Polsinelli Shughart

TAX & BUSINESS PLANNING

IN THE NEWS

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Tax Increases Coming On Heels of Supreme Court Decision Upholding Health Reform Law

A Polsinelli Shughart Update

New Federal Tax Increases

The highly anticipated Supreme Court decision of *National Federation of Independent Business v. Sebelius*, Sup. Ct. Dkt. No. 11-393 (U.S. 6/28/12) upheld the constitutionality of the Patient Protection and Affordable Care Act (Health Care Act) requirement to maintain minimum healthcare coverage. The Supreme Court held that the "individual mandate" provisions of the Health Care Act are within Congress's power to tax under Article 1 of the Constitution. Although the individual mandate requiring those without insurance to obtain it or pay a tax begins in 2014, many provisions of the Health Care Act have already been implemented and there are some important tax provisions that come into effect beginning January 1, 2013.

Payroll Tax Increase

Beginning in 2013, a 0.9 percent payroll tax increase will be imposed on wages and self-employment income in excess of $250,000 for individuals married filing jointly, $125,000 for individuals married filing separately, and $200,000 for single and head of household. It is important to note that the above-mentioned threshold amounts are not currently indexed for inflation, which broadens the scope of affected taxpayers in the future. The tax increase works by increasing the 1.45 percent Medicare tax employees pay on their wage and self-employment income to 2.35 percent above these threshold amounts. Although the tax increase will not apply to the employer portion, employers do have a withholding obligation and could be liable for the tax if they fail to withhold the required tax from employees whose wages are over the threshold amounts.

With respect to married filing joint returns, the payroll tax increase is on the combined wages of the employee and the employee's spouse. In the case where both spouses receive wage income, there is a potential withholding issue that may surprise married taxpayers when they file their returns. Employers are only required to withhold the tax only on wages in excess of $200,000 of the employee, and they are not required to take wages received by a spouse into consideration. Therefore, in the case where both spouses receive wage income, there is potential that the full 0.9 percent tax increase will not be withheld, resulting in the under-withheld amount to be reported when the couple files their tax return. In addition, under withholding could occur when an employee switches employers during a tax year and the combined wages are over the threshold. Accordingly, taxpayers may want to increase their withholdings through their employer or make additional quarterly estimated payments to avoid potential penalties.

Example:

Assume that Kathy has wage income of $325,000 and her husband John has wage income of $190,000. Kathy's employer is required to withhold the new 0.9 percent wage surtax from her income in excess of $200,000 or $1,125 (($325,000-$200,000)*0.9 percent). However, since John's income is less than the threshold amount, his employer has no withholding obligation. When John and Kathy file their joint return, the wage surtax will be $2,385 (($325,000+$190,000-$250,000)*0.9 percent) resulting in a withholding shortfall of $1,260.

Investment Income Surtax

Also beginning in 2013, a new 3.8 percent Medicare investment income surtax will be imposed on individuals whose net investment income exceeds certain modified adjusted gross income levels. There are three main components to this tax:

1. Net Investment Income. This is the sum of Investment Income over allocable investment expenses. Investment Income generally includes interest, dividends, annuities, royalties, rents, capital gains, and other passive activity income. However, tax-exempt interest income is excluded from Investment Income. Gain from the disposition of an interest in a partnership (including a limited liability company taxed as a partnership) or S corporation is included only to the extent gain is attributable to nonbusiness property (gain attributable to an active trade or business, in which the taxpayer actively participated is not taken into account for this investment income surtax). Gains from the sale of personal residences may also be included in the investment income definition to the extent the home sale exclusion does not apply (i.e. the surtax does not affect with the current tax-free exclusion on the first $500,000, for joint filers, or $250,000, for single

filers, of gain on the sale of your primary residences); however, sales of vacation homes, rental real estate, and other capital assets may be subject to the surtax.

2. Modified Adjusted Gross Income (MAGI). Modified Adjusted Gross Income for purposes of the surtax is the sum of the adjusted gross income (from page 1 of IRS Form 1040) plus the net foreign income exclusion amount. Note that since the surtax is based on MAGI, it is determined on income before many tax deductions are considered.

3. Threshold Amount. The threshold amount is the same as the threshold for the wage surtax discussed above (i.e. $250,000 for individuals married filing jointly, $125,000 for individuals married filing separately, and $200,000 for single and head of household individuals).

The investment income surtax will be imposed on the lesser of (A) the net Investment Income or (B) the excess of Modified Adjusted Gross Income over the Threshold Amount.

Example:

Kathy and John's MAGI is $600,000 and they have $85,000 of net investment income in 2013. Accordingly the investment income surtax is $3,230 which is the lesser of:

(A) $3,230 (3.8 percent * $85,000) or
(B) $13,300 (($600,000 - $250,000)*3.8 percent)

As you can determine from the above example, taxpayers generating capital gains could face a significant higher tax cost in 2013 verses 2012. Moreover, unless there is Congressional action, the capital gains tax rate is scheduled to increase from 15 percent to 20 percent in 2013, so the total tax on capital gains (including the surtax) could be 23.8 percent in 2013 and beyond for high income taxpayers.

Trusts and Estates

The investment income surtax also affects trusts and estates, but the calculation works a little differently. For trusts and estates, the 3.8 percent tax will be imposed on the lesser of (A) the undistributed net investment income for the year; or, (B) the excess, if any of: (i.) the adjusted gross income for the year, over (ii.) the dollar amount at which the highest tax bracket in Code Section 1(e) begins for the year ($11,650 in 2012). Because of the low threshold for trusts, trustees may want to plan for distributions to beneficiaries, which carry out net investment income, to avoid the 3.8 percent surtax if the beneficiary's income is below the threshold amounts for individuals.

Increased Threshold for Deducting Medical Expenses

In addition to the above-mentioned tax increases effective January 1, 2013, the Health Care Act increases the threshold for deducting medical expenses on the federal income tax return from 7.5% of adjusted gross income (AGI) to 10 percent of AGI. However, for any taxpayer who is 65 or older the threshold remains 7.5 percent until 2017.

Planning Opportunities

If your income is above the threshold amounts, there may be planning opportunities to minimize the wage and investment income tax increases. These planning opportunities include:

1) Utilizing S corporations where appropriate to reduce self-employment income;
2) Accelerating capital gains to 2012 to take advantage of lower rates and to reduce investment income and MAGI in later years;
3) Deferring capital loss to 2013 and later years to reduce MAGI in later years;
4) Changing investment strategies to produce more tax-exempt income or less dividend income;
5) Roth IRA conversions (required minimum distributions from a traditional IRA are exempt from the 3.8 percent surtax; but, they increase MAGI);
6) Exercising stock options in 2012 verses later years;
7) Increase estimated payments or withholdings to avoid potential penalties; and
8) Making trust distributions to beneficiaries.

We recommend that you contact a Polsinelli Shughart tax attorney or your current tax advisor well in advance of end of the year so your particular facts and circumstances may be reviewed in order to assist you evaluating the potential impact of these new tax law changes.

For More Information

If you would like to discuss any of the items covered in this e-Alert, or discuss other matters, please contact one of the members of the Tax & Business Planning group listed below:

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About our

Tax and Business Planning Group

The Tax and Business Planning practice group provides these e-Alerts periodically to keep our clients, taxpayers and businesses updated on recently adopted legislation and key changes in tax laws. We intend to provide these alerts to you as new developments warrant. This Tax Alert focuses on a variety of issues impacting businesses and individuals at the federal and state level. If you have questions about any of the information contained in this e-Alert, please contact your legal or tax advisor or a member of the Polsinelli Shughart PC Tax & Business Planning practice group at 1-800-473-6014.

All companies, organizations and individuals can expect to encounter issues in the tax arena. The Tax Group of Polsinelli Shughart PC provides creative solutions and legal guidance on international, federal, state and local tax laws to entities in all major industries and tax status classifications. Our attorneys partner with our clients to develop business solutions for both short-term and long-term planning. The Tax Group's strong reputation is built on its skills in sound and effective planning, in-depth analysis and favorable resolutions and outcomes, particularly in complex tax matters involving diverse businesses. Our attorneys pride themselves on innovative thinking and expertise in structuring business formation, combinations, reorganizations, mergers and acquisitions, and liquidations in the most tax-advantageous manner.

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About

Polsinelli Shughart

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