2013 Tax Issues

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On January 1, 2013, Congress approved the American Taxpayer Relief Act of 2012 (ATRA). ATRA helped taxpayers to avoid the looming fiscal cliff, but provides for a number of important tax increases, especially when viewed in conjunction with tax increases effected by the Patient Protection and Affordable Care Act (PPACA) of 2010. In addition, changes to the California Revenue and Tax Code will cause many taxpayers with high earnings to see major increases in their tax rates. This alert provides a broad overview of the recent changes in federal and California income tax laws.

Income Tax Rates

ATRA extended most ordinary tax rates on individual filers, heads of households and married persons filing jointly for 2013. Provided their taxable incomes are at or below $400,000, $425,000 or $450,000 respectively, the rates remain unchanged at 24%, 28%, 33% and 35%. However, for earners above these thresholds, the rates are increased to 39.6% for 2013. Additionally, ATRA reinstitutes the “Pease” limitation on itemized deductions for high-income earners. Those who itemize will see a reduction in the amount of allowable deductions on Schedule A for each dollar of adjusted gross income in excess of $250,000 for single filers, $275,000 for head of households and $300,000 for married filing jointly.

ATRA also increases the rates for qualified dividends and capital gains for high earners. While most taxpayers will see no increase in the rate of tax on long-term capital gains and dividends, those taxpayers in the 39.6% bracket will see the rate rise to 20% for both long-term capital gains and dividends.

New Tax on Net Investment Income

Apart from increases in rates under ATRA, PPACA imposes a new 3.8% “unearned income Medicare contribution” tax on higher-income individuals, trusts and estates. For joint filers with adjusted gross income of $250,000 or more, PPACA imposes a surtax on “net investment income.” This includes passive income generally (including interest, dividends, and income subject to the IRC Section 469 limitations) as well as capital gains. Thus, a couple who sell their home in 2013 could potentially be subject to the 3.8% net investment income tax.

Changes in Payroll Taxes

Wages earners are not immune to the changes effected by ATRA and PPACA. First, ATRA did not extend the payroll tax holiday that wage earners enjoyed during 2012. For the last two years, the employee share of Social Security and Medicare taxes had been reduced from 6.2% to 4.2%. Thus, most taxpayers will see their take-home pay reduced by virtue of the increased FICA withholding.

PPACA also phases in a special 0.9% additional Medicare tax on the wages of high-income employees. This surcharge is distinct from the 3.8% tax on net investment income that PPACA will impose beginning in 2013. For joint filers with wages, compensation, or self-employment income in excess of $250,000 their Medicare tax portion of the payroll will rise from 1.45% to 2.35%.

California Income Tax Changes

In addition to federal income tax increases for individuals, recently passed Proposition 30 also imposes increased income taxes on California high-earners. Joint filers with taxable incomes of $500,000-$600,000 will see their California personal income tax increase by 1% for a total marginal rate of 10.3%. Joint California filers with taxable incomes above $1,000,000 will be subject to a highest marginal tax rate of 12.3%. Interestingly, Proposition 30 is retroactive and effective January 1, 2012, so taxpayers may see a significant increase in their California tax bill when they file their 2012 income tax returns.

Positive Income Tax Developments

There are a number of advantageous business tax provisions contained in ATRA. For taxpayers considering the conversion of their C corp to an S corp, ATRA allows special dispensation for built-in gains on the sale of contributed assets. Assets held by a C corp which converts to a S corp in 2012 or 2013 must be held for only 5 years to avoid the net built-in gains tax. This is certainly preferable to the normal rule which requires a 10 year holding period to avoid the 35% tax rate imposed on the disposition of assets contributed to an S corp by a C corp.

ATRA also extends helpful business expense provisions. Up to $500,000 of §179 property (machinery, equipment, vehicles, furniture and other qualifying property) placed in service in 2012 and 2013 can be immediately deducted, rather than depreciated over time. ATRA also continues to allow bonus depreciation through 2013, where taxpayers may deduct an additional 50% of the basis of qualified property during its first year of service.

Finally, ATRA retroactively extends the 100% exclusion from gross income for qualified small business stock (QSBS) acquired after September 27, 2010 and before January 1, 2014. Of course, California taxpayers should bear in mind that the *state* law treatment of QSBS appears unsettled and potentially onerous for Californians who have disposed of QSBS since 2008. For more on the FTB's position on QSBS, see a Corporate Alert.

Additionally, ATRA provides limitless roll-over provisions for Roth account conversions. See a Corporate Alert for more on these provisions.

Gift/Estate/GST Tax

Despite the many federal and state income tax increases, there was good news in the gift/estate/GST tax area. Perhaps most importantly, ATRA makes permanent the $5 million per individual ($10 million per couple) gift/estate/GST tax exemptions (each adjusted to $5.25 million for inflation). ATRA also extends the ability of a surviving spouse to make use of a predeceasing spouse's unused gift/estate tax exemptions ("portability"). The annual gift tax exclusion has also been increased from $13,000 to $14,000 to adjust for inflation.

The current economic environment of reduced valuations and low interest rates, the high gift tax exclusion amount of $5.25 million per person, and the possibility of future Congressional action to eliminate intra-family discounting and the benefits of "intentionally defective grantor Trusts" ("IDGTs") offer significant current transfer tax planning opportunities through techniques such as: gifts and sales of interests in assets that can be discounted (e.g., minority business interests or undivided interests in real property) to IDGTs; grantor retained annuity trusts("GRATs"); charitable lead annuity trusts ("CLATs"); AFR intra-family loans; "financed net gifts" to IDGTs; and other techniques.

For taxpayers with questions about any issues related to ATRA or other federal or state tax provisions, please contact the Hanson Bridgett Tax Practice Group.

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