

A 92 YEAR-OLD SOLUTION FOR REAL ESTATE INVESTORS FACING HIGHER TAXES IN 2013

"1031 EXCHANGES OFFER FULL DEFERRAL OF THE NEW 3.8% MEDICARE SURTAX AND 20% CAPITAL GAIN TAX"



Compliments of

The familiar adage, "It's not how much you make, but how much you keep" rings truer than ever for real estate investors in 2013. Not only have capital gain taxes increased significantly for high earners, but many investors below the top tax bracket face an additional 3.8% surtax on passive investment income like capital gains. Fortunately, IRC Section 1031, a provision which has been in the tax code since 1921, provides critically needed tax relief.

Under the American Taxpayer Relief Act of 2012, the top capital gain tax rate has been permanently increased to 20% (up from 15%) for single filers with incomes above \$400,000 and married couples filing jointly with incomes exceeding \$450,000. In addition, the new IRC Section 1411 3.8% Medicare surtax on net investment income, which includes capital gains, results in an overall rate for higher-income taxpayers of 23.8% -- a staggering 58% increase from 2012 tax rates!

Four Steps Involved in Determining Capital Gain Taxation

Absent the tax deferral benefits of a 1031 exchange, below is a summary of the four ways investors will be taxed on the sale of an investment property:

1. **Depreciation Recapture:** Taxpayers will be taxed at a rate of 25% on all depreciation recapture.
2. **Federal Capital Gain Taxes:** Investors owe Federal capital gain taxes on the remaining economic gain depending upon their taxable income. Since a new higher capital gain tax rate of 20% has been added to the tax code, investors exceeding the \$400,000 taxable income threshold for single filers and married couples filing jointly with over \$450,000 in taxable income will be subject to the new higher tax rate. The previous Federal capital gain tax rate of 15% remains for investors below these threshold income amounts.
3. **New Medicare Surtax Pursuant to IRC Section 1411:** The Health Care and Education Reconciliation Act of 2010 added a new 3.8% Medicare Surtax on "net investment income." This 3.8% Medicare surtax applies to taxpayers with "net investment income" who exceed threshold income amounts of \$200,000 for single filers and \$250,000 for married couples filing jointly. Pursuant to IRC Section 1411, "net investment income" includes interest, dividends, capital gains, retirement income and income from partnerships (as well as other forms of "unearned income").
4. **State Taxes:** Taxpayers must also take into account the applicable state tax, if any, to determine their total tax owed. Some states have no state taxes at all, while other states, like California, have a 13.3% top tax rate.



**ASSET PRESERVATION
INCORPORATED**

A National IRC §1031 "Qualified Intermediary"

National Headquarters

800-282-1031

Eastern Region Office

866-394-1031

apixchange.com

info@apixchange.com

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Snapshot of 2013 Federal Capital Gain Tax Rates

Single Taxpayer	Married Filing Jointly	Capital Gain Tax Rate	Section 1411 Medicare Surtax*	Combined Tax Rate
\$0 - \$36,250	\$0 - \$72,500	0%	0%	0%
\$36,250 - \$200,000	\$72,500 - \$250,000	15%	0%	15%
\$200,000 - \$400,000	\$250,000 - \$450,000	15%	3.8%	18.8%
\$400,001+	\$450,001+	20%	3.8%	23.8%

* The 3.8% Medicare surtax only applies to "net investment income" as defined in [IRC Section 1411](#).



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1031 Exchanges Help Investors Defer the New 3.8% Medicare Surtax

Under recently proposed regulations, [REG-130507-11](#), taxpayers have received proposed guidance from the IRS that notes: "to the extent gain from a like-kind exchange is not recognized for income tax purposes under Section 1031, it is not recognized for purposes of determining net investment income under Section 1411." [§1.1411-5(C)(i)(2)(ii)]. Although these regulations are not yet finalized, taxpayers may rely on the proposed regulations to be in compliance with Section 1411 until the effective date of the final regulations.

1031 Tax Deferred Exchanges

Despite these new tax increases, one aspect of the tax code provides real estate investors with a huge tax advantage. Section 1031 allows property owners holding property for investment purposes to defer taxes that would otherwise be recognized upon the sale of investment property. Savvy investors use 1031 exchanges to redeploy their investment capital into better performing investment properties. An exchange provides a fantastic opportunity for investment property owners to defer all capital gain taxes that would otherwise be owed.