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1031 exchanges offer full deferral of the new 3.8 percent Medicare surtax tax and 20 percent capital gain tax

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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. Capital gain taxes have increased significantly for high earners, and many other investors face an additional 3.8% surtax on passive investment income like capital gains. Fortunately, section 1031 of the Internal Revenue Code, a provision which has been around since 1921, provides critically needed tax relief.

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

There are four ways investors may be taxed on the sale of an investment property :

1) Depreciation Recapture: Taxpayers are taxed at a rate of 25% on all depreciation recapture.

2) Federal Capital Gain Taxes: On the remaining economic gain, investors and married couples exceeding the $400,000 / $450,000 income thresholds will be subject to the new 20% capital gain tax rate. The 15% tax rate remains for investors below these threshold income amounts.

3) New "Obamacare" Medicare Surtax: The Health Care and Education Reconciliation Act of 2010 added a new 3.8% Medicare Surtax on "net investment income." It applies to individuals earning over $200,000 and married couples filing jointly earning over for $250,000. "Net investment income" includes interest, dividends, capital gains, retirement income and income from partnerships.

4) State Taxes: Taxpayers must pay applicable state taxes, 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.

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." [Â§1.1411-5(C)(i)(2)(ii)]. Taxpayers may rely on these proposed regulations to be in compliance with Section 1411 until the effective date of the final regulations.

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. An exchange provides a fantastic opportunity for investment property owners to defer all capital gain taxes that would otherwise be owed.

This information is not intended to replace qualified legal and/or tax advisors. Every taxpayer should review their specific transaction with their own legal and/or tax counsel. 2013 Asset Preservation,

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