.009). Like the 3.8% tax described herein, this additional or alternative tax is based on AGI thresholds of $200,000 for an individual and $250,000 on a joint return.

And 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 the 0.9% tax is presented in Example 5.

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"), while 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.

THE BASICS

The new law applies to individuals with adjusted gross income (AGI) above $200,000 or couples filing a joint return with more than $250,000 AGI. The types of income affected include interest, dividends, rents (less expenses), and capital gains (less capital losses). The basic formula for the tax is that is applies to the LESSER of the investment income amount that is in excess of AGI over the $200,000 or $250,000 threshold.

EXAMPLE 1

CAPITAL GAIN: SALE OF A PRINCIPAL RESIDENCE

Brad and Angelina sold their principal residence and realized a gain of $525,000. They have $325,000 in AGI 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 Brad and Angelina 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.

EXAMPLE 5

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 as follows.

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**

NOTE: 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.

However, 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.

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
Earned Income Tax Due	**$270** ($30,000 x .009)

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 Griffiths 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 Griffiths 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. If, however, the second residence is solely a rental property, it is treated as an investment property.

EXAMPLE 7

SALE OF AN INHERITED INVESTMENT PROPERTY (RESIDENTIAL OR COMMERCIAL)

In 2010, Ethan inherited a four-plex investment property from his great aunt. He had used it for many years as an investment rental property in Atherton. 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. 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 ($1.19M + 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)

Anne has purchased an investment property for $900,000. During her period of ownership, she takes $230,000 in depreciation deductions. She has also made some improvements to the property. At the time of sale, her adjusted basis in the property is $760,000. She subsequently sells the property for $1.2 million. In the year of sale, she 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: Unfortunately, the law provides no guidance as to whether Anne can defer the 3.8% tax by entering into a like-kind exchange when she sells the property. This question may be addressed in regulations at a later time, but for the present is not resolved.