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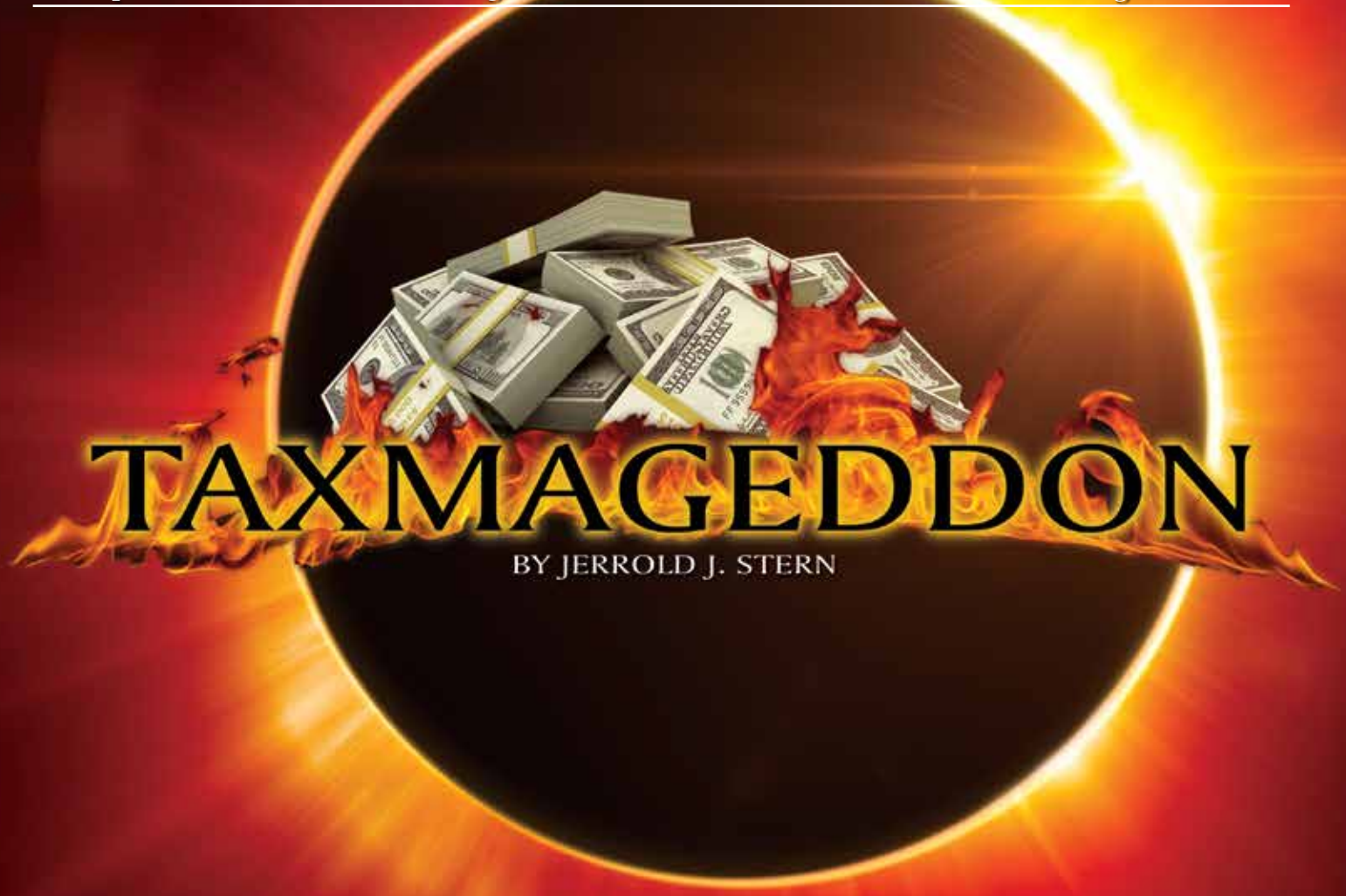

TAXMAGEDDON

BY JERROLD J. STERN

"Taxmageddon" and "fiscal cliff" are terms being used throughout the financial press to describe the potential result of federal government inertia regarding the tax system.

Without new legislation, automatic tax hikes could top $4 trillion during the coming years, according to the *Washington Times*. The Congressional Joint Committee on Taxation predicts a $300 billion tax increase in 2013 alone.

Some economists predict a return to recession if the tax increases materialize and $1.2 trillion in defense and domestic spending cuts occur over the next ten years (including cuts of $110 million in 2013). The budget cuts are required by the 2011 Budget Control Act.

While many tax commentators expect at least minimal tax legislation, they do not foresee any new tax laws being enacted prior to the November presidential election. Predicting the final outcome with certainty is not possible even though Democrats and Republicans agree on postponing some of the scheduled tax increases. The inability to predict future tax rules is a significant problem that has long plagued the U.S. tax system.

Current law requires major tax increases that include a significant rise in tax rates on ordinary income, capital gains and other types of investment income for virtually all Americans. In addition, numerous tax hikes will affect the real estate industry if the federal government does not act.

Tax Rates on Ordinary Income

The 2001–03 Bush-era tax cuts, originally set to expire after 2010, are now scheduled to end after 2012. Expiration will increase rates in almost every tax bracket for every taxpayer starting in 2013. For example, Table 1 shows the increases for married taxpayers who file jointly.

The top tax rates on ordinary income such as salaries and self-employment income are scheduled to increase to 36 and 39.6 percent in 2013, from 35 percent (Table 1). High-income taxpayers who itemize their deductions (such as mortgage interest and real estate taxes) will see a decline in total itemized deductions as well as personal and dependency exemptions thanks to the return of complex phase-out rules in 2013. The phase-out rules will cause the *effective* marginal tax rates for these taxpayers to increase.

Also scheduled to return is the so-called "marriage tax penalty." The Bush tax cuts widened the married-filing-jointly tax brackets to be twice that of singles. Thus, for example, two married individuals earning $50,000 each in salary would pay the same tax as a single person earning $100,000 (assuming equal deductions). In 2013, the two married individuals would pay more in tax as the second $50,000 salary would push them into a higher tax rate bracket.

Scheduled changes to salary (payroll) and self-employment (SE) taxes will push *effective* top marginal tax rates higher. Real estate professionals are generally considered self-employed for tax purposes. The current payroll/SE tax rates of 5.65/13.3 percent will return to their pre-2011 levels, 7.65/15.3 percent, in 2013. Income levels determine the actual amount of payroll/SE taxes paid.

Table 1
Comparison of 2012 Income Tax Brackets*
Married Filing Jointly

Taxable Income	2012 Current Tax Rates	2013 Scheduled Tax Rates
$0 – $17,400	10%	15%
$17,400 – $59,000	15%	15%
$59,000 – $70,700	15%	28%
$70,700 – $142,700	25%	28%
$142,700 – $217,450	28%	31%
$217,450 – $388,350	33%	36%
$388,350 –	35%	39.6%
standard deduction	$11,900	$9,950
personal exemption	$3,800	$3,800

* The table assumes the current 2012 tax brackets will remain the same in 2013. The actual 2013 tax brackets, which will widen slightly based on inflation, are not yet known.

Source: Table 1 in "An Overview of Tax Provisions Expiring in 2012," by Margot L. Crandall-Hollick, 4-17-12, Congressional Research Service. The information was compiled from the Tax Policy Center and the IRS.

Investment Income Rates

Table 2 summarizes the scheduled 2013 top tax rate increases for most types of income.

Starting in 2013, a 3.8 percent surtax will apply to the investment income of taxpayers whose adjusted gross income (AGI) is more than $200,000 for singles and $250,000 for marrieds. (In all cases, "singles" includes "unmarried heads of households" — typically, singles who support a dependent.)

The surtax will increase taxes on capital gains, interest, dividends, "passive income" from real estate investments (such as the passive rental of farm land, or passive income from real estate partnerships/limited liability companies), royalties, and some annuities. Capital gains include gains from the sale of a principal residence more than $500,000 for marrieds and $250,000 for singles (Table 2). The $500,000/$250,000 exclusion does not apply to sales of second homes.

The following *are exempt* from the 3.8 percent surtax: "active business rents" (such as apartment and commercial building rents); municipal bond interest; social security income; earned income (such as salary and self-employment income); and qualified retirement income from qualified pensions such as 401(k) plans, certain annuities and IRAs.

Moreover, the regular capital gains tax rate in 2013 will be 20 percent for most investors, up from the current 15 percent. Thus, the effective capital gains tax rate for $200,000/$250,000 AGI taxpayers would reach 23.8 percent (20 percent + 3.8 percent).

For example, in 2013 a married couple with $250,000 salary and $100,000 capital gains (AGI of $350,000) will pay $23,800 tax ($100,000 × [20 percent + 3.8 percent, or 23.8 percent]) on the $100,000. Under current 2012 law, the tax would be $15,000 ($100,000 times 15 percent). Thus, the tax increase will be $8,800, or 8.8 percent on $100,000.

The same $23,800 capital gains tax would be generated if the $100,000 capital gain resulted from selling a personal residence for a $600,000 profit. The taxable capital gain would be $100,000 and not $600,000 because of the $500,000 personal residence exclusion, mentioned previously. If the residence was a second home, the entire $600,000 profit would be a taxable capital gain, taxed at 23.8 percent in 2013 (rather than the 15 percent rate in 2012).

The story is much worse for dividend income. Currently, dividends are taxed like capital gains and have a maximum tax rate of 15 percent. Starting in 2013, dividends will be treated as ordinary income, subject to the tax rates in Table 1. (Interest income has always been taxed as ordinary income.) Adding the 3.8 percent surtax for high-income individuals, the top tax rate on dividends (and interest) would reach 43.4 percent (3.8 percent plus the 39.6 percent top tax bracket rate

noted in Table 1). From a tax-investment planning perspective, municipal bonds may be preferable to some stocks (depending on risk, growth potential and other factors) because municipals typically provide interest that is exempt from federal income taxation.

Alternative Minimum Tax

The federal government initiated the first version of the alternative minimum tax (AMT) in 1969 following a realization that roughly 150 individuals with AGIs over $200,000 paid no tax in 1966. Since 1969, the AMT's objective has remained the same: "to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions and credits" (1986 Senate Finance Committee Report).

During its long history, the number of individuals paying the AMT has expanded dramatically. According to the Urban Institute's Tax Policy Center, the number of taxpayers paying the AMT expanded from roughly 20,000 in 1970 to about four million in 2011. Many of these taxpayers are in the middle and upper-middle classes and would have paid significant taxes without additional AMT taxes. The primary reason for the enormous 1970–2011 increase is that AMT tax brackets and rates are not indexed for inflation.

The Bush tax cuts initiated a series of one- and two-year "tax patches" to slow the AMT's growth. The 2011 tax patch provided exemptions of $48,450 for singles and $74,450 for marrieds, along with certain tax credits that can be applied against the AMT. If the government does not extend the patch to 2012, the exemption amounts will fall to $33,750/$45,000, and the new AMT credits will disappear. Alarmingly, the lack of a patch will cause an estimated 30 million taxpayers (almost 20 percent of all taxpayers) to pay the AMT in 2012, according to the Congressional Research Service. However, some tax commentators believe a 2012 patch is highly likely.

Real Estate Taxation

Without new federal legislation, real estate professionals will pay higher self-employment taxes; high-income homeowners will pay higher capital gains taxes on large home sale profits; real estate investors will be subjected to higher capital gains taxes; certain real estate rental income will be subject to a new 3.8 percent surtax; and home mortgage interest and real estate tax deductions may yield less tax savings. Additional real estate-related tax issues should be considered as well.

$2 Million Foreclosure Tax Exemption

The $2 million tax exemption for personal residence foreclosures is scheduled to expire after 2012 but has been reinstated in the past. Consider the following example. A married couple purchased a residence for $300,000, paying $60,000 down and mortgaging the $240,000 balance with a recourse mortgage. By the time the mortgage balance was $210,000, the property value had dropped to $140,000. Because of financial difficulties, the couple could not continue making mortgage payments, and the lender foreclosed on the property. Without the taxable income exemption, the couple would have to pay tax at ordinary tax rates on $70,000 ($210,000 minus $140,000).

Currently, the exemption applies even if the $70,000 was $2 million. The exemption is not needed in cases of insolvency, bankruptcy or nonrecourse loans, for which no tax would be due regardless of mortgage balance.

Table 2

Top Tax Rates[1]

	2012 Current Top Tax Rates	2013 Scheduled Top Tax Rates[2]	
		Adjusted Gross Income under $200k (singles) $250k (marrieds)	Adjusted Gross Income over $200k (singles) $250k (marrieds)
Capital gains	15%	20%	23.8%[3]
Sales of personal residences			
On profits under:			
$250k (singles)	0%	0%	0%
$500k (marrieds)	0%	0%	0%
On profits over:[4]			
$250k (singles)	15%	20%	23.8%[3]
$500k (marrieds)	15%	20%	23.8%[3]
Dividends	15%	39.6%	43.4%[3]
Interest and "passive" rental income	35%	39.6%	43.4%[3]
"Active" rental income	35%	39.6%	39.6%
Ordinary income (e.g., salary, payroll, self-employment [SE])	35%	39.6%	39.6%
Payroll/SE tax rates[5]	5.65%/13.3%	7.65%/15.3%	7.65%/15.3%

[1] All top *effective* tax rates (other than 0% tax rates) could be higher due to the alternative minimum tax (AMT).
[2] Top *effective* tax rates could be higher due to phase-outs of itemized deductions, and personal and dependency exemptions.
[3] Tax rate includes 3.8% investment income surtax.
[4] These profits are taxable capital gains.
[5] Paid in addition to ordinary income tax rates (depending upon income level).

Note: "Singles" includes "unmarried heads of households" — typically, singles who support a dependent.

Source: Jerrold Stern

Federal Estate Tax

In 2013, the estate tax exemption is scheduled to become $1 million, and the top estate tax rate will be 55 percent — a significant tax-increasing change from the $5 million/35 percent rules now in place. Thus, according to the Research Institute of America, a $5 million property left to heirs in 2012 would escape tax entirely, whereas the same bequest in 2013 could generate an estate tax as high as $2 million (depending on estate tax deductions).

15-Year Write-Offs of Certain Real Estate

Through 2011, the write-off period for qualified leasehold improvements, retail improvements and restaurant property was 15 years. The write-off period increased to 39 years in 2012.

A retroactive reinstatement of the 15-year write-off period for 2012 and later years is possible.

Mortgage Insurance Premium Deduction

This deduction expired at the end of 2011, but will likely be reinstated for 2012 and possibly future years. The deduction has been retroactively reinstated in the past.

Under the rule, the amount paid for mortgage insurance for the first year of homeownership is deductible as mortgage interest. The deduction phases out gradually once AGI reaches $100,000. No deduction is available if AGI is higher than $109,000.

Deducting Environmental Contamination Cleanup Costs

This deduction expired in 2011. In the past, however, the deduction has typically been reinstated. The deduction pertains to expenses for physical cleanup, legal fees, consultants and the like.

Credit for Energy-Efficient Home Construction

Although it expired in 2011, this credit has a history of reinstatement. A $1,000 or $2,000 credit per home (depending on the level of energy efficiency) is provided to the builder/manufacturer. Specific criteria pertain to heating and cooling systems as well as the building envelope.

Credits for Home Residence Energy Property

A series of small home energy credits expired in 2011. Reinstatement for 2012 is possible. The credits range from $50 to $300 for certain windows, fans, water heaters, insulation and exterior doors. The lifetime limit of such credits is $500.

Major tax increases will start in 2012 without new legislation. Attention to the financial press and assistance from a competent tax accountant or tax attorney are advised.

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THE TAKEAWAY

Without new legislation, taxes for almost everyone will rise. Most tax increases are scheduled to begin in 2013 while a few will take effect in 2012. A number of these increases directly or indirectly affect the real estate industry.

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About the Real Estate Center

The Real Estate Center at Texas A&M University is the nation's largest publicly funded organization devoted to real estate research. The Center was created by the Texas Legislature in 1971 to conduct research on real estate topics to meet the needs of the real estate industry, instructors and the public.

Most of the Center's funding comes from real estate license fees paid by more than 135,000 professionals. A nine-member advisory committee appointed by the governor provides research guidance and approves the budget and plan of work.

Learn more at www.recenter.tamu.edu

triple play

hired

DR. LUIS TORRES

Dr. Luis Torres has joined the Center staff as an associate research scientist. Dr. Torres comes to the Center from Banco de Mexico where he was an economist and communications analyst. He is an author, lecturer and researcher who has extensively studied the Mexican regional economy and U.S.- Mexico issues.

Dr. Torres received a master of economics in 2006 and a Ph.D. in economics from the University of Colorado in 2011.

Born in California, he has a master of science degree from the University of Texas at El Paso (2002). He received a bachelor of arts degree in economics from the Instituto Tecnologico de Estudios Superiores in Monterrey, Mexico (1995).

The new Center researcher is fluent in written and spoken English and Spanish.

To read more on Dr. Torres, go to:
http://recenter.tamu.edu/staff/ltorres

honored

GARY MALER

Gary Maler, Real Estate Center director, is one of nine 2012 Outstanding Alumni for the College of Architecture at Texas A&M University. Maler received a master of architecture degree in 1974. He lifted the Real Estate Center to global prominence after a private-sector career spearheading some of Houston's most notable developments.

"Under his leadership, the Center has become one of the most highly respected and trusted sources of research and information that is heavily relied on by members of the legislature, the governor's office, state agencies and the business community," said Susan Combs, Texas comptroller of public accounts.

More on Maler's award can be found at
http://recenter.tamu.edu/news/pdf/NewsRel27-0812.pdf

published

DR. CHARLES GILLILAND

A book by Dr. Charles Gilliland — *Buying Rural Land in Texas* — will be released by the Texas A&M University Press this month. In it, Dr. Gilliland demonstrates that buyers can and should arm themselves with knowledge of the land-buying process, potential problems and available resources.

Dr. Gilliland has been with the Center since 1977. He is a clinical professor of finance, research economist and the Helen and O.N. Mitchell Fellow for the Mays Business School. He is a recognized authority on property taxation and appraisal, but it is his rural land expertise that he called on to complete his latest major undertaking.

Buying Rural Land in Texas is $25 and is available from the Texas A&M University Press Consortium at http://www.tamupress.com

See more on Dr. Gilliland at
http://recenter.tamu.edu/staff/cgilliland

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