Fox Rothschild LLP
ATTORNEYS AT LAW

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TAXATION & WEALTH PLANNING

ALERT

CONGRESS AND PRESIDENT OBAMA SIGN INTO LAW THE AMERICAN TAXPAYER RELIEF ACT OF 2012: ADDED IMPACT OF THE NEW MEDICARE CONTRIBUTION TAX

Last November, Fox Rothschild issued a Taxation and Wealth Planning Department Alert informing you of the pending fiscal tax cliff that required Congress to act decisively to provide relief from the harsh income tax effects that would otherwise go into place on January 1, 2013, attributable to the phase out of the Bush Administration's tax cuts under The Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16, 6/17/01; EGTRRA or the 2001 Act). The EGTRRA reforms were extended in 2010 and were due to expire at the end of 2012, at which time the law prior to EGTRRA would return, yielding higher income and wealth transfer taxes.

Were We Going Over the "Fiscal Tax Cliff": Planning in Case of the Fall

Going over the "fiscal tax cliff", i.e., triggered by Congress' failure to act to either extend EGTRRA once again or arrive at a permanent and more favorable solution, would significantly increase marginal rates of federal income tax for individuals at all income levels. For high-income individuals, the highest marginal income tax rate increases to 39.6 percent from 35 percent Dividend income would also increase to as much as 39.6 from 15 percent for years ending prior to 2013 (but after 2001). Capital (long term) gains would also increase for high-income taxpayers from 15 percent to 20 percent. There were other business tax incentives in the form of accelerated expensing and cost recovery allowances as well as certain tax credits for research and development costs and "new markets tax credits" and similar credit provisions, which wither away and die unless Congress acted to extend such incentives. On the transfer tax (wealth tax) side, Fox Rothschild Alerts were issued last Summer and Fall (June 2012 and September 2012 respectively) informing you of the pending fiscal tax cliff and the potential for a substantial increase in federal gift, estate and generating skipping tax for transfers made or decedents dying after 2012. There would also be an accompanying reduction in the $5 million (per individual) exemption for federal transfer taxes to $1 million. We were all waiting each day to see what news there was from Washington on this critical tax (and spending) matters.

Congress Avoids the Fiscal Tax Cliff (It Was Only a Few Hours Late in So Acting)

On January 1, the Senate, by a vote of 89-8, passed H.R. 8, the "American Taxpayer Relief Act of 2012" (ATRA). ATRA was then rushed to the House of Representatives, which passed the bill by a more partisan vote of 257 to 167. On January 2nd, President Obama signed the bill into law. ATRA avoids the return to higher income tax rates for nearly all individuals based on the tax rates in effect prior to passage of The Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16, 6/7/01; EGTRRA or the 2001 Act). Dividends and capital gains will be taxed at a maximum rate of 20 percent. ATRA further retains many favorable tax incentives that were due to expire at the end of 2012. ATRA will, however, increase income tax rates for high-income individuals. It will also increase the transfer tax rates but retain the existing exemption equivalent amount in effect during 2012.

ATRA Increases the Maximum Marginal Rates on Ordinary Income, Capital Gains and Dividend Income of High-Income Taxpayers

Although previously extended by Congress from expiring in 2010 for an additional two years, the 2001 Bush income tax rates expired on December 31, 2012. Under ATRA, for tax years beginning after 2012, the income tax rates for most individuals will remain at 10 percent, 15 percent, 25 percent, 28 percent, 33 percent and 35 percent instead of increasing to 15

percent, 28 percent, 31 percent, 36 percent and 39.6 percent as would have occurred if Congress failed to act. Under ATRA, the highest marginal income tax rate increases to 39.6 percent from 35 percent but only for certain high-income individuals, those having taxable income in excess of $400,000 per year ($450,000 for joint filers and $425,000 for heads of household). Dividends and capital gains (long term) will increase from a maximum marginal rate of 15 percent to 20 percent but again, only for high-income individuals. Certain rates of tax on gains from recapture of straight-line depreciation will remain at 25 percent as will gain from the taxable disposition of collectibles at 28 percent.

Congress also provides permanent relief from the harsh effects some taxpayers had suffered under the alternative minimum tax rules. Retroactive to tax years commencing after 2011, ATRA permanently increases the AMT exemption amounts for individuals based on filing category and further indexes the exemption amounts for inflation. ATRA also permanently allows an individual to offset her regular tax liability as well her AMT liability by certain nonrefundable personal credits.

The higher income tax rates on high income individuals from ordinary income, including interest and income from rents, as well as capital gains and dividends, may become a more significant factor in structuring the sale of a closely held business or the merger and acquisition between two companies. Thus, a privately owned company thinking of selling out at a favorable "net-after tax" price will have to reset its "net-after-tax" negotiating position. Consideration must also be given to passive income generated both as to income from operations or from the sale of the business or ownership interest where the business is conducted as a partnership, limited liability company or Subchapter S corporation. Again, as discussed below, the Medicare Contribution Tax of 3.8 percent is added onto the applicable marginal federal income tax rate. This can increase the marginal income tax rate to as high as 43.4 percent and 23.8 percent on dividends and capital gain. As also mentioned in our November 2012 Alert, the change in rate structure may also affect the preferred entity form for many businesses to engage in particularly if the much talked about reduction in the corporate income tax rate eventually occurs. If the C corporation income tax rates were to be significantly reduced, there eventually could be a wide disparity between the highest rate of tax on a regular or C corporation in contrast with the higher individual rates on businesses conducted through S corporations or partnerships.

Extenders: Continuation of Certain Business Tax Incentives

ATRA extended parts of the credits and other tax incentives contained in the American Recovery and Investment Tax Act of 2009 which were due to expire at the end of 2012. The legislation also continues some personal tax provisions which were also due to expire including special rules for contributions of capital gain real property made for conservation purposes, the option to deduct state and local general sales taxes, and the exclusion for cancellation of debt income from qualified personal residences. ATRA extended the American Opportunity tax credit, which permits eligible taxpayers to claim a credit equal to 100 percent of the first $2,000 of qualified tuition and related expenses, and 25 percent of the next $2,000 of qualified tuition and related expenses (for a maximum tax credit of $2,500 for the first four years of post-secondary education); There are also depreciation provisions for accelerated expensing and cost recovery allowances over shorter periods for certain eligible property that were extend by ATRA through 2014. These business extenders generally are effectively through 2013 or 2014 and are not permanent.

Permanent Retention of Federal Transfer Tax.

ATRA permanently retains the federal estate tax (and generation skipping transfer tax) at a maximum rate of 40 percent. The federal gift tax is also retained as part of the unified gift-estate tax system that is a long-standing feature of the federal transfer tax. The exemption amount will remain at $5 million per individual for lifetime taxable gifts and testamentary transfers for estates of decedents dying after December 31, 2012. ATRA also makes permanent the "portability" among spouses of any unused exemption amount of the first spouse to die provided an appropriate election is made. ATRA also extends the estate tax deduction for state estate taxes. The generation skipping tax provisions remain in effect and related provisions and technical rules under the GST which were due to expire are permanently retained.

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 rule 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." It is obvious that many capital gains and dividend income, as well as the pass through of passive types of income to investors in a pass through entity, will be subject to the 3.8 percent tax. Note that the threshold amounts for the 3.8 percent. Medicare tax is set at $250,000, etc., which is considerably lower than the threshold level for the increased income and capital gains taxes.

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 passive activity loss rules in 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.

As with prior major changes in tax rates, taxpayers and their advisers need to address the potential impacts. If you have questions regarding this Alert, please contact Fox Rothschild's Taxation and Wealth Planning Department Co-chairs Jerald David August at 215.299.2883, 561.804.4401 or jaugust@foxrothschild.com or Michael C. McBratnie at 610.458.4946 or mmcbratnie@foxrothschild.com.