COMMERCIAL PROPERTY OWNERS: HOW TO LIVE WITH THE NEW HIGHER TAX RATES

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This article summarizes the new tax rates that apply to high-income individuals and points out some tax planning techniques that are particularly important for commercial property owners.

Ordinary Income Rates

The recent tax code change that has received the most attention is the new maximum individual income tax rate of 39.6%. This rate applies only to ordinary income that exceeds a threshold amount. For married people filing jointly and for qualified surviving spouses, the threshold amount is $450,000. For heads of households, the threshold amount is $425,000. For single taxpayers it is $400,000. For married taxpayers filing separately, it is $225,000. These thresholds will be adjusted for inflation. In 2012, for joint filers, the maximum marginal rate was 35% on amounts over $250,000. A married couple with $460,000 of taxable income in 2013 would pay taxes at the same rates as in 2012 on the first $450,000 of taxable income (i.e., $102,574), but they would pay the new 39.6% rate on the last $10,000 of their income instead of 35%. That is, they would pay a tax of $3,960 on the last $10,000 under the new rates instead of $3,500 under the old rates, for an additional $460 tax burden. For taxpayers whose incomes only slightly exceed the threshold amount, the change will not be substantial. However, the new maximum marginal rate is 13.14%, higher than the old rate, and for taxpayers with incomes that are well in excess of the threshold amount, the change will be very significant.

Taxpayers pay ordinary income tax rates on investments held for less than one year (either as ordinary income tax or as short term capital gains). Many taxpayers who normally would have incomes below the new threshold levels could find themselves far into the 39.6% tax bracket if they were to recognize a substantial short term gain. A few strategies to consider in order to reduce this tax effect are:

(a) Use an IRC § 1031 like kind exchange or § 1033 exchange (if applicable) to acquire replacement property. Tax deferred exchanges allow the taxpayer to tack the holding period of the relinquished property onto the holding period for the replacement property, avoiding short term capital gain problems. Also, at the taxpayer's option, recognizing gain can be deferred indefinitely or even permanently if the taxpayer leaves appreciated real property in his or her estate.

(b) Sell the property in an installment sale so that as much income as possible is recognized at lower marginal rates.

(c) Strategically use well timed offsetting losses to reduce the amount of the taxable gain.

(d) Simply delay selling the asset until one year has passed since the date that the asset was acquired.

Another situation in which a real estate investor may pay ordinary income tax rates occurs when real property is sold along with *IRC § 1245* personal property (for example, after property has been the subject of a cost segregation study for the purpose of accelerating depreciation). When *IRC § 1245* personal property is depreciated and then sold, recapture of that depreciation is taxed at ordinary income tax rates. In this case, strategies (b) and (d), above, would not be helpful. However, (a) and (c) may be.

Ordinary Capital Gains

For individual taxpayers, capital gains are commonly taxed at 15% of the profits realized (except for collectibles, which are taxed at 28%). The recent changes to the tax code have created a new 20% marginal capital gains tax rate for taxpayers who have income in excess of the same threshold levels that apply to ordinary income tax (i.e., $450,000 for married taxpayers filing jointly and qualified surviving spouses, $425,000 for heads of households, $400,000 for single taxpayers and $225,000 for married taxpayers filing separately). This is a 33% increase in the top capital gains marginal tax rate. It is also particularly significant to a broad range of real estate investors because the sale of a single investment property can easily overshadow all other sources of income in a given tax year.

Consider the case of a married couple filing jointly who have ordinary income of $400,000. They sell vacant land that they have owned for many years for a gross sales price of $2,000,000. It has a basis of $500,000. They would realize a gain of $1,500,000 on the transaction. Of that amount, $50,000 would be taxed at the 15% rate and $1,450,000 would be taxed at the 20% high income capital gains rate. Therefore, the tax on this sale would be $290,000 under the new tax rates. It would have been $225,000 under the old rates. That is a 32% net tax increase.

Similar to the cases above, the taxpayers here should consider (a) a like kind exchange; (b) an installment sale; or (c) the strategic use of offsetting losses in order to reduce net tax burdens.

Other Taxes

IRC § 1411 imposes a 3.8% Medicare tax on net investment income for taxpayers whose adjusted income exceeds a threshold amount. That threshold is $250,000 for married taxpayers filing jointly and for qualified surviving spouses, $125,000 for married taxpayers filing separately and $200,000 for all other taxpayers. The tax is in addition to all other taxes, and it applies either to the taxpayer's passive income or to the taxpayer's income in excess of the threshold amount, whichever is less. It appears that this tax can be applied to investment income, even if that income is taxed at ordinary tax rates (*e.g.*, short term capital gains). Real estate income appears to be subject to this tax unless more than half of the taxpayer's work-time was devoted to real estate trades or business *and* the taxpayer spent than 750 hours during the year working in real estate trades or business. (*IRC § 469(c)(7)*.) This tax is owed only on taxable transactions. It is not owed when properties are traded in a tax deferred like kind exchange.

State and local taxes apply as well. Pennsylvania does not recognize like kind exchanges. However, state taxes can be deferred in a like kind exchange in New York, New Jersey, Connecticut and almost all other states. New York City taxes can also be deferred. The top marginal tax rate for New York State is currently 8.82% for income in excess of $2,000,000 for married taxpayers filing jointly, $150,000 for heads of households and $100,000 for single taxpayers. The next lower rate is 6.85%. The top New York City tax rate is 3.875% on all income in excess of $500,000. Therefore, the top New York City/State marginal rate is 12.695%. The next lower rate is 10.725%. New Jersey has state income taxes, but does not have local income taxes. Its top state tax rate is 8.97% on income in excess of $500,000.

As mentioned above, when *IRC § 1245* personal property has been depreciated and then sold, depreciation is recaptured at ordinary income tax rates. Real estate is classified as *IRC § 1250* property. When ordinary *IRC § 1250* property is depreciated and later sold *IRC § 1(h)(1)(D)*, imposes a limit of 25% on "unrecaptured secton 1250 gain." Essentially, this amounts to a 25% tax on the recapture of § 1250 depreciation. This rate has not been changed by the new tax law.

Putting all of this information together, in a worst case scenario where a taxpayer has an ordinary income or a short term capital gain at the top federal, New York State and New York City rates, the aggregate marginal tax rate would be 56.1% of profits. In New Jersey, the marginal rate would be 52.4%. If the tax is, instead, "unrecaptured section *1250* gain," the top marginal rate would be 41.5% in New York City and 37.8% in New

Jersey. If the tax is ordinary capital gains, the then top marginal rate is 36.5% in New York City and 32.8% in New Jersey.

One more thing to consider is that the *IRC §68* overall limitation on itemized deductions has also been modified. Under the old law, limitations were based on a percentage of adjusted gross income. Now deductions are phased out at set income levels: $300,000 for married taxpayers filing jointly, $275,000 for heads of households; $250,000 for single taxpayers; and $150,000 for married taxpayers filing separately. The taxpayer can lose the benefit of these deductions when a transaction takes him or her over these applicable amounts.

The good news is that estate taxes have been left in comparatively good shape, with a 40% top rate. Repeated tax-deferred *IRC § 1031* exchanges of appreciated real estate lasting lifetime, a/k/a "*Swap 'til you drop*," is looking like better advice now than ever.

Of course, all property owners should seek advice based on their particular circumstances from their own accountants, CPAs, attorneys and independent financial advisors.