Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Sticker Shock Lurking For Taxpayers Filing 2013 Returns

Law360, New York (January 31, 2014, 3:05 PM ET) -- Many taxpayers who are just now beginning to file their federal income tax returns for 2013 are in for some "sticker shock" as a result of the increase in tax rates and numerous other changes made by two recent laws — the American Taxpayer Relief Act and the Patient Protection and Affordable Care Act.

The changes made by these two laws will affect a wide range of Americans, including individuals, small business owners and real estate investors, and will hit them where it hurts — in their pocket books.

Tax Rate Increases in the American Taxpayer Relief Act

Let's start with the American Taxpayer Relief Act, which is somewhat deceptively named. While the law provides some relief for certain taxpayers, it created additional tax burdens for others when it became effective in 2013.

The act contains a number of changes and "extenders." The act's main change — and its most contentiously debated aspect — increases the maximum marginal individual tax rate of 35 percent to 39.6 percent for individuals with taxable income of more than $400,000, as well as married couples filing jointly with taxable incomes of more than $450,000. The following table offers a more detailed description of the law's effects:

Tax Rate	Single	Married Filing Joint	Married Filing Separate	Head of Household
10%	Up to $8,925	Up to $17,850	Up to $8,925	Up to $12,750
15%	$8,926 – $36,250	$17,851 – $72,500	$8,926 – $36,250	$12,751 – $48,600
25%	$36,251 – $87,850	$72,501 – $146,400	$36,251 – $73,200	$48,601 – $125,450
28%	$87,851 – $183,250	$146,401 – $223,050	$73,201 – $111,525	$125,451 – $203,150

33%	$183,251 – $398,350	$223,051 – $398,350	$111,526 – $199,175	$203,151 – $398,350
35%	$398,351 – $400,000	$398,351 – $450,000	$199,176 – $225,000	$398,351 – $425,000
39.6%	Over $400,000	Over $450,000	Over $225,000	Over $425,000

Although the tax rate changes will adversely affect higher income taxpayers, the Taxpayer Relief Act preserves some of the “Bush-era” tax cuts, or tax breaks on capital gains and dividends with a slightly higher rate, which was set to expire.

The maximum marginal income tax rate on dividends would have dramatically increased, from 15 percent to 39.6 percent absent any changes. This law establishes a maximum marginal income tax rate on capital gains and dividends of 20 percent for individuals with taxable income of more than $400,000, as well as married couples filing joint returns with taxable income of more than $450,000. For individuals having taxable income less than the threshold amounts, the capital gains tax rate and dividends tax rate will general remain at 15 percent.

“Hidden” Tax Increases

Though the changes in the maximum marginal income tax rate received the most attention, the American Taxpayer Relief Act includes other, less publicized provisions, that have the effect of increasing taxpayers’ rates. With their lack of awareness among most Americans, these “hidden” taxes affect individual taxpayers with adjusted gross income (AGI) of $250,000 or more, as well as couples who file jointly and have AGI of $300,000 or more.

It’s important to note that these changes affect a greater number of taxpayers due to the lower thresholds that apply as opposed to the higher thresholds that apply for the general tax rate changes.

First among these is the so-called “Pease” limitation on itemized deductions, which requires these taxpayers to reduce the amount of their itemized deductions by 3 percent of the amount by which the taxpayer’s AGI exceeds the applicable threshold (i.e., $250,000 or $300,000, depending on the filing status of the taxpayer).

Under this provision, the federal government can eliminate up to a maximum of 80 percent of the itemized deductions for taxpayers having AGI in excess of these threshold amounts. This elimination of itemized deductions will raise the effective tax rate for those individuals subject to the new limitation.

The act also revives the phase-out of personal exemptions in effect prior to the “Bush-era” tax cuts, reducing the total amount of a taxpayer’s exemptions by 2 percent for each $2,500 by which the taxpayer’s AGI exceeds the applicable threshold (i.e., $250,000 or $300,000, depending on the filing status of the taxpayer).

Again, taxpayers subject to the phase-out of personal exemptions will see their effective tax rate increase. Because both of these changes apply to taxpayers earning less than the much-debated $400,000/$450,000 threshold, some Americans will be surprised to find their tax burdens have increased much more than expected.

Payroll Tax Increases

Another tax "increase" for 2013 is the elimination of the "payroll tax holiday," which reduced employees' Federal Insurance Contributions Act and self-employment taxes by 2 percent. Under this provision, the workers' portion of the FICA tax was reduced from 6.2 percent to 4.2 percent for 2011 and 2012.

Similarly, the non-Medicare portion of the self-employment tax on self-employed individuals was reduced from 12.4 percent to 10.4 percent for 2011 and 2012. But these lower rates were eliminated beginning in 2013.

Finally, the Social Security wage base increased from $110,100 in 2012 to $113,700 in 2013 (it will be $117,000 for 2014). The Social Security portion of FICA and the self-employment tax — 6.2 percent on both the employer and the employee under the FICA tax and 12.4 percent on self-employed individuals under the self-employment tax — is imposed only up to the maximum wage base. The "Hospital Insurance" or Medicare portion of FICA tax and self-employment tax is imposed on all wages/self-employment income without regard to the wage limitations.

ACA Tax Increases

Now let's take a look at the ACA, which includes a multitude of tax changes and tax rate increases, as well as sweeping changes to existing health care laws. The ACA raises the Medicare portion of the FICA tax and the self-employment tax from 2.9 percent to 3.8 percent.

This change applies to employee wages and net earnings from self-employment in excess of $200,000 for individual filers and $250,000 for joint filers. Note again that this tax rate change kicks in at a much lower threshold ($200,000/$250,000) than the hotly debated $400,000/$450,000 threshold for the new 39.6 percent income tax bracket.

Another aspect of the ACA that has received little attention is the fact that so-called "wealthy," self-employed taxpayers (again, with thresholds of $250,000 for joint filers or $200,000 for individuals) cannot deduct the self-employment taxes attributable to the 0.9 percent increase.

Generally, self-employed individuals can deduct one-half of their self-employment taxes on their income tax return, but if they are paying the additional 0.9 percent because they are in higher tax brackets, none of the tax attributable to the additional 0.9 percent is deductible.

The ACA also includes a new tax, which will affect many different types of businesses and individual owners of businesses, called the Net Investment Income tax. Effective Jan. 1, 2013, a 3.8 percent tax is imposed on income from interest, dividends, annuities, royalties and rents, unless such items fall within the Active Business Exception. Other revenue sources are also subject to the NII tax, including active operating income from a trade or business in which the taxpayer is passive, as well as net gains on the sale of property.

The NII tax can come as quite a surprise to a member of a limited liability company or a shareholder of an S corporation where the entity is generating profits from an active trade or business, but the LLC member or S corporation shareholders does not "materially participate" in the LLC's or S corporation's business. In such cases, the LLC member or S corporation shareholder will not only be paying income taxes on his or her distributive share of the LLC's or S corporation's income, but will also be subject to the 3.8 percent NII tax on such income.

It should also be noted that the new NII tax generally has the effect of raising the capital gains rate and the dividends rate on higher income taxpayers from 20 percent to 23.8 percent.

This tax — which is in addition to income tax and the rate changes mentioned earlier — applies to individuals having modified AGI over the threshold amount of $200,000 for individuals and $250,000 for married couples filing jointly. It also applies to estates and trusts, for which the threshold is just $11,900.

The NII tax does not apply to S corporations, partnerships or LLCs, but it does apply to their shareholders, partners and members, even (as discussed above) with respect to active operating income of the S corporation, partnership or LLC to the extent the shareholder, partner or member is "passive" (does not materially participate) in the business.

The impact of the NII tax could be dramatic on business and real estate income of passive investors whose modified AGI exceeds the threshold amounts ($200,000/$250,000). There are a variety of scenarios that bear this out. For instance, even a "real estate professional" who actively participates in rental activity will be subject to the NII tax on rental income and gain on sale of the property unless he or she can demonstrate that the rental activity rises to the level of a "trade or business."

Prior to the issuance of recent regulations, another example where practitioners speculated that the the NII tax could apply is when a doctor is the sole member of an LLC that owns one piece of commercial property for his or her medical practice and the LLC leases the property to the doctor's medical practice (conducted in a separate entity) to provide liability protection.

Fortunately, the Internal Revenue Service listened to practitioners' concerns in this regard, and the newly issued regulations provide that in this situation (where a taxpayer is leasing property from his or her LLC to a business in which the taxpayer is materially participating), the rental income from the LLC will not be subject to the NII tax.

And finally, let's consider a hardware store, which is run by the sole shareholder of an S corporation. Because the taxpayer works full time in the store and generates an operating profit, his or her share of the S corporation income is not subject to the NII tax. However, if the S corporation took on another shareholder who didn't participate in the business and was passive, that taxpayer's income from the business would be subject to the NII tax.

Minimizing the NII Tax

With so many new considerations stemming from the ACA's provisions, business owners and partners should carefully consider their options with respect to the new NII tax. They must first determine whether they will be subject to the NII tax as recipients of pass-through business income. If so, there are several steps that should be considered to minimize the impact of the NII tax.

The use of S corporations is one possibility. As long as a shareholder of an S corporation materially participates in the business, the dividend distributions received should not be subject to the 3.8 percent

NII tax. Additionally, nonwage distributions from S corporations will remain untouched by the FICA tax and self-employment tax as long as the S corporation is paying “reasonable compensation” to its shareholders who are providing services to the S corporation.

Another option is for an LLC member or limited partner to materially participate so the distributive share of income would not be subject to the NII tax. However, this would likely result in the income being subject to the self-employment tax, including the increased 3.8 percent Medicare tax imposed on the self-employment income for higher income taxpayers. This brings us back to S corporations, which seem to be the best choice for operating a business with minimal impact from FICA, self-employment taxes and the NII tax.

Without a doubt, the tax changes made by the American Taxpayer Relief Act and ACA will result in some unpleasant surprises for taxpayers filing their 2013 federal income tax returns this year. Additionally, these changes will also impact a spectrum of businesses and their decisions about the type of entity through which they should conduct business. To choose the best path in this brave new world, taxpayers should consult a tax attorney, accountant or other professional tax advisor.

—By Stephen R. Looney, Dean Mead Egerton Bloodworth Capouano & Bozarth PA

Stephen Looney serves as chairman of the tax department at the law firm of Dean Mead Egerton Bloodworth Capouano & Bozarth in Orlando. He is a former chairman of the S Corporations Committee of the American Bar Association’s Tax Section. He represents clients in a variety of business and tax matters including entity formation, acquisitions, dispositions, redemptions, liquidations, reorganizations, tax-free exchanges of real estate and tax controversies.