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Federal Income Tax Changes for 2013

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With the resolution of the so-called "fiscal cliff" by the enactment of the American Taxpayer Relief Act of 2012 (the "2012 Tax Act"), there have been changes to the tax laws that were to apply to individuals and other taxpayers beginning in 2013. This memorandum summarizes changes to the Internal Revenue Code of 1986, as amended (the "Code"), that were scheduled to apply in 2013 as modified by the changes enacted as part of the 2012 Tax Act, which are generally effective as of January 1, 2013. This memorandum also summarizes new taxes that take effect in 2013. Additional tax law changes may be proposed in further fiscal discussions during the year.

Individual Income Tax Rates

- **Extension of the 10% Income Tax Bracket** - Under prior law, the 10% individual income tax bracket (the lowest individual income tax rate) expired at the end of 2012, and the lowest tax rate would have been 15% beginning in 2013. The 2012 Tax Act extends the 10% individual income tax bracket.
- **Extension of the 25%, 28%, and 33% Income Tax Brackets** - Under prior law, the 25%, 28%, 33%, and 35% individual income tax brackets expired at the end of 2012 and the brackets were set to become 28%, 31%, 36%, and 39.6%, respectively, beginning in 2013. The 2012 Tax Act extends the 25%, 28%, and 33% brackets.
- **35% and 39.6% Income Tax Brackets** - The 2012 Tax Act increases the top tax bracket from 35% to 39.6% on taxable income above $400,000 (individual filers) and $450,000 (married filing jointly). The 35% bracket under prior law is extended, but will apply only to taxable income not exceeding $400,000 (individual filers) and $450,000 (married filing jointly).

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Capital Gains and Dividends Tax Rates

Prior to 2013, the rates for long-term capital gains and qualified dividend income were 0% for individuals whose taxable income was below the 25% bracket and were 15% for individuals whose taxable income was in the 25% bracket and above. These rates expired at the end of 2012, and, under prior law, the rates for long-term capital gains would have become 0% and 20%, respectively, and all dividends would have been taxable at the ordinary income rates. The 2012 Tax Act increases the tax rate on long-term capital gains and qualified dividend income to 20% for individuals with taxable income above $400,000 (individual filers) and $450,000 (married filing jointly). Long-term capital gains and qualified dividend income continue to be taxed at 0% or 15% for all other individuals. Significantly, the 2012 Tax Act continues to tax qualified dividend income at the same rates as long-term capital gain, preserving the parity in tax rates between dividends and long-term capital gain.

Payroll Tax

The reduction in Social Security payroll taxes paid by employees from 6.2% to 4.2% that had been in effect for the past two years was not extended as part of the 2012 Tax Act. As a result, beginning in 2013, the Social Security payroll tax rate payable by employees will be 6.2% on their income that does not exceed the maximum taxable earnings amount, which is $113,700 in 2013. Likewise, the 2% reduction in the Self-Employment Contributions Act (“SECA”) tax rate was not extended, and the total SECA tax rate will be 15.3% beginning in 2013, including the Medicare component, but subject to the increased Medicare payroll tax discussed below.

Increased Medicare Payroll Taxes

Prior to 2013, employees paid a Medicare payroll tax of 1.45% on their wages and employers paid a 1.45% tax, and self-employed individuals paid Medicare payroll tax of 2.9% on net earnings from self-employment. Beginning in 2013, employees and self-employed individuals will pay an additional 0.9% tax on wages and net earnings from self-employment in excess of $200,000 (individual filers) or $250,000 (married filing jointly). The Medicare tax paid by employers will not change.

Medicare Tax on Investment Income

The 2010 Patient Protection and Affordable Care Act imposes a new 3.8% Medicare tax beginning in 2013 on “net investment income” in excess of specified thresholds. Net investment income generally includes income from interest, dividends, annuities, royalties, rents, and capital gains, but does not include tax-exempt income, such as interest from municipal bonds, or qualified distributions from retirement plans such as a traditional IRA, 401(k), or 403(b). The amount of net investment income subject to this new tax is the lesser of (a) total net investment income or (b) the amount of a taxpayer’s modified adjusted gross income that exceeds $200,000 (individual filers) or $250,000 (married filing jointly). Because of these relatively high thresholds, this new Medicare tax on investment income will only apply to so-called high-income taxpayers. Modified adjusted gross income includes adjusted gross income (“AGI”) and foreign earned

income. In December 2012, the Treasury released proposed regulations implementing this new tax that, among other items, provide further guidance on the definition of net investment income.

Repeal of the Personal Exemption Phase-out

Due to the Personal Exemption Phase-out ("PEP"), personal exemptions are phased out for individuals with AGI above certain thresholds. For 2010, 2011, and 2012, the PEP was repealed for all taxpayers, but was scheduled to return at thresholds that would have affected many middle-income individuals. The 2012 Tax Act increases those thresholds to $250,000 (individual filers) and $300,000 (married filing jointly). Individuals above these income thresholds will be subject to the PEP.

Repeal of the Itemized Deduction Limitation

Since 1991, the "Pease limitation" has reduced most itemized deductions for individuals by 3% of the amount by which AGI exceeded a specified threshold, up to a maximum reduction of 80% of such itemized deductions. However, the Pease limitation was repealed from 2010 through 2012. The 2012 Tax Act reinstates the Pease limitation but increases the specified thresholds to $250,000 (individual filers) and $300,000 (married filing jointly). These thresholds are indexed for inflation for future tax years. Individuals above these income thresholds will be subject to the Pease limitation.

Business Tax Extenders

The 2012 Tax Act extended several other tax provisions that were scheduled to expire at the end of 2012, or in some cases had already expired.

- **Exceptions Under Subpart F for Active Financing Income** - Under prior law, subpart F income of a controlled foreign corporation ("CFC") did not include certain income of a foreign subsidiary engaged in a banking, financing, or similar business if the subsidiary was predominantly engaged in such business and conducted substantial activity with respect to such business. The provision applies only to income from the active conduct of a banking, financing, or similar business in the subsidiary's home country in transactions with non-US customers. Under prior law, this exception applied to tax years of qualifying foreign subsidiaries that began before January 1, 2012. The 2012 Tax Act extends the prior law through 2013 by making the exception applicable to tax years that began in 2012 or begin in 2013.
- **Look-through Treatment for Payments Between Related Controlled Foreign Corporations** - Under prior law, subpart F income did not include certain income (interest, dividends, rents, and royalties) from a related CFC to the extent the income was allocable or attributable to income of the related CFC that was not subpart F income or income effectively connected with the conduct of a trade or business in the United States. Under prior law, this exception applied to tax years of foreign corporations that began before January 1, 2012. The 2012 Tax Act extends the prior law by making the exception applicable to tax years of foreign corporations that began in 2012 or begin in 2013.
- **Bonus Depreciation** - The 2012 Tax Act extends the bonus depreciation rules for one year, until December 31, 2013. Under these rules, businesses may take an additional depreciation deduction, in the year in which the property is placed in service, equal to 50% of the cost of the depreciable property for qualifying property purchased and placed in service before January 1, 2014 (before January 1, 2015 for certain longer-lived and transportation assets).

- **Energy Tax Credits** - The 2012 Tax Act extends the availability of the production tax credit and the 30% investment tax credit to otherwise qualifying wind facilities the construction of which begins before January 1, 2014. In addition to wind energy facilities, this "beginning of construction" requirement replaces the prior "placed in service" requirement (previously set at January 1, 2014) for several other types of qualified facilities, including closed and open-loop biomass facilities, geothermal facilities, landfill gas facilities, trash facilities, qualified hydropower facilities, and qualified marine and hydrokinetic renewable energy facilities.
- **Principal Residence Mortgage Debt Relief** - Under prior law, individuals who had mortgage debt canceled or forgiven after 2012 would have been required to include the amount of the canceled or forgiven debt in their taxable income. Under the 2012 Tax Act, up to $2 million of canceled or forgiven principal residence debt is eligible to be excluded from taxable income through 2013.
- **Miscellaneous Tax Extenders** - The 2012 Tax Act extends other business and individual tax provisions, including the research credit and the deduction for state and local sales taxes, for one year. In addition, the 2012 Tax Act extends the Earned Income Tax Credit, the Child Tax Credit, and the American Opportunity Tax Credit for five years.

Alternative Minimum Tax Exemption Inflation Indexing

Under the Alternative Minimum Tax ("AMT"), an individual is subject to the AMT on the excess of alternative minimum taxable income ("AMTI") over an exemption amount. The exemption amount is subject to a phase-out for individuals with AMTI above a threshold amount. In addition, the AMT rate on the first $175,000 of AMTI over the exemption amount is 26% and AMTI in excess of that amount is taxed at a 28% rate. Since the inception of the AMT, all of the exemption amount, the phase-out threshold, and the $175,000 amount at which the AMT rate increases have never been indexed for inflation, and thus Congress needed to enact a "patch" periodically to increase the AMT exemption and threshold amount to ensure that the AMT did not apply to middle class taxpayers. The 2012 Tax Act increases the exemption amount for 2012 to $50,600 (individual filers) and $78,750 (married filing jointly). The 2012 Tax Act also indexes for inflation the exemption amount, the threshold amount at which the exemption is phased-out, and the amount at which the AMT rate increases for future tax years.

Estate Tax Reform

For decedents dying after December 31, 2012, the 2012 Tax Act increases the estate tax from 35% to 40% for estates valued at over $5,000,000, and this threshold will be indexed for inflation. In the case of an individual who was the surviving spouse of a person who died after December 31, 2010 (the "prior decedent"), the $5,000,000 threshold for that individual upon death will generally be increased by the portion of the $5,000,000 threshold unused by the prior decedent. Without the 2012 Tax Act, the estate tax would have risen to 55% on estates valued at over $1,000,000 (which was not indexed for inflation).

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The 2012 Act largely only addressed some of the tax law changes that were scheduled to become effective automatically beginning in 2013. Additional fiscal negotiations still are likely and additional tax changes may be proposed and enacted as revenue offsets as part of such discussions. These changes could include changes applicable to individuals, corporations, publicly-traded partnerships, carried interests, and international taxation. Discussion of more comprehensive tax reform is also likely to continue. Taxpayers are urged to follow the progress of these discussions and further tax law changes.

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