INTRODUCTION
The Taxpayer Relief Act of 1997 (the "1997 Act") and the IRS Restructuring and Reform Act of 1998 (the "1998 Act") provide for an exclusion from income for certain amounts of gain from the sale of a principal residence. The Mortgage Forgiveness Debt Relief Act of 2007 (the "2007 Act") provides clarification regarding certain capital gains issues as well.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (the "2003 Act") also made important changes to the federal taxation laws including, among other matters, lower capital gains tax rates, acceleration of a reduction in tax rates, increased child tax credits and a reduction in the so-called marriage penalty. Sunset provisions in the 2003 Act were extended by the Tax Increase Prevention and Reconciliation Act of 2005 (the "2005 Act").

With passage of H.R. 3221, the Housing and Economic Recovery Act of 2008, further changes were made to capital gains exclusions for a principal residence that wasn't used as a principal residence part of the time of ownership.

This legal article discusses portions of all of these laws having an impact on capital gains treatment for the sale of real property and providing an exclusion from income for gain from the sale of a principal residence.

In addition, this article discusses the tax impact of the federal health care reform law and the American Tax Payer Relief Act of 2013 (HR8).
II. Taxation on Sale of Principal Residence

Q 1. What happens if I sell my principal residence?

A Individuals are generally permitted to exclude from income up to $250,000 ($500,000, in general, for married couples filing a joint return) realized on the sale or exchange of their principal residence (26 U.S.C. § 121 also cited as IRC § 121).

Q 2. May I use this exclusion more than once?

A Yes, but generally not more than once every two years. In order to qualify, you must have owned and used the property as your principal residence for at least two years during the five-year period ending on the date of the sale or exchange. In addition, the two-year periods do not have to be continuous. (IRC § 121.)

Q 3. May I use this exclusion in connection with Internal Revenue Code ("IRC") section 1034 "rollover" of gain on the sale of my principal residence if I purchase a home of equal or greater value?

A No. The IRC § 1034 provision allowing a delay in the recognition of gain when purchasing a replacement residence of equal or greater value was repealed by the 1997 Act (IRC § 121).

Q 4. May I still take a one-time exclusion of $125,000 of gain from the sale of my principal residence if I am age 55 years or older?

A No. This exclusion was also repealed by the 1997 Act.

Q 5. If I have previously used the $125,000 exclusion of gain, am I prohibited from using the new $250,000 ($500,000 for married couples filing jointly) exclusion of gain?

A Generally no. Even if you have previously taken the one-time $125,000 exclusion, if you are otherwise eligible for the exclusion you can take advantage of the $250,000 exclusion ($500,000 for married couples filing jointly) as often as you meet the requirements. (IRC § 121.)

Q 6. How does the exclusion apply to married couples?

A The $500,000 exclusion applies to married couples filing jointly when all of the following conditions are met:

- Either spouse meets the ownership requirement;
- Both spouses meet the use requirement; and
- Neither spouse has had a sale of their principal residence in the preceding two years subject to the exclusion.

(IRC § 121.)

Q 7. What if I marry someone who has used the exclusion within two years prior to our
Q 8. If my spouse dies, must I sell our principal residence within the year of my spouse's death in order to take advantage of the $500,000 exclusion from gain?

A No. The 2007 Act amends IRC § 121(b) to allow the exclusion of $500,000 in capital gains tax if the principal residence is sold within two years of the spouse's death (but this applies only for sales after December 31, 2007).

Q 9. What if I move before I have occupied my residence for two years or before two years have elapsed since the last time I sold or exchanged my principal residence?

A If you fail to meet either two-year requirement, you will still be entitled to a pro-rata amount of the exclusion as long as the failure to meet the requirement is because the sale or exchange is by reason of a change in place of employment, health or other unforeseen circumstances.

The 1998 Act provides that this ratio is that portion of the $250,000/$500,000 exclusion equal to the fraction of the two years that the ownership and use requirement is met. Therefore, an unmarried taxpayer who owns and uses a principle residence for one year and then sells because of a job transfer may exclude up to $125,000 of gain (one-half of the regular $250,000 exclusion).

Example: Ms. Seller purchased and occupied her principal residence in 1998. One year later, she is transferred by her employer to another city and sells her house for a $100,000 gain. Because she occupied her residence for one-half of the required two years, Ms. Seller is entitled to exclude up to one-half of the $250,000 otherwise allowed, thereby covering her entire $100,000 gain. This is a change from the IRS's previous position allowing her to exclude only one-half of her gain, or $50,000.

Q 10. Are there clarifications to the permissible reasons for sale or exchange allowing a pro-rata exclusion?

A Yes. Treasury regulations provide clarifications and safe harbors for the exemptions from the two-year period. Treasury Regulation 1.121-3(b) provides that a sale or exchange is by reason of a change in employment, health, or unforeseen circumstances only if the primary reason for the sale or exchange is a change in place of employment, health or unforeseen circumstances. The regulation provides the following guidelines and safe harbors:

**Place of Employment**

Generally, a sale or exchange is deemed to be a change in employment if the primary reason for the sale or exchange is a change in the location of a qualified individual's place of employment. (See Question 11 for a definition of qualified individual.)

The regulation provides a distance safe harbor if (i) the change of employment occurs during
the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence, and (ii) the individual's new place of employment is at least 50 miles further from the residence sold or exchanged than was the former place of employment, or, if there was no former place of employment, the distance between the individual's new place of employment and the residence sold or exchanged is a least 50 miles.

For purposes of the regulation, employment includes starting a job with a new employer, continuing employment with the same employer, and starting or continuing self-employment.

**Health**

A sale or exchange is by reason of health if the primary reason for the sale or exchange is to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of a qualified individual, or to obtain or provide medical or personal care for a qualified individual suffering from a disease, illness or injury. A sale or exchange that is merely beneficial to the general health or well-being of the individual is not a sale or exchange by reason of health.

The regulations provide a safe harbor if a physician recommends a change of residence for reasons of health. (See Question 11 for a definition of qualified individual.)

**Unforeseen Circumstances**

A sale or exchange is by reason of unforeseen circumstances if the primary reason for the sale or exchange is the occurrence of an event that the taxpayer does not anticipate before purchasing and occupying the residence.

The regulations provide a safe harbor for any of the following events occurring during the taxpayer's ownership and use of the residence as the taxpayer's principal residence:

1. The involuntary conversion of the residence;
2. Natural or man-made disasters or acts of war or terrorism resulting in a casualty to the residence;
3. In the case of a qualified individual:
   a. Death;
   b. The cessation of employment as a result of which the individual is eligible for unemployment compensation;
   c. A change in employment or self-employment that results in the taxpayer's inability to pay housing costs and reasonable basic living expenses for the taxpayer's household (including amounts for food, clothing, medical expenses, taxes, transportation, court-ordered payments, and expenses reasonably necessary to the production or income, but not for the maintenance of an affluent or luxurious standard of living);
   d. Divorce or legal separation under a decree of divorce or separate maintenance;
   e. Multiple births resulting from the same pregnancy; or
4. An event determined by the Commissioner to be an unforeseen circumstance to the
extent provided in published guidance of general applicability or in a ruling directed to a specific taxpayer.

(See Question 11 for a definition of qualified individual.)

(26 C.F.R. § 1.121-3.)

Q 11. Who is a "qualified individual" as used in Question 10?

A Qualified individual is defined in the regulations as the taxpayer, the taxpayer's spouse, a co-owner of the residence, or a person whose principal place of abode is in the same household as the taxpayer. For purposes of the pro-rata exclusion of gain for a sale or exchange due to health only, a qualified individual also includes (i) an individual with a relationship described as a dependent in IRC § 152(a)(1) through (8), without regard to whether they are actually a dependent, or (ii) a descendent of the taxpayer's grandparent. (26 C.F.R. § 1.121-3(f).)

Q 12. What if I do not qualify for a safe harbor?

A The regulations provide the following factors, which may be relevant in determining the taxpayer's primary reason for the sale or exchange:

1. The sale or exchange and the circumstances giving rise to the sale or exchange are proximate in time;
2. The suitability of the property as the taxpayer's principal residence materially changes;
3. The taxpayer's financial ability to maintain the property materially changes;
4. The taxpayer uses the property as the taxpayer's residence during the taxpayer's ownership of the property;
5. The circumstances giving rise to the sale or exchange are not reasonably foreseeable when the taxpayer begins using the property as the taxpayer's principal residence; and
6. The circumstances giving rise to the sale or exchange occur during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence.

(26 C.F.R. § 1.121-3(b).)

Q 13. May I deduct a loss on the sale of my principal residence?

A No. Although there were discussions about allowing homeowners to deduct losses on the sale of their principal residence, this provision did not become law.

Q 14. If I have gains from the sale of my principal residence above the $250,000/$500,000 exclusion limits, what tax rate will I pay?

A Depending on the length of time you owned your principal residence, your gain may be taxed at the more favorable capital gain rates discussed below. See Section II, below.
Q 15. Are there more special rules?

A Yes, including, among others, the following:

- A taxpayer can elect not to have the exclusion apply to any sale or exchange.
- Certain periods an individual resides in a nursing home on account of physical or mental incapacity are included as part of the two-year use requirement if certain other rules apply.
- An individual whose spouse is deceased on the date of the sale of the property can include the period the deceased spouse owned and used the property before death.
- An individual is treated as using the property as his or her principal residence during any period of ownership while the individual's spouse or former spouse is granted use of the property under a divorce or separation instrument.

Q 16. What happens if I transfer my principal residence into a revocable living trust?

A IRC § 676 provides that a grantor (the person who creates and funds the trust) is treated as the owner of the property when the grantor retains the power to revoke the trust and reveset title in him or herself. The 2003 Act does not change this provision. This means that the $250,000 exclusion ($500,000 if married filing jointly) applies to a sale or exchange by a revocable living trust so long as the grantor of the trust and owner of the property before it was conveyed to the trust are the same person and that person, either as owner or grantor, has owned and used the property as his or her principal residence for two of the previous five years. In other words, because the grantor is still treated as the owner of the property, the transfer into the trust is not a taxable event.

Q 17. May I utilize an IRC 1031 (“like kind” tax-deferred exchange) in connection with an owner-occupied residence?

A No. However, individuals sometimes exchange one rental property for another planning to move into the acquired property and, after living in it for two years, sell it and take advantage of the capital gains exclusion. This sometimes occurred as soon as three or four years after the acquisition. As of October 22, 2004, this was no longer possible. Pursuant to the American Jobs Creation Act of 2004, a property acquired in a 1031 exchange and later converted to a principal residence must be owned for five years from the date of the exchange before the owner can claim the capital gains exclusion. Therefore, in order to take advantage of a 1031 exchange and the capital gains exclusion, the owner must both have used the acquired property as a principal residence for two years and owned it for five years.

Q 18. Is the exclusion treated differently for the sale of a principal residence that was used as a second home or as income property during the ownership period?

A Yes. For any periods of ownership occurring on or after January 1, 2009, under the Housing and Economic Recovery Act of 2008 (H.R. 3221), the exclusion from capital gains recognition will be reduced by the amount of time the property was not used as a principal residence (“non qualified use”). The gain from the sale will be allocated between periods when the property was used as a principal residence (“qualified use”) and periods of non-qualified use. The math is as follows: The gain is multiplied by a fraction where the top number (the numerator) is the period that the property was used as a principal residence (qualified use) and the lower number (the denominator) is the total period of ownership.
Gain x (Time of qualified use/Total time owned) = exclusion from capital gains (capped at $250,000 and $500,000).

Example: A married couple filing jointly purchased a vacation property on January 2, 2009 which they sell on January 2, 2017 for a gain of $600,000. During the last two years of ownership they occupied the property as their principal residence. They would multiply $600,000 gain by 2 years of qualified use divided by 8 total years of ownership (or $600,000 x ¼ = $150,000). They could exclude $150,000 from capital gains (which is less than the $500,000 cap for joint filers) and the balance of the $600,000 gain, $450,000 would be taxed as capital gains.

Q 19. Are there exemptions from the non qualified use rules?

A Yes. There are three exemptions from the non qualified use rules:

1) Any portion of the 5-year ownership and use requirement occurring after the last date the property was used as a primary residence of the taxpayer or the taxpayer’s spouse.

Some examples may help.

Example One:

In January 2009, married taxpayers filing a joint return buy a house and use it as their principal residence for the first two years. They then convert the residence to a rental for the next three years, after which they sell the residence and realize gain of $600,000. None of the three years of otherwise non qualified use after the initial use as a principal residence would be used to reduce the capital gains exclusion. They would be entitled to the full $500,000 exclusion and would owe capital gains on $100,000.

The formula would be the $600,000 gain times the five years of qualified use (the initial two-year qualifying use period plus the balance of the five-year qualifying ownership period following the two-year qualifying use period) over the five year total ownership period.

\[ \frac{600,000 \times 5}{5} = 600,000 \text{ qualifying gain (capped at } \$500,000 \text{ for joint filers).} \]

Example Two:

The same couple buys a house in January 2009 and rents it out for the first three years. They then convert it to their principal residence for the next two years. Following this they once again rent the residence out, this time for three years, after which they sell the residence for $600,000 gain. They owned the property for a total of eight years. They have three years of non qualified use and five years of qualified use (the two-year qualifying use period plus the balance of the five-year qualifying ownership following the two-year qualifying use period).

The formula would be $600,000 gain times five years of qualified use over eight total years of ownership.

\[ \frac{600,000 \times 5}{8} = 375,000 \text{ excluded from capital gains and capital gains tax would be owed on } \$225,000. \]

Example Three:
The same couple buys a house in January 2009 and rents it out for six years. They then occupy it as their principal residence for two years and sell it for $600,000 gain. Since none of the five-year qualifying ownership period occurs after the two-year qualifying use period only the last two years of occupancy count as qualified use.

The formula would be $600,000 times 2 years of qualified use over 8 total years of ownership.

$$600,000 \times \frac{2}{8} \text{ or } \frac{1}{4} = $240,000$$

excluded from gain and capital gains tax would be owed on $360,000.

The other two exemptions from the non-qualified use rules are:

2) Any period (not to exceed an aggregate period of 10 years) during which the taxpayer or taxpayer’s spouse is serving on extended official duty as a member of the Foreign Service or the uniformed services of the United States, and

3) Any other period of temporary absence (not to exceed an aggregate of two years) due to change of employment, health conditions, or other such unforeseen circumstances.


III. Capital Gains Tax

Q 20. What are the basic capital gains tax rates?

A The 2003 Act reduced the maximum rate on the net capital gains rate of an individual (net long-term capital gains less net short-term capital losses) from 20 percent to 15 percent. Net capital gains previously taxed at 10 percent were reduced to 5 percent.

Q 21. Has the holding period for long-term capital gains changed?

A In order to qualify for long-term capital gains treatment, property must be held for more than 12 months.

Q 22. Are there further capital gains tax rate reductions?

A In 2008, the capital gains tax rate for gains taxed in the lowest tax bracket (5 percent) was reduced to zero.

Q 23. When did the reductions in capital gains take effect?

A The 2003 Act took effect May 6, 2003 and applies to taxable years ending on or after May 6, 2003.

Q 24. Do these capital gains rates expire?
Under HR8, The American Tax Payer Relief Act of 2013, the capital gains rate reductions were extended for most taxpayers. For tax payer's whose income exceeds $400,000 for single filers, $450,000 for joint filers, and $425,000 for heads of households, the top capital gains rate will be 20 percent. For all others, the capital gains rate will continue to be 15 percent. For those in the lowest tax bracket, the capital gains rate rate will continue to be zero.

Q 25. Are there any changes to depreciation recapture rules?

A No. Generally, when selling investment real property, a tax is imposed on all amounts previously taken as depreciation. Under prior law, these amounts were taxed as ordinary income and not capital gains.

The 1997 Act provides for a 25 percent maximum tax rate on any gain attributable to depreciation already claimed on the property in the case of real property for which the maximum tax rate is reduced to 15 and 5 percent. Although there was an effort to reduce the recapture rate, no reduction materialized.

Example:
Ms. Seller purchases a triplex for $200,000 after January 1, 2001, and takes depreciation deductions of $50,000 over the six years she owns it. She sells the duplex for $300,000. Her basis in this property is reduced to $150,000 because of her deductions for depreciation, and she would have a $150,000 gain.

Under the 2003 Act, she would be taxed at a 15 percent (or 5 percent) rate on the $100,000 portion of gain over her original $200,000 basis and at a 25 percent rate on the $50,000 portion of gain attributable to her depreciation deduction.

Q 26. Can you provide a summary of the capital gains tax rates?

A Yes. Sales of assets held more than 12 months and sold on or after May 6, 2003 qualify for the 15 percent capital gains rate (5 percent for lowest income taxpayers and zero percent beginning in 2008). The capital gains rate reverts to 20 and 10 percent for assets held for more than 12 months and sold after December 31, 2010.

Q 27. Can I still take advantage of an IRC 1031 ("like kind" tax-deferred) exchange?

A Yes. The tax-free exchange of "like-kind" property used in a trade or business is not affected by the 1997, 1998, 2003 or 2007 Acts.

IV. Health Care Reform Tax Impact

A. New Medicare Tax on "Unearned" Net Investment Income

There has been great confusion in the REALTOR® world about a provision in the recently-passed health care reform bill that creates a 3.8% Medicare tax on unearned income for high-income households. Recently, one newspaper article made its way around the internet defining the new tax as a “Tax on Home Sales.” Sadly, the information going around the REALTORS® community does not present a full and detailed explanation of exactly what the new provision entails.
The new Medicare tax is for all unearned net investment income and includes interest-income, dividends, rents and capital gains. The new Medicare tax will not impact the capital gains exclusion for principal residences ($250,000 for individuals/$500,000 for married couples). So the 3.8% tax will apply to taxable gains above this exclusion.

The tax will take effect on January 1, 2013, and will be applicable for high-income taxpayers with adjusted gross incomes of $200,000 or more for individuals or $250,000 or more for married couples.


**Q 28. What is “unearned” net investment income?**

**A** Unearned income is the income that an individual derives from investing his/her capital. It includes capital gains, rents, dividends and interest income. It also comes from some investments in active businesses if the investor is not an active participant in the business.

The portion of unearned income that is subject both to income tax and the new Medicare tax is the amount of income derived from these sources, reduced by any expenses associated with earning that income. (Hence the term “net” investment income.) Thus, in the case of rents, the taxable amount would be gross rents minus all expenses (including depreciation) incurred in operating the rental property. So if gross rents were $100,000 with associated expenses of $40,000, net rents of $60,000 ($100,000 minus $40,000) would be included in Adjusted Gross Income (AGI).

**Q 29. Who will be subject to the new taxes imposed in the health legislation?**

**A** A new 3.8% tax will apply to the “unearned” income of “High Income” taxpayers. Another 0.9% tax will apply to the “earned” income of many of these same individuals. Both levies are referred to as “Medicare” taxes.

**Q 30. Who is a “High Income” Taxpayer?**

**A** Those whose tax filing status is “single” will be subject to the new unearned income taxes if they have Adjusted Gross Income (AGI) of more than $200,000. Married couples filing a joint return with AGI of more than $250,000 will also be subject to the new tax. (The AGI threshold for married filing separate returns is $125,000.)

**Q 31. Are the $200,000 and $250,000 thresholds indexed for inflation?**

**A** No. Thus, over time, more individuals may become subject to this tax.

**Q 32. When does the new 3.8% Medicare tax take effect?**

**A** The new Medicare tax on unearned income will take effect January 1, 2013.

**Q 33. Will the new tax will apply to rents from investment properties that I own?**
Maybe. Remember that net investment income includes only net rental income. Thus, gross rents would not be subject to the tax. Rather, gross rents would be reduced (as they are under the income tax) by all allowable expenses, including depreciation, cost of repairs, property taxes and all other expenses related to the property. AGI includes net income from rent, so if your AGI is above the $200,000/$250,000 thresholds, then the rental income might be subject to the tax. For many investment real estate owners, the net rents will be the same as or similar to the amounts reported on their Schedule E, filed with their Form 1040 Income Tax Return. (For calculations, see Question 35, below. See also Question 36 through Question 39 related to capital gain from sale of principal residence, losses on sale and to vacation homes, below.)

Q 34. Does the tax apply to the yearly appreciation of an asset?

No. Capital gains are subject to this new tax only in the year when the asset is sold. The amount of the gain will be measured in the same way that it is for income tax purposes. This rule applies to real estate and all other appreciating capital assets. Net capital gains are taxable only in the year of sale.

Q 35. How is the new 3.8% Medicare tax calculated?

The new 3.8% Medicare tax is assessed only when Adjusted Gross Income (AGI) is more than $200,000/$250,000. (See Question 29 above.) AGI includes net income from interest, dividends, rents and capital gains, as well as earned compensation and several additional forms of income presented on a Form 1040 Income Tax Return.

The tax is NOT imposed on the total AGI, nor is it imposed solely on the investment income. Rather, the taxable amount will depend on the operation of a formula. The taxpayer will determine the LESSER of (1) net investment income OR (2) the excess of AGI over the $200,000/$250,000 AGI thresholds. Thus, if net investment income is the smaller amount, then the 3.8% tax is applied only to the net investment income amount. If the excess over the thresholds is the smaller amount, then the 3.8% tax would apply only to the excess amount.

For example, if AGI for a single individual is $275,000, then the excess over $200,000 would be $75,000 ($275,000 minus $200,000). Assume that this individual’s net investment income is $60,000. The new 3.8% tax applies to the smaller amount. In this example, $60,000 of net investment income is less than the $75,000 excess over the threshold. Thus, in this example, the 3.8% tax is applied to the $60,000.

If this single individual had AGI if $275,000 and net investment income of $90,000, then the new tax would be imposed on the smaller amount: the $75,000 of excess over $200,000.

Rules of thumb for predicting the application of this tax year to year are not readily determinable, largely because the proportion of net investment income compared to AGI will vary from year to year and from individual to individual.

Q 36. Will the $250,000/$500,000 exclusion on the sale of a principal residence continue to apply?

Yes. Any gain from the sale of a principal residence that is less than $250,000 (individual) or $500,000 (joint return) will continue to be excluded from the income tax. The new 3.8% tax will NOT apply to this excluded amount of the gain.
Q 37. Will the 3.8% tax apply to any part of the gain on the sale of a principal residence?

A The new Medicare tax would apply only to any gain realized that is more than the $250K/$500K existing primary home exclusion (known as the “taxable gain”), and only if the seller has AGI above the $200K/$250K AGI thresholds.

So, for example, if the taxable gain was $30,000 and a married couple had AGI (which would include the taxable gain) of $180,000, the 3.8% tax would not apply because AGI is less than $250,000. If that same couple had AGI of $290,000, then the application of the 3.8% tax would be subject to the same formula described above. The $30,000 taxable gain on the sale would be less than the $40,000 excess above $250,000 AGI, so the $30,000 gain would be subject to the new 3.8% tax.

Q 38. Is rent from a vacation home subject to the 3.8% tax? And what about the gain on sale of a vacation or rental property?

A The application of the tax will depend on whether the vacation home has been rented out, the period for which it has been rented and whether the property is solely for the enjoyment of the owner. If the owner has rented the home out to others, then the 14-day rent exclusion will continue to apply. Thus, if the owner rents the property to others (including family members) for 14 or fewer days, there would be no net investment tax. (Note that no deductions for expenses would be available, as under current law.)

If the home has been rented to others (including family members) for more than 14 days, then the rents (minus related expenses) would be considered as part of net investment income and could, depending on AGI and the calculations described above, be subject to the new tax.

If the vacation home has been used solely for personal enjoyment (i.e., there is no rental income and no associated expenses), then a gain on sale would be treated as net investment income and could be subject to the tax, depending on AGI. Similarly, if the property had generated rents, any net gain on sale could also be included in net investment income. The amount of the tax (if any) would depend on the calculation formula, above in Question 34.

Q 39. My rental property generates a net loss each year. How will those losses be factored into the new tax? And what if I have net capital losses when I sell?

A Net losses from rents and net capital losses reduce AGI. Thus, the losses themselves would not be subject to the tax. If, after losses, AGI still exceeds the High Income thresholds, the 3.8% tax would still apply if there were any interest or dividends income. (Capital losses reduce capital gains. If losses exceed gains, no more than $3000 of capital losses may reduce other income in any year.)

Note that passive loss limitations will continue to apply to rental income and loss.

Q 40. All of my income is derived from real estate investments that I own and operate myself. Will my rents and gains be subject to the new tax?

A No. If the ownership and operation of real estate you own is your sole occupation, then those activities are what’s called your “trade or business.” Income derived from a trade or business is not subject to the new 3.8% tax, but could be subject to the 0.9% tax on earned income.
If the owner of rental properties has a “day job,” however, real estate investments are not considered as a trade or business, but are rather considered as investments, even if they are a major source of income. Note that many Realtors engage in business activities that are the “typical” selling, leasing and brokerage endeavors usually associated with the term “REALTOR®.” If they also own real estate assets as part of their own personal investment portfolio, the rents from that portfolio could become subject to the new 3.8% tax on net investment income, depending on AGI.

Q 41. Is there a real estate “sales tax” or a transfer tax in the new health care bill?

A No. There is neither a real estate “sales tax” nor a real estate transfer tax in the bill.

Q 42. Will “High Income Filers” lose any portion of the Mortgage Interest they are allowed to deduct?

A No. The mortgage interest deduction is unchanged. No cap was imposed on any itemized deductions.

Q 43. Why is this new tax called a “Medicare tax?”

A The revenues generated from this tax will be allocated to the Medicare Trust Fund that is part of the Social Security System. That fund is currently on shaky financial footing. The additional revenues generated from the new earned income and unearned income taxes are intended to shore up the Medicare Trust Fund.

Q 44. How will this new tax affect marginal (the highest) tax rates when it is combined with existing law and with the possible expiration of the Bush tax cuts enacted in 2001?

A Marginal tax rates are the tax rates assessed on the “last” dollars included in taxable income. If the Bush tax cuts are allowed to expire, then the marginal rates for upper income individuals will increase, particularly for capital gains income. Download the chart below to view the impact of those changes, based on implementation of current law effective dates.

B. New Medicare Tax on Earned Income: Wages, Salaries and Commissions

Q 45. What is “earned” income?

A The term “earned income” is essentially the income derived from an individual's labor. It can take the form of wages, salaries, commissions or similar compensation arrangements. Employees of an organization and self-employed individuals are generally compensated for the work they do in some form of earned income.

Q 46. Who will be subject to the new taxes imposed in the health legislation?

A A new 0.9% tax will apply to the “earned” income of “High Income” taxpayers. Another 3.8% tax will apply to the “unearned” income of many of these same individuals. Both are described as “Medicare” taxes.
47. **Who is a “High Income” Taxpayer?**

**A** Those whose tax filing status is “single” will be subject to the new taxes on earned income if the earned income that is part of Adjusted Gross Income (AGI) is more than $200,000. Married couples filing a joint return with earned income of more than $250,000 will also be subject to the new tax. (The earned income threshold for married filing separate returns is $125,000)

48. **Are the $200,000 and $250,000 thresholds indexed for inflation?**

**A** No. Thus, over time, more individuals could become subject to this tax.

49. **When does this tax go into effect?**

**A** Implementation will begin **January 1, 2013**.

50. **Does the new 0.9% tax apply to all of an individual’s earned income?**

**A** No. The 0.9% tax applies only to the portion of a high income taxpayer’s earnings that exceed the $200,000 or $250,000 thresholds. Taxpayers with adjusted gross income below those amounts will experience no change in their Medicare taxes.

51. **Does the new tax apply to gross commissions?**

**A** No. The tax applies only to net commissions, i.e., gross commissions minus the expenses of earning the commission. For many Realtors, this will be the amount reflected in the Schedule C they file as part of their annual Form 1040 income tax filings.

52. **So will a self-employed person pay an additional tax of 1.8% (i.e., both the “employer” and “employee” portions of the Medicare tax) on the taxable portion of earnings?**

**A** No. There is no “employer” portion of this new tax. The rate for all individuals subject to the tax will be 0.9%, whether they are employees or they are self-employed. Real estate professionals who have employees would not be required to pay any portion of this tax for any of their employees who might become subject to it. (Note, however, that real estate professionals who have employees may have responsibility to withhold the new tax on behalf of employees who might be subject to it.) Independent contractor sales agents will always pay the full share of this tax they might owe on their earned income.

53. **How does the new tax on self-employment income interact with the current rules for the Self-employment Tax (SECA)?**

**A** Under current law, self-employed individuals must pay a Medicare tax (also known as Hospital Insurance tax, or HI) of 2.9 percent (1.45% “employer” and 1.45% on “employee”) on ALL self-employment income. Generally, self-employment income is comprised of earnings from self-employment activities minus the expenses associated with generating those earnings.
For example, a REALTOR® might have gross commissions of $95,000 and expenses associated with that income of $35,000. That individual’s self-employment income would be $60,000 ($95,000 minus $35,000). Assuming no other earned income sources, this Realtor would not be subject to the new tax.

By contrast, a high producer REALTOR® might have net self-employment income of $280,000. If that Realtor were single, the tax would apply only to the $80,000 that exceeds the $200,000 AGI threshold. Thus, the additional new tax would be $720. ($280,000 minus $200,000 = $80,000) ($80,000 x .009 = $585). A married couple with earned income of $280,000 would pay an additional new tax of $270 ($280,000 minus $250,000 = $30,000) ($30,000 x .009 = $270).

(Note that these examples are over-simplified. Determination of self-employment income requires more calculations than are presented here. The example is intended to illustrate that the new tax applies only to a portion of an individual’s or couple’s earned income.)

Q 54. Under current law, a self-employed Realtor deducts one-half of his/her SECA/HI payment for income tax purposes. Can all or some portion of this new tax be deducted?

A NO AMOUNT of any payment of the new 0.9 percent HI tax on self-employment income will be deductible for income tax purposes.

Q 55. Why is this tax called a “Medicare” tax when it is structured so differently from SECA?

A The revenues generated from this tax will be allocated to the Medicare Trust Fund that is part of the Social Security System. That fund is currently on shaky financial footing. The additional revenues generated from the new earned income and unearned income taxes are intended to shore up the Medicare Trust Fund.

Q 56. Is there a real estate “sales tax” or a transfer tax in the new health care bill?

A No. There is neither a real estate “sales tax” nor a real estate transfer tax in the bill.

Q 57. Will “High Income Filers” also see a reduction in the amount of Mortgage Interest they are allowed to deduct?

A No. The mortgage interest deduction is unchanged. No cap was imposed on any itemized deductions.

Q 58. Where can I obtain additional information?

A This legal article is just one of the many legal publications and services offered by C.A.R. to its members. For a complete listing of C.A.R.’s legal products and services, please visit car.org.

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