A Reprint from *Tierra Grande*

Two major legislative acts passed in 2010 contain tax implications for individuals. Some provisions extend the Bush-era tax cuts until 2013 when tax rates will rise to pre-Bush era levels. Other rules introduce new taxes that take effect in 2013.

Here is a review of tax changes most relevant to our readers. There may be further changes to the tax law in December 2011 or during 2012 based on August 2011 legislation.

Tax Rates

Vigorously debated changes concern tax rates for all individuals, especially those earning above $200,000. For 2011 and 2012, the tax bracket rates for 2010 and earlier years (10, 15, 25, 28, 33 and 35 percent) remain intact.

In 2013, the rates become 15, 28, 31, 36 and 39.6 percent. Thus, the increase will affect all taxpayers.

In 2013, payroll taxes will increase by 0.9 percentage points for singles earning more than $200,000 salary and married couples earning more than $250,000 salary. The same is true for self-employed individuals (which include most brokers and sales associates) earning over $200,000/$250,000.

'Unearned Income' Taxes

Starting in 2013, a 3.8 percent surtax will apply to unearned income of high-income taxpayers earning more than the $200,000/$250,000 threshold. "Unearned income" generally includes income from investments, such as capital gains, interest, dividends, "passive activity" rents (for example, the passive rental of farm land), royalties and some annuities.

The following *are not* considered unearned income: "active business rents" such as apartment and commercial building rents; municipal bond interest; and qualified retirement income from qualified pensions such as 401(k) plans, certain annuities and IRAs.

The top capital gains and dividends tax rate in 2013 will be 20 percent, up from 15 percent. This change will affect the majority of investors.

The combination of the unearned income surtax and the tax increase for capital gains and dividends will be particularly felt by high-income individuals and couples. For example, a married couple with $250,000 earned income and $100,000 capital gains will pay $23,800 tax ($100,000 × [20 percent + 3.8 percent]) on their capital gains rather than $15,000 ($100,000 × 15 percent), an increase of $8,800, or 8.8 percent from what they would owe under current tax law.

Itemized Deduction Phaseout

Beginning in 2013, taxpayers will have to reduce most itemized deductions (mortgage interest, real estate taxes, charitable contributions and miscellaneous itemized deductions) by 3 percent of the excess of adjusted gross income (AGI) over a threshold amount. The 3 percent rate represents an upward adjustment of the current 1 percent rate. For example, $169,550 is the threshold amount in 2011. Taxpayers could lose up to 80 percent of their itemized deductions.

Assume a married couple has $250,000 AGI and $30,000 itemized deductions subject to phaseout. Because their AGI exceeds the threshold amount by $80,450 ($250,000 minus $169,550 threshold), their itemized deductions would decrease by $2,414 (3 percent × $80,450), costing them an additional $869 ($2,414 × 36 percent).

Exemptions Phaseout

Also in 2013, the total amount of personal and dependency exemptions is subject to phaseout. The total will be reduced by 2 percentage points for each $2,500 by which AGI exceeds a threshold amount. If this phaseout existed in 2011, the threshold amount would be $169,550 for singles and $254,350 for married couples.

Let's say a married couple has $350,000 AGI and four personal dependency exemptions totaling $14,800 (4 × $3,700). Their exemptions would be reduced by $11,544. The reduction is calculated as follows: ($350,000 minus $254,350 threshold) ÷ $2,500 = 39 (rounded up). Then, 39 × 2 percentage points = 78 percent and 78 percent × $14,800 = $11,544. The tax cost of this reduction would be $4,571 ($11,544 × 39.6 percent).

The 2010 tax changes are complex and affect other areas of taxation as well. Consultation with a tax accountant or tax attorney is recommended.

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THE TAKEAWAY

Taxes for individuals, particularly high-income individuals and investors, are scheduled to rise in 2013. Areas affected include tax bracket rates, payroll and self-employment tax rates, capital gains, dividends, itemized deductions, and personal and dependency exemptions.

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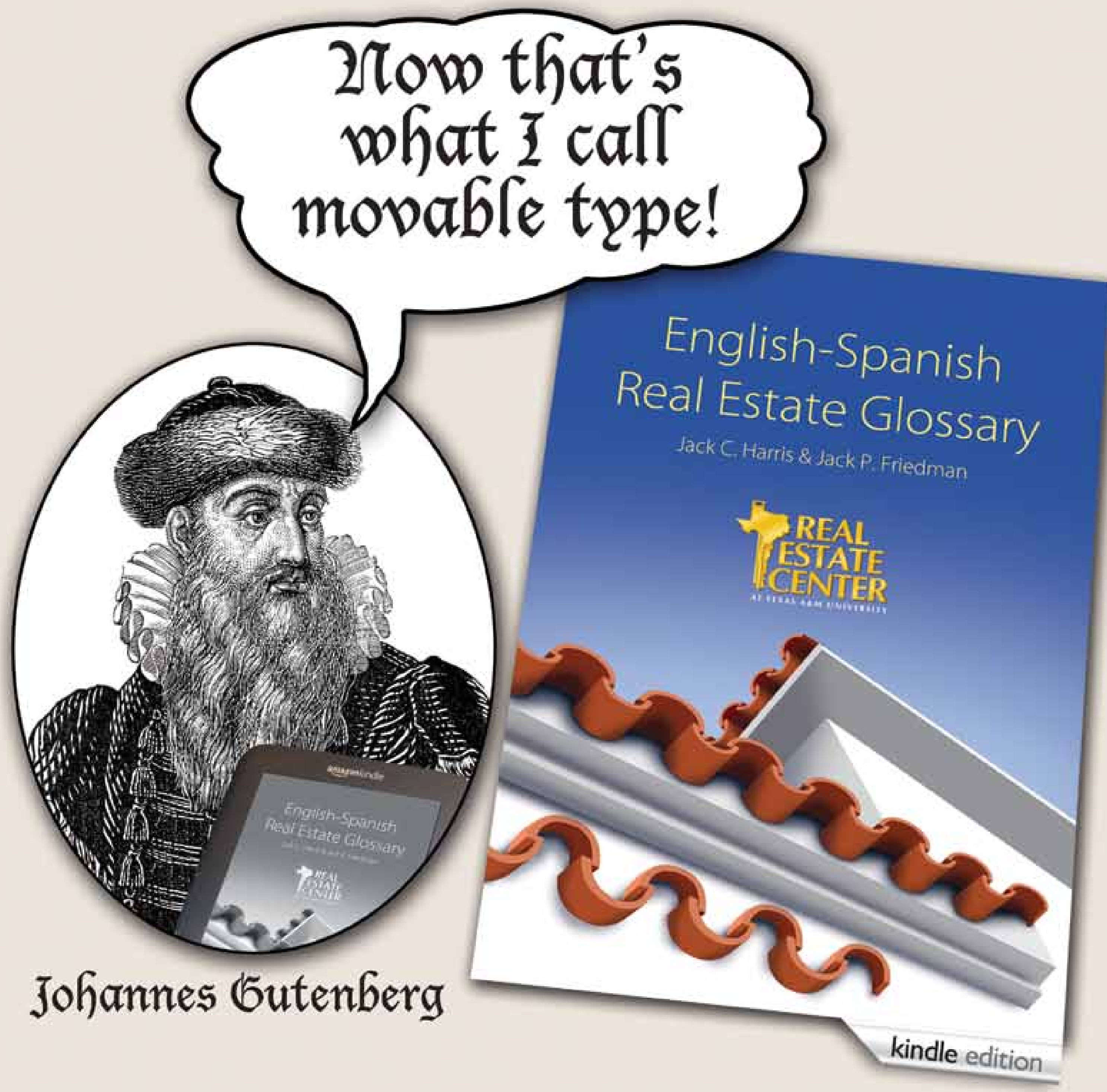
Tierra Grande (ISSN 1070-0234) is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115. Subscriptions are free to Texas real estate licensees. Other subscribers, $20 per year. Views expressed are those of the authors and do not imply endorsement by the Real Estate Center, Mays Business School or Texas A&M University. The Texas A&M University System serves people of all ages, regardless of socioeconomic level, race, color, sex, religion, disability or national origin.



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