GODFREY & KAHN S.C.

Tax & Employee Benefits Focus

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2013 Federal Income Tax Update

This may be the final year that the so-called Bush tax cuts remain in effect, unless Congress acts to further extend them. The Bush tax cuts, enacted in 2001 and 2003, were originally scheduled to expire for tax years beginning in 2011. However, President Obama signed legislation in late 2010 that temporarily extended the Bush tax cuts through 2012.

Many commentators agree that Congress is unlikely to extend the Bush tax cuts prior to the November elections, but uncertainty remains as to whether Congress will take action following the elections. Provided that Congress fails to extend the Bush tax cuts, many significant rate changes and other substantive changes will take effect in 2013. This article summarizes the major federal income tax changes that are scheduled take effect in 2013 if Congress allows the Bush tax cuts to expire, certain other changes scheduled to take effect independent of the Bush tax cuts, and planning strategies to reduce the impact of these changes. If you or your company would like to discuss any of these scheduled changes or planning strategies, please contact any member of the Tax and Employee Benefits Team.

Individual Income Tax Rates

If Congress allows the Bush tax cuts to expire, ordinary income tax rates will increase for most individual taxpayers beginning in 2013. As discussed below, qualified dividend income that is currently taxed at long-term capital gain rates will be taxed at these higher ordinary income rates. The following table sets forth the scheduled rate increases, using 2012 dollar amounts which will be adjusted for inflation in 2013.

Tax Brackets (2012 Dollar Amounts)				Marginal Rate	
Unmarried Filers		Married Joint Filers			
Over	But Not Over	Over	But Not Over	2012	2013
$0	$8,700	$0	$17,400	10%	15%
8,700	35,350	17,400	70,700*	15%	15%
35,350	85,650	70,700*	142,700	25%	28%
85,650	178,650	142,700	217,450	28%	31%
178,650	388,350	217,450	388,350	33%	36%
388,350	...	388,350	...	35%	39.6%

* In 2013, this dollar amount will decrease to 167% of the amount for unmarried taxpayers in the same bracket (which is $58,900 in 2012), rather than 200% of the amount for unmarried taxpayers under current law. This change will have the effect of putting more middle-income joint filers in the 28% bracket and increasing the “marriage penalty” for many taxpayers.

Long-Term Capital Gain Rates

The maximum rate on long-term capital gain is scheduled to increase from 15 to 20 percent in 2013. Individual taxpayers in the 10 and 15 percent ordinary income tax brackets currently pay no tax on long-term capital gain. These taxpayers are scheduled to be subject to a 10 percent long-term capital gain rate in 2013. An 18 percent maximum rate will apply to capital assets purchased after 2000 and held for more than five years. Additionally, the 3.8 percent Medicare contribution tax discussed below will increase the effective rate of tax on long-term capital gains for certain higher-income taxpayers to as high as 23.8 percent. See the table below for the scheduled rate increases.

Maximum Rates	2012	2013	2013 (including Medicare contribution tax)
Long-Term Capital Gain	15%	20%	23.8%
Qualified 5-Year Capital Gain	15%	18%	21.8%

Planning Strategies. If Congress fails to take action as the year-end approaches, investors who were otherwise considering selling appreciated stocks or securities in early 2013 should give additional consideration to selling in 2012 to take advantage of the lower rate, assuming they will have held the asset for longer than one year. Additionally, business owners who are considering selling their business in the near future should consult with their tax adviser to discuss whether electing out of the installment method for an installment sale in 2012 would be more advantageous from a tax planning perspective.

Dividend Income Rates

The Bush tax cuts created the concept of "qualified dividend income," which currently allows dividends received from domestic corporations and certain foreign corporations to be taxed at the taxpayer's long-term capital gain rate. Additionally, qualified dividend income earned by mutual funds and exchange-traded funds may be distributed to shareholders and treated as qualified dividend income by the shareholder. Prior to the Bush tax cuts, all dividend income was taxed as ordinary income. If Congress fails to extend these provisions, the qualified dividend income provisions will expire, and all dividends will once again be taxed as ordinary income. Most notably, taxpayers in the highest marginal income tax bracket who currently enjoy the 15 percent rate on qualified dividend income will be taxed at 39.6 percent for dividends received from the same issuer in 2013. Additionally, the 3.8 percent Medicare contribution tax discussed below will increase the effective rate of tax on dividend income for certain higher-income taxpayers to as high as 43.4 percent. See the table below for the scheduled rate increases.

Maximum Rates	2012	2013	2013 (including Medicare contribution tax)
Qualified Dividend Income	15%	39.6%	43.4%
Ordinary Dividend Income	35%	39.6%	43.4%

Planning Strategies. Because of the impending increase to tax rates applicable to dividends, owners of closely held corporations should consider declaring and paying a larger-than-normal dividend this year if the corporation has sufficient earnings and profits. Owners should carefully plan any such distributions, as distributions in excess of the corporation's earnings and profits will reduce the shareholder's stock basis and subject the shareholder to increased long-term capital gain taxable at potentially higher rates when the shareholder subsequently disposes of the stock. Owners of closely held corporations should consult their tax adviser to discuss dividend planning and other strategies such as leveraged recapitalizations to take advantage of the low rate currently applicable to qualified dividend income.

New Medicare Contribution Tax

A new 3.8 percent Medicare contribution tax on certain unearned income of individuals, trusts, and estates is scheduled to take effect in 2013. This provision, which was enacted as part of the Patient Protection and Affordable Care Act (PPACA), is scheduled to take effect regardless of whether Congress extends the Bush tax cuts. For individuals, the 3.8 percent tax will be imposed on the lesser of the individual's net investment income or the amount by which the individual's modified adjusted gross income (AGI) exceeds certain thresholds ($250,000 for married individuals filing jointly or $200,000 for unmarried individuals). For purposes of this tax, investment income includes interest, dividends, income from trades or businesses that are passive activities or that trade in financial instruments and commodities, and net gains from the disposition of property held in a trade or business that is a passive activity or that trades in financial instruments and commodities. Investment income excludes distributions from qualified retirement plans and excludes any items that are taken into account for self-employment tax purposes.

Planning Strategies. Until the Department of Treasury issues clarifying regulations, uncertainty remains regarding which types of investment income will be subject to this new tax. Taxpayers whose modified AGI exceeds the thresholds described above should consult their tax adviser to plan for the imposition of this tax. Specifically, business owners should discuss with their tax adviser whether it would be more advantageous to become "active" in their business rather than "passive" for purposes of this tax. Owners of certain business entities such as partnerships and LLCs should also consider whether a potential change to "active" status in the business could trigger self-employment tax liability. Investors in pass-through entities such as partnerships, LLCs, and S corporations should also review the tax distribution language in the relevant entity agreement to ensure that future tax distributions will account for this new tax.

Additionally, individuals will have a greater incentive to maximize their retirement plan contributions since distributions from qualified retirement plans are not included in investment income for purposes of the tax. While distributions from traditional IRAs and 401(k) plans are not included in investment income for purposes of the tax, they do increase an individual's modified AGI and may push the individual above the modified AGI threshold, thus subjecting the individual's other investment income to the tax. Individuals may also consider converting their traditional retirement plan into a Roth IRA or Roth 401(k) this year since Roth distributions are not included in investment income and do not increase the individual's modified AGI. Although the Roth conversion would be taxable at ordinary rates, individuals should consider converting this year to avoid the higher ordinary rates scheduled to take effect in 2013.

Reduction in Itemized Deductions

Under current law, itemized deductions are not subject to any overall limitation. If the Bush tax cuts expire, an overall limitation on itemized deductions for higher-income taxpayers will once again apply. Most itemized deductions, except deductions for medical and dental expenses, investment interest, and casualty and theft losses, will be reduced by the lesser of 3 percent of AGI above an inflation-adjusted threshold or 80 percent of the amount of itemized deductions otherwise allowable. The inflation-adjusted threshold is projected to be approximately $174,450 in 2013 for all taxpayers except those married filing separately.

Planning Strategies. Because the overall limitation on itemized deductions will automatically apply to higher-income taxpayers, planning strategies are limited and highly individualized. Accelerating certain itemized deductions in 2012 to avoid the limitation may trigger alternative minimum tax (AMT) liability in 2012. Taxpayers should consult with their tax adviser to discuss the impact of this limitation and whether it may be advantageous to accelerate certain deductions, if possible, to 2012.

Reduction in Election to Expense Certain Depreciable Business Assets

Taxpayers may currently elect to expense certain depreciable business assets (Section 179 assets) in the year the assets are placed into service rather than capitalize and depreciate the cost over time. Section 179 assets include machinery, equipment, other tangible personal property, and computer software. Computer software falls out of this definition in 2013. The maximum allowable expense cannot exceed a specified amount, which is reduced dollar-for-dollar by the amount of Section 179 assets placed into service exceeding an investment ceiling. Both the maximum allowable expense and the investment ceiling will decrease next year, as shown in the table below.

	2012	2013
Maximum allowable expense	$139,000	$25,000
Investment ceiling	560,000	200,000

Planning Strategies. The change in law will both significantly decrease the dollar amount of Section 179 assets that may be expensed and cause the phaseout to be triggered at a lower threshold. Accordingly, business owners should consider placing Section 179 assets into service in 2012 to take advantage of the immediate tax benefit. Additionally, purchases of qualifying computer software should accelerated to 2012 if possible, as such purchases will no longer qualify for expensing in 2013.

AMT Preference for Gain Excluded on Sale of Qualified Small Business Stock

Taxpayers may exclude from their income all or part of the gain from selling stock of certain qualified C corporations that the taxpayer held for more than five years. The percentage of gain that may be excluded depends upon when the taxpayer acquired the stock (a 100 percent exclusion applies only to qualified stock acquired between September 28, 2010 and December 31, 2011). Under current law, 7 percent of the excluded gain is a preference item for AMT purposes. In 2013, this tax preference is scheduled to increase to 42 percent of the excluded gain (or 28 percent of the excluded gain for stock acquired after 2000). Gain excluded on stock for which the 100 percent exclusion applies will not be a tax preference for AMT purposes.

Planning Strategies. The increase in the percentage of excluded gain that will be treated as a tax preference for AMT purposes effectively eliminates the tax benefit of selling qualified small business stock. Those who are structuring a new business venture should reconsider forming a C corporation to take advantage of this provision, and should consult with their tax adviser to consider other entity choices. Owners of qualifying businesses who are considering selling their stock in the near future should also give additional consideration to a 2012 sale to take advantage of the current 7 percent AMT preference rate before the AMT preference rate increases in 2013.

Built-in Gains Tax Applicable to Certain S Corporations

Businesses that have converted from a C corporation to an S corporation are potentially subject to a corporate-level 35 percent built-in gains tax (BIG tax) on the disposition of their assets to the extent that the aggregate fair market value of the corporation's assets exceeded the aggregate basis of such assets on the conversion date. In the case of fiscal years beginning in 2011, the BIG tax does not apply if the five-year anniversary of the conversion date has occurred prior the beginning of the fiscal year. However, in the case of fiscal years beginning in 2012 or thereafter, the BIG tax will not apply only if the ten-year anniversary of the conversion date has occurred prior to the beginning of the fiscal year.

Planning Strategies. Owners of S corporations that are still in their 2011 fiscal year and that are considering selling corporate assets (or stock if a Section 338(h)(10) election will be made) within the near future should consider selling in the current fiscal year, if possible, to the extent their conversion to S corporation status occurred more than five, but less than ten years prior to the beginning of the fiscal year. For example, a C corporation that converted to an S corporation at the beginning of its fiscal year commencing October 1, 2005 would not be subject to the BIG tax on any of its built-in gain if it sold assets at any time prior to September 30, 2012, but would be subject to the tax if it sold assets on or after October 1, 2012.

Other Changes Affecting Individuals

- *Additional employee portion of payroll tax*. The employee portion of the hospital insurance payroll tax will increase by 0.9 percent (from 1.45 percent to 2.35 percent) on wages over $250,000 for married taxpayers filing jointly and $200,000 for other taxpayers. The employer portion of this tax remains 1.45 percent for all wages. This provision, which was enacted as part of the PPACA, is scheduled to take effect in 2013 regardless of whether Congress extends the Bush tax cuts.

- *Phaseout of personal exemptions*. A higher-income taxpayer's personal exemptions (currently $3,800 per exemption) will be phased out when AGI exceeds an inflation-indexed threshold. The inflation-adjusted threshold is projected to be $261,650 for married taxpayers filing jointly and $174,450 for unmarried taxpayers.

- *Medical and Dental Expense Deduction*. As part of the PPACA, the threshold for claiming the itemized medical and dental expense deduction is scheduled to increase from 7.5 to 10 percent of AGI. The 7.5 percent threshold will continue to apply through 2016 for taxpayers (or spouses) who are 65 and older.

- *Decrease in standard deduction for married taxpayers filing jointly*. The standard deduction for married taxpayers filing jointly will decrease to 167% (rather than the current 200%) of the standard deduction for unmarried taxpayers (currently $5,950). In 2012 dollars, this would lower the standard deduction for joint filers from $11,900 to $9,900.

- *Above-the-line student loan interest deduction*. This deduction will apply only to interest paid during the first 60 months in which interest payments are required, whereas no such time limitation applies under current law. The deduction will phase out over lower modified AGI amounts, which are projected to be $75,000 for joint returns and $50,000 for all other returns.

- *Income exclusion for employer-provided educational assistance*. This exclusion, which allows employees to exclude from income up to $5,250 of employer-provided educational assistance, is scheduled to expire.

- *Home sale exclusion*. Heirs, estates, and qualified revocable trusts (trusts that were treated as owned by the decedent immediately prior to death) will no longer be able to take advantage of the $250,000 exclusion of gain from the sale of the decedent's principal residence.

- *Credit for household and dependent care expenses*. Maximum creditable expenses will decrease from $3,000 to $2,400 (for one qualifying individual) and from $6,000 to $4,800 (for two or more individuals). The maximum credit will decrease from 35 percent to 30 percent of creditable expenses. The AGI-based reduction in the credit will begin at $10,000 rather than $15,000.

- *Child credit*. The maximum credit will decrease from $1,000 to $500 per child and cannot be used to offset AMT liability.

- *Earned Income Tax Credit*. The phaseout ranges for claiming the credit, which vary depending on the number of qualifying children, are scheduled to decrease for joint returns. Further, the credit will be reduced by the taxpayer's AMT liability.

Other Withholding Rate Changes

The following employer withholding rate changes will take effect in 2013:

	2012	2013
Employee portion of FICA payroll taxes	4.2%	6.2%
Backup withholding rate on reportable payments	28%	31%
Minimum withholding rate under flat rate method...		
...on supplemental wages up to $1 million	25%	28%
...on supplemental wages in excess of $1 million	35%	39.6%
Voluntary withholding rate on unemployment benefits	10%	15%

Foreign Account Tax Compliance Act

Regardless of whether Congress extends the Bush tax cuts, beginning in 2014, a new 30 percent withholding tax will be imposed on certain withholdable payments paid to foreign financial institutions (FFIs) and non-financial foreign entities (NFFEs) unless they collect and disclose to the IRS information regarding their direct and indirect U.S. account holders. FFIs include foreign entities that accept deposits in the ordinary course of a banking or similar business, that hold financial assets for the account of others as a substantial part of their business, or that are engaged primarily in the business of investing or trading in securities, commodities, and partnership interests. Any foreign entity that is not an FFI is an NFFE.

Withholdable payments will include U.S.-source interest, dividends, fixed or determinable annual or periodical income, and U.S.-source gross proceeds from sales of property that produce interest and dividend income. While the withholding obligation on withholdable payments to FFIs and NFFEs does not begin until 2014, FFIs will need to enter into agreements with the IRS by June 30, 2013 to avoid being subject to the withholding tax. In general, under such agreements, FFIs must agree to provide the IRS with certain information, including the name, address, taxpayer identification number and account balance of direct and indirect U.S. account holders, and must agree to comply with due diligence and other reporting procedures with respect to the identification of U.S. accounts.

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