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ALERT

CAPITAL GAINS AND DIVIDEND INCOME TAX RATES SCHEDULED TO INCREASE IN 2013: ADDED IMPACT OF NEW MEDICARE CONTRIBUTION TAX

Unless Congress can act decisively before the end of this year, the marginal federal income tax rates will increase for taxable years beginning on or after January 1, 2013. While the House and Senate had passed separate versions of extensions of the current tax rates through the end of 2013 to give the Congress some added time to resolve tax rates as well as other tax provisions, such actions have failed. It therefore is uncertain whether the extenders will be enacted into law or whether the Obama Administration will be able to work out a year end resolution of the "fiscal tax cliff," which includes, of course, the scheduled rate increases. If no progress is made before year end, then we are in for a significant tax increase on net investment income, including capital gains.

This Fox Rothschild Alert focuses on three income tax rate increases generally affecting individuals as well as estates and trusts. There are other significant impacts resulting from the expiration of the Bush tax cuts, and other tax legislation that has been enacted in the past few years. As an illustration, we have previously sent out Fox Rothschild Alerts (June 2012 and September 2012) on the substantial increase in federal gift, estate and generation skipping tax after 2012 and substantial reduction in the current $5 million exemption amounts to $1 million. There are also other important provisions in the tax code that are due to expire at the end of this year. It is also reasonable to expect a major tax bill to be enacted by Congress this year.

Increase in Maximum Marginal Rates on Ordinary Income and Capital Gains

Although previously extended by Congress from expiring in 2010 for an additional two years, the 2001 Bush tax rate cuts will expire on December 31, 2012. On January 1, the top individual marginal income tax rate will increase from 35 percent to 39.6 percent and the 10 percent tax bracket will be eliminated. The maximum marginal tax rate on long term capital gains will increase from 15 percent to 20 percent (with "qualified 5 year (capital) gain" at an 18 percent/8 percent rate structure). Corresponding rate increases of 5 percentage points will apply for 25 percent taxable gains (e.g., recapture of straight line depreciation) and 28 percent taxable gains (e.g., gain from the sale of collectibles). Another important item is the increase in the rate of tax from 15 percent to as much as 39.6 percent for dividend income with respect to "qualified dividend income" received from domestic and qualified foreign corporations.

The significant increase in capital gains rates and taxes on dividend income have already resulted in taxpayers attempting to realize gains or accelerating the receipt of dividends from closely held corporations before the end of this year. If the rates do increase, i.e., Congress does not resolve the fiscal tax cliff in a manner that reduces or eliminates the anticipated tax rate hikes, then the new tax rates will certainly have a widespread and dramatic effect on future tax planning for all taxpayers, including closely held businesses and investors. For example, many owners of appreciated real property may prefer to engage in tax-free exchanges instead of having a preference for cash sales.

From a merger and acquisition standpoint, privately owned companies looking to sell out may want to either postpone the sale of its business or consider being acquired in a tax-free reorganization or perhaps engage in a joint venture, which could be partially taxed to the extent cash is received. With higher rates also brings along a greater tax benefit from depreciation and other tax deductions, including tax credits. The change in rate structure may also affect the preferred entity form for many businesses particularly if the much talked about

reduction in the corporate income tax rate occurs. There could be a wide disparity then in the rate of tax a regular or C corporation pays instead of a flow through entity used by individuals in operating a closely held business or professional service organization causing the entity owners to reassess the best tax form for doing business.

Social Security Taxes, Medicare Tax and Self-Employment Taxes: Increase in Medicare Tax in 2013

Prior to the enactment of the recent healthcare legislation, social security benefits and certain Medicare benefits were primarily funded by payroll taxes on "covered" wages as well as self-employment taxes. As to the former, FICA imposes tax on employers based on the amount of wages paid to an employee during the year. The tax imposed is composed of two parts: (1) the OASDI tax equal to 6.2 percent of covered wages up to the taxable wage base ($110,100 for 2012), which generally increases annual in small increments; and (2) the Medicare hospital insurance (HI) tax amount equal to 1.45 percent of covered wages. In addition to the tax on employers, each employee is subject to social security taxes equal to the amount of tax imposed on the employer. The employee level tax generally must be withheld and remitted to the Federal government by the employer.

As a parallel to social security taxes on covered wages, the self-employment tax imposes taxes on the net income from self employment of self employed individuals. The rate of the self-employment taxes is equal to the combined employee-employer taxes on social security taxes up to the FICA taxable wage base. Similarly, the rate of the HI portion is the same as the combined employer and employee HI rates and there is no cap on the amount of self employment income to which the rate applies. For purposes of computing net earnings from self employment, taxpayers are permitted a deduction equal to the product of the taxpayer's earnings (determined without regard to this deduction) and one-half of the sum of the rates for combined social security taxes (12.4 percent) and HI tax (2.9 percent), i.e., 7.65 percent of net earnings. This deduction reflects the fact that the social security taxes on an employee's wages, do not include FICA taxes paid by the employer, whereas the self-employed individual's net earnings are economically equivalent to an employee's wages plus the employer share of FICA taxes.

The 2010 Health Care Act increases the employee portion of the HI tax after 2012 by an additional tax of 0.9 percent on wages received in excess of the applicable "threshold amount" to 3.8 percent. This added HI tax applies to net earnings from self-employment and wages in excess of $250,000 (per year) for taxpayers filing a joint return, $125,000 for married individuals filing separate returns and more than $200,000 for other taxpayers.

The New Medicare Contribution Tax of 3.8 percent on Net Investment Income

The New Medicare Contribution Tax, which was enacted in 2010 as part of The Health Care and Education Reconciliation Act of 2010, P.L. No. 111-152, effect on January 1, 2013. It closes the gap between Federal social security taxes imposed on "wages" or "self employment income" and investment income, which, of course, is not subject to social security tax. For the first time Congress imposes an income tax on investment income for funding Medicare. This new tax of 3.8 percent on net investment income from passive activities, contained in new Section 1411 of the Internal Revenue Code, and applies to individuals, trusts and estates. It also applies to income passed through to partners, members of a limited liability company or shareholders in an S corporation. The new tax does not apply to non-resident aliens or corporations subject to federal income tax.

For individuals, the New Medicare Contribution Tax, which is applied at a flat rate of 3.8 percent, and is imposed as an add-on to a taxpayer's overall federal income tax liability, is imposed on the lesser of: (i) the taxpayer's excess of modified adjusted gross income over a "threshold amount", or (ii) such taxpayer's net investment income.

For trusts and estates, the tax applies to the lesser of: (i) the excess of adjusted gross income over the amount where the highest income tax bracket begins ($11,650 in 2012); or (ii) "undistributed net investment income." It is important to note that the "threshold amount" for married individuals filing joint returns is $250,000 ($125,000 for married couples filing separate returns) or $200,000 for other taxpayers. This "threshold amount" does not apply to (non-grantor) trusts and estates.

The term "net investment income" includes gross income from interest, dividends, annuities, royalties, and rents other than such income that is derived in the ordinary course of a trade or business. It follows that interest, dividends, annuities, royalties, and rents which pass through a partnership, LLC or S corporation to its partners, members or shareholders, will retain their character as net investment income and will be subject to the new 3.8 percent Medicare tax.

Additionally, the definition of net investment includes: (1) any other gross income derived from a trade or business if such trade or business is a "passive activity" with respect to the taxpayer within the meaning of the passive activity loss rules; and (2) any net gain (to the extent taken into account in computing taxable income) attributable to the taxable sale or disposition of property other than property held in a trade or business that is not a passive activity as to the taxpayer. The definition of net investment income, as mentioned, includes

"interest, dividends, annuities, royalties and rents", etc., but such items are not taken into account if "derived in the ordinary course of a trade or business," as long as that trade or business (i) does not constitute a passive activity with respect to the taxpayer, and (ii) does not constitute "trading in financial instruments or commodities."

Net investment income does not include any distribution from a qualified retirement plan or individual retirement account. Net investment income further does not include income that is taken into account in determining self-employment income eliminating the prospect of being double-taxed under both tax provisions.

Where an individual is actively engaged in a trade or business, then such individual's profits or share of profits from such trade or business will generally not be included in "net investment income" for purposes of the 3.8 percent New Medicare Tax. Whether an individual is "active" or "passive" in a particular economic activity is determined annually in accordance with Section 469 of the Internal Revenue Code and applicable regulations. Generally, under Section 469 trade or business activities that are not rental activities or working interests in oil and gas properties are treated as passive activities unless the taxpayer materially participates in the activity. A taxpayer is not treated as materially participating in an activity unless his involvement in the operations of the activity is regular, continuous, and substantial.

The current regulations under section 469 provide that a taxpayer materially participates, and therefore is not "passive", in an activity if he or she can prove meeting one of seven applicable tests set forth in the regulations. See Treas. Reg. §1.469-5T(a). Moreover, the regulations contain an election whereby a taxpayer can "aggregate" his or her involvement in more than one business activity in order to satisfy the "active" participation requirement. The passive activity loss rules are also important in determining whether losses from a particular activity can only be used against passive income. What makes sense to a particular individual can only be determined by examining such individual's tax profile both for prior years, the current year and as further projected into the future.

Impact of Tax Rate Hikes and New Medicare Contribution Tax

The remaining weeks to 2012 will determine whether Congress will act now to extend otherwise expiring tax benefits, including the employee 2 percent payroll tax reduction, and possibly reduce expected tax rate hikes on ordinary income and capital gains. Perhaps the imposition of the New Medicare Contribution Tax of 3.8 percent is less likely to be reduced or eliminated inasmuch as the Supreme Court upheld its constitutionality and President Obama having won re-election. As with prior major changes in tax rates, taxpayers and their advisors need to address the potential impacts.

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