

2013 FEDERAL TAX RATE UPDATE

Federal/International Tax Alert
January 4, 2013

After months of fiscal cliff negotiations, Congress finally reached an agreement to address the tax rate increases that were scheduled to take effect automatically on January 1, 2013. The American Taxpayer Relief Act (H.R. 8) was signed by President Obama on January 2 and applies as of January 1, 2013. It includes the following major tax provisions, which will significantly affect the amount of tax paid by higher-income taxpayers:

- **Top Individual Tax Rate.** The top federal income tax rate increases from 35 percent to 39.6 percent for individuals making more than \$400,000 per year (\$450,000 for joint filers; \$425,000 for heads of household). However, due to the application of the new 3.8 percent Medicare tax on “net investment income,” discussed below, some taxpayers will actually pay a top tax rate of 43.4 percent!
- **Capital Gains and Dividends.** The top rate for capital gains and qualified dividends will permanently rise to 20 percent (up from 15 percent) for taxpayers with incomes exceeding \$400,000 (\$450,000 for joint filers). For taxpayers whose ordinary income is generally taxed at a rate below 25 percent, capital gains and dividends will permanently be subject to a 0 percent rate. Taxpayers who are subject to a 25 percent-or-greater rate on ordinary income, but whose income levels fall below the \$400,000/\$450,000 thresholds, will continue to be subject to a 15 percent rate on capital gains and dividends. Taxpayers should note that the 3.8 percent Medicare tax on net investment income will also generally apply to this category of income depending on the taxpayer’s income level.
- **Personal Exemption Phaseout (PEP) and Pease Limitation to Apply to “High-Earners.”** The PEP and Pease limitation on itemized deductions, which had previously been suspended, are reinstated for those making \$300,000 for joint filers; \$275,000 for heads of household; \$250,000 for single filers; and \$150,000 for married taxpayers filing separately. The provisions reduce the amount of exemptions and itemized deductions that can be claimed by taxpayers meeting the income thresholds.
- **Permanent AMT Relief.** The higher exemption amounts for alternative minimum tax (AMT)—the so-called patch—are made permanent, resulting in an estimated 30 million taxpayers escaping the AMT.
- **Estate, Gift, and GST Tax.** The estate, gift, and generation-skipping transfer (GST) tax exemption is made permanent at \$5,000,000 (indexed for inflation; the 2013 exemption is expected to be \$5.25 million), and the top estate, gift, and

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GST tax rate is also permanently increased from 35 percent to 40 percent. The portability feature that allows the estate of the first spouse to die to transfer his or her unused exclusion to the surviving spouse has been continued.

- **Payroll Tax Holiday Expires.** The temporary 2 percent reduction in payroll taxes enjoyed by most employees was allowed to expire without renewal.

In addition to the changes made by the American Taxpayer Relief Act, taxpayers are reminded that the new 3.8 percent Medicare contribution tax on net investment income and a 0.9 percent additional Medicare tax on wage and self-employment income went into effect on January 1, 2013, as summarized below:

- **3.8 Percent Medicare Contribution Tax.** This new tax affects individuals whose modified AGI exceeds \$250,000 for joint filers, \$200,000 for single taxpayers and heads of household, and \$125,000 for a married individuals filing separately (not indexed for inflation). It also applies to certain trusts and estates and at a much lower threshold. The 3.8 percent tax applies to the lesser of the taxpayer's (1) net investment income for the tax year or (2) the excess of modified AGI for the tax year over the threshold amount. This tax is in addition to the income tax that applies to that same income, resulting in a top federal tax rate of 43.4 percent on certain types of income. The net investment income that is subject to the 3.8 percent tax consists of interest, dividends, annuities, royalties, rents, and net gains from property sales. Income from an active trade or business isn't included in net investment income, nor is wage income, but passive business income is included.
- **Additional 0.9 Percent Medicare Tax on Wage and Self-Employment Income.** Some high wage earners will pay an extra 0.9 percent Medicare tax on a portion of their wage income, in addition to the 1.45 percent Medicare tax that all wage earners pay. The 0.9 percent tax applies to wages in excess of \$250,000 for joint filers; \$125,000 for a married individuals filing separately; and \$200,000 for all others. The 0.9 percent tax applies only to employees, not to employers. An extra 0.9 percent Medicare tax also applies to self-employment income for the tax year in excess of \$250,000 for joint filers, \$125,000 for married individuals filing separately, and \$200,000 for all others. This 0.9 percent tax is in addition to the regular 2.9 percent Medicare tax on all self-employment income. While self-employed individuals can claim half of their self-employment tax as an income tax deduction, the additional 0.9 percent tax is not deductible.

For more information about the tax provisions in the American Taxpayer Relief Act and the new Medicare taxes on net investment income and wages/self-employment income, please contact one of the following members of Hodgson Russ's Federal/International Tax Practice Group or Estates & Trusts Practice Group.