“High-income” Taxpayers Face Higher Medicare Taxes

As part of the recently enacted healthcare legislation, Congress passed a double-whammy Medicare tax increase for those deemed to be “high-income taxpayers.”

- Tax rate increase of 0.9% on wages and self-employment income above $200,000 for individuals and $250,000 for married couples filing jointly.
- For “high income” households, the 3.8% Medicare tax will now be imposed on unearned income, including interest, dividends, capital gains and other investment income.
- These changes are slated to take effect in 2013

Higher Medicare tax on wages and self-employment income.

Under current law, wages are subject to a 2.9% Medicare tax. Workers and employers each pay half (1.45%). The self-employed pay the full 2.9%.

Unlike the payroll tax for Social Security, which applies to earnings up to an annual ceiling, the Medicare tax is levied on all of a worker's wages without limit.

Under the provisions of the new law, which take effect in 2013, single persons earning more than $200,000 and married couples earning more than $250,000 will be taxed at an additional 0.9% (2.35% in total) on the excess over those base amounts. Self-employed persons will pay 3.8% on earnings over those thresholds.

The $200,000/$250,000 thresholds are not indexed for inflation, so there is a close parallel with the Alternative Minimum Tax. Even though the new rates are currently targeted on “high income” households, over time these new higher rates will apply to more and more taxpayers.

Employers will collect the extra 0.9% on wages exceeding $200,000, but won't be responsible for determining whether a worker's combined income with his or her spouse made them subject to the tax. Instead, some employees will have to remit additional Medicare taxes when they file income tax returns, and some will get a tax credit for amounts overpaid. Married couples with combined incomes approaching $250,000 will have to keep tabs on both spouses' pay to avoid an unexpected tax bill.

Medicare tax extended to investments.

Under current law, the Medicare tax only applies to wages and self-employment income. The new law imposes the (now higher) 3.8% Medicare tax on net investment income of single taxpayers with AGI above $200,000 and joint filers over $250,000 (unindexed).

Net investment income includes interest, dividends, royalties, rents, gross income from a trade or business involving passive activities, and net gain from disposition of property (other than property held in a trade or business). Net investment income is reduced by the deductions that are allocable to that income. One bright spot: the new tax won't apply to income in tax-deferred retirement accounts such as 401(k) plans.❖

Tax & Business Newsletter

Samuel A. Lambert – Editor

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36 South State Street, Suite 1400
Salt Lake City, Utah
84145-0385
Tele: (801) 532-1500
Fax: (801) 532-7543
rqntax@rqn.com
www.rqn.com

ALSO INSIDE THIS ISSUE

NO “SHAREHOLDER” FIDUCIARY DUTY

By Bryan K. Bassett

In its 2010 general session, the Utah legislature made a significant amendment to Utah Code Annotated Section 16-10a-622, Liability of Shareholders. This Section states that a purchaser of a corporation’s shares from that corporation is not liable to the corporation or its creditors with respect to the shares except to pay or provide the consideration for the shares. This Section also states that unless otherwise provided in the articles of incorporation, a shareholder or subscriber for shares of a corporation is not liable for the acts or debts of the corporation solely by reason of the ownership of the corporation’s shares.

The 2010 amendment adds new provisions to Section 16-10a-622, including a provision that a shareholder of a corporation, when acting solely in the capacity as a shareholder, has no fiduciary duty or other similar duty to any other shareholder of the corporation, including no duty of care, loyalty or good faith. This new standard applies both to a public corporation and to a closely-held corporation.

Amended Section 16-10a-622 is significant in that it essentially reverses the holding by the Utah Supreme Court in McLaughlin v. Schenk, 640 Utah Adv. Rep. 27 (2009). In *McLaughlin*, the Court considered whether the duties owed by shareholders under the Utah Revised Business Corporation Act differ in closely held corporations and public corporations. In a public corporation, directors and officers owe the corporation and the shareholders collectively a duty to act in good faith and in the best interests of the corporation, but in general, shareholders do not owe any such duty to one another. In *McLaughlin*, the Court concluded that similar to a partnership, in a closely-held corporation, a *shareholder*, *individually*, has a fiduciary duty to act in “utmost good faith” in relation to other shareholder(s). The Court stated that this standard was originally articulated by Massachusetts and has subsequently been adopted by several other states, and determined that the “majority” position among the states is to impose some duty among shareholders in a closely-held corporation. The Court declined to adopt the “minority” position, adopted by Delaware and Texas, which imposes identical duties on shareholders of closely-held corporations and public corporations.

It is possible that further amendments to Section 16-10a-622 may be made in the future as Utah law on this subject continues to develop.❖

Future Federal Income Tax Rates Remain Murky

By Bruce L. Olson

Long range tax planning for individuals under current federal law remains difficult. In 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act (EGTRRA). That law addressed both estate and income tax rates, keeping them relatively steady through 2009, making 2010 a transition year and making them less favorable for 2011 and beyond. Our previous newsletters, annual tax seminar and special mailings to estate planning clients have addressed the estate tax implications of EGTRRA. This column briefly summarizes the income tax features of EGTRRA.

Income Tax Rates. Under current tax rules, income is taxed at the rates of 10%, 15%, 25%, 28%, 33% and 35%. Absent further changes in the law, beginning in 2011, the following rates will apply: 15%, 28%, 31%, 36% and 39.6%. The Obama Administration has proposed for 2011 the following rates: 10%, 15%, 25%, 28%, 36% and 39.6%. The income levels at which these rates would start and stop differ in each of the foregoing three regimes.

Alternative Minimum Tax. AMT exemption amounts for 2009 were $46,700, $70,950 and $35,475 for unmarried taxpayers, joint filers and marrieds filing separately respectively. For 2010 those numbers dropped to $33,750, $45,000 and $22,500. Also, nonrefundable personal credits claimed after 2009 are subject to greater limitations for AMT purposes. It is possible that Congress will enact another 1-year "patch" to restore AMT exemption amounts for 2010 to their 2009 levels and to allow nonrefundable personal credits to offset the AMT as well as regular tax. The Obama Administration's 2011 budget proposals are consistent with that likelihood.

Capital Gains and Qualified Dividends. Under current rules, net capital gain is taxed at a maximum rate of 15%. If the long-term capital gain rate would otherwise be taxed at a rate below 25% if it were ordinary income, it is taxed at a zero percent rate. Qualified dividends are taxed to noncorporate shareholders at the same rates that apply to long-term capital gain. Absent Congressional action, beginning in 2011, long-term capital gains will be taxed at 20% and dividends paid to individuals will be taxed at ordinary income rates. The Obama Administration has proposed for years beginning in 2011 a 20% tax rate for long-term capital gains and qualified dividends of married taxpayers filing jointly with income over $250,000, less the standard deduction and two personal exemptions and for single taxpayers with income over $200,000, less the standard deduction and one personal exemption. Taxpayers in lower income levels would be subject to the same rates that now apply to long-term capital gains and qualified dividends.

Deductions. Both the law as currently planned for 2011 and the Obama Administration have provisions to reduce itemized deductions and phase out personal exemptions for high income taxpayers. Also the Administration proposes that the tax value of all itemized deductions would be limited to 28% whenever they would otherwise reduce taxable income in the 36% or the 39.6% tax brackets.

The foregoing are only summaries of some of the provisions of EGTRRA and Administration proposals. Stay tuned for Congressional action on these and other issues, perhaps even retroactively, and a likely bumpy ride in pursuing income tax planning for the future.❖

CARRYOVER BASIS IN 2010

By Gregg D. Stephenson

There has been much written and said regarding the repeal of the federal estate tax in 2010. However, often lost in the discussion is the loss of the "step-up in basis" for federal income tax purposes for assets passing to the heirs of a decedent.

As background, the basic rule at the end of 2009 (which had been in place for many years) was that assets pass to beneficiaries with a basis equal to fair market value as of the decedent's date of death. In other words, if the decedent bought stock for $100, and it was worth $200 at his death, his heirs inherited that stock with a "stepped-up" basis of $200, and could sell the stock for $200 without incurring income taxes. Of course, if the fair market value of an asset had decreased, the basis could also be "stepped-down" under the old law. The step-up in basis rules will return along with the estate tax on January 1, 2011, or sooner if Congress reinstates the estate tax in 2010.

In the meantime, the heirs of a decedent dying in 2010 will be subject to the "carryover basis" rules under IRC Section 1022 which state that assets pass to beneficiaries with the decedent's basis, unless the fair market value on date of death is less than decedent's basis, in which case basis is decreased to fair market value. In other words, for 2010 we lost the step-up in basis, but kept the possible step-down in basis. Under the carryover basis rules, if a decedent bought stock for $100, and it was worth $200 at his death, his heirs inherit that stock with a carryover basis of $100, and will be liable for income tax on the gain of $100 if they sell the stock for $200.

Fortunately, there is some good news. There are two separate modifications to basis that are allowed. First, there is basis adjustment of $1.3 million that is available to all decedents. For example, if a decedent purchased stock for $2 million, and the stock has a fair market value on his date of death of $4 million, then the executor of the estate can allocate the $1.3 million basis adjustment to the stock, and it will pass to the heirs with a basis of $3.3 million (the purchase price of $2 million plus the $1.3 million basis adjustment). The heirs could then sell the stock for $4 million and are only liable for income tax on the gain of $700,000, which is the difference between the sales price of $4 million and the adjusted basis of $3.3 million. Second, there is a spousal basis adjustment of $3 million that is available for assets that pass to a surviving spouse, or to a qualified terminable interest property trust (QTIP trust) for the surviving spouse's benefit.

The carryover basis rules greatly complicate an already difficult situation. Executors of an estate of a decedent dying in 2010 who owned assets in excess of $1.3 million will be required to file a report with the IRS that details the basis of the assets, and the allocation of both the $1.3 million standard basis adjustment and the $3 million spousal basis adjustment. Individuals are well advised to update their records as to the tax basis of their property, and to analyze the possible problems that may follow a death in 2010 with a carryover basis regime in effect.

For more details on the carryover basis rules and to discuss how they may apply to you and your particular situation, please contact a member of the Ray Quinney & Nebeker's Tax, Trusts and Estate Planning Section.

ATTORNEY PROFILE – SAMUEL A. LAMBERT

The Tax Section wishes to introduce you to its newest shareholder, Sam Lambert, who practices primarily in the area of federal and state tax planning and tax controversies. Since joining the firm in 2007, Sam has assisted our clients favorably resolve income, sales, employment, UBIT, excise, and property tax controversies, both large and small, and has helped eliminate millions of dollars of taxes and penalties that have been asserted against clients.

After graduating at the top of his Columbia Law School class, Sam served in the U.S. Department of Justice as Counsel to the Deputy Assistant Attorney General in the Tax Division, who oversees all tax settlements and appellate tax litigation in the Department of Justice. Also, as a member of the Appellate Section of the Tax Division, Sam successfully handled and argued cases involving a wide variety of taxes and taxpayers in federal appellate courts across the country. Sam also served as a law clerk to Judge Amalya Kearse on the U.S. Court of Appeals for the Second Circuit.

Sam is an adjunct professor at the J. Reuben Clark Law School at Brigham Young University. Sam's greatest joy are his wife and five children.