

A Condensed Review of New Taxes Coming Your Way by: Tony Meyer and Bob Romanchek

With all of the factors that go into designing and quantifying executive compensation, the effects of the tax code do not always receive adequate consideration. Moreover, with 2012 swiftly approaching, it seems an appropriate time to discuss taxes. The tax code has seen numerous changes in the past few years, as new legislation has been passed and other parts of the tax code have expired. In specific, there are three areas of the tax code that you should be aware of as you develop compensation plans for the coming years and as you plan for your own financial future.

Unemployment Insurance and Job Creation Act of 2010

2012 Income Tax Rates

The first area containing important tax rule changes is the Unemployment Insurance and Job Creation Act ("UIJCA"). Passed in late December of 2010, UIJCA extended many of the tax cuts passed during the Bush Era under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"). One accomplishment of UIJCA was extending all of the income tax rates that were created by EGTRRA through December 31, 2012. Thus, if you find yourself in the highest tax bracket (35%), you can rest assured that your tax rate will not increase in 2012. (Other 2012 tax rates can be found in the tables below.)

2012 Single Tax Brackets

Taxable Income Brackets	Ordinary Income Tax Rate	Qualified Dividend Tax Rate
\$0-\$8,700	10%	0%
\$8,701-\$35,350	15%	0%
\$35,351-\$85,650	25%	15%
\$85,651-\$178,650	28%	15%
\$178,651-\$388,350	33%	15%
\$388,351 And Over	35%	15%

2012 Married Filing Joint and Surviving Spouse Tax Brackets

Taxable Income Brackets	Ordinary Income Tax Rate	Qualified Dividend Tax Rate
\$0-\$17,400	10%	0%
\$17,401-\$70,700	15%	0%
\$70,701-\$142,700	25%	15%
\$142,701-\$217,450	28%	15%
\$217,451-\$388,350	33%	15%
\$388,351 And Over	35%	15%

2013 Income Tax Rates

Barring another extension, the ordinary income tax rates will revert to pre-EGTRRA levels in 2013. Interestingly, many Americans' ordinary income tax rates would not change if the tax cuts expired. Only those in the highest tax brackets would be affected. Instead of 33% and 35%, the highest tax brackets would be 36% and 39.6%. Assuming a 2.5% increase for inflation in 2013 (similar to the increase in 2012), the new tax brackets would appear as in the tables below.

2013 Single Tax Brackets (Estimated)

2012 Taxable Income Brackets	2012 Ordinary Income Tax Rates	2013 Projected Taxable Income Brackets	2013 Ordinary Income Tax Rates
\$0–\$8,700	10%	\$0–\$8,918	10%
\$8,701–\$35,350	15%	\$8,919–\$36,234	15%
\$35,351–\$85,650	25%	\$36,235–\$87,791	25%
\$85,651–\$178,650	28%	\$87,792–\$183,116	28%
\$178,651–\$388,350	33%	\$183,117–\$398,059	36%
\$388,351 And Over	35%	\$398,060 And Over	39.6%

2013 Married Filing Joint and Surviving Spouse Tax Brackets (Estimated)

2012 Taxable Income Brackets	2012 Ordinary Income Tax Rates	2013 Projected Taxable Income Brackets	2013 Ordinary Income Tax Rates
\$0–\$17,400	10%	\$0–\$17,835	10%
\$17,401–\$70,700	15%	\$17,836–\$72,468	15%
\$70,701–\$142,700	25%	\$72,469–\$146,268	25%
\$142,701–\$217,450	28%	\$146,269–\$222,886	28%
\$217,451–\$388,350	33%	\$222,887–\$398,059	36%
\$388,351 And Over	35%	\$398,060 And Over	39.6%

Capital Gains and Dividend Rates

The maximum tax rate on qualified capital gains and dividends will remain at 15% in 2012. UIJCA has extended the qualified treatment of dividends to include those earned through regulated investment companies (“RICs”), real estate investment trusts (“REITs”), and other pass-through entities through 2012. Thus, both the tax rate and scope of dividends have been affected by UIJCA.

However, as part of the expiring Bush tax cuts, the maximum long-term capital gains rate is scheduled to increase from 15% to 20% in 2013. Taxpayers in lower brackets that did not pay capital gains tax under UIJCA would be subject to a 10% tax starting in 2013. Further, unlike in 2012, dividend income would be taxed at an individual’s highest marginal tax rate (also see the discussion below on the new 3.8% “unearned income” tax that will apply to capital gains and to dividend income, and to other items).

Alternative Minimum Tax

Other parts of UIJCA expire at the end of 2011 and their existence going forward is less certain. For instance, in an effort to protect middle-income taxpayers from the reach of the Alternative Minimum Tax (“AMT”), the exemption amounts were raised for 2010 and 2011. Known as a “patch,” the AMT exemption amount for 2011 is \$48,450 for individuals and \$74,450 for joint filers. As the AMT patch provision expires at the end of 2011, the AMT exemption amounts are scheduled to decrease to \$33,750 for individuals and \$45,000 for joint filers in 2012. If this happens, taxpayers in the income range of \$200,000 to \$500,000 will be most affected. If a new patch is not created, the projection is that the AMT will affect over 30 million taxpayers in 2012, an amount significantly higher than the roughly four million taxpayers subject to the AMT in 2009.

Alternative Minimum Tax Exemptions

	2011	2012
Married Filing Jointly	\$74,450	\$45,000
Single/Head of Household	\$48,450	\$33,750

FICA Tax Rates

Similar to the AMT patch, the payroll tax cuts from UIJCA are scheduled to expire at the end of 2011. Typically, both employers and employees contribute 6.2% of their earnings, up to a threshold amount of base wages (\$106,800 in 2011), to Social Security, Old-Age, Survivors, and Disability Insurance (“OASDI”). However, UIJCA lowered the amount paid by employees to 4.2% for 2011. Without any new legislation, the employee portion of OASDI will revert to 6.2% at yearend. Yet, new legislation is likely. President Obama has proposed a plan in which employers and employees would each pay 3.1% in 2012, up to a threshold amount of base wages for each employee. Employers would only pay the lower rate on the first \$5 million of payroll. Additionally, an incentive would exist such that firms which hired new employees or increased the wages of current employees could potentially eliminate payroll taxes altogether, but only on the first \$50 million in wages. Further, companies hiring workers unemployed for more than six months would receive a \$4,000 tax credit for each new hire. However, again, these provisions are not yet law.

Social Security Contribution Rates

	2011	2012 (As Scheduled)	2012 Obama Proposal
Employer	6.2%	6.2%	3.1% (Up to \$5 Million in Total Payroll)
Employee	4.2%	6.2%	3.1%

Estate and Gift Tax

Finally, UIJCA set the inheritance and gift tax for 2012. The estate tax exemption for decedents dying in 2012 will be \$5.12 million with a maximum estate tax rate of 35%. Property received after a decedent's death will remain subject to a stepped up basis, as was provided for in EGTRRA. For those planning to make gifts in 2012, the top gift tax rate will be 35%. As it has been for the past few years, the annual exclusion for gift tax purposes will remain at \$13,000 per donee for individuals and \$26,000 per donee for gifts made jointly by married couples. Only when gifts to one donor, in the aggregate, exceed the annual exclusion amount does a gift tax return need to be filed. Additionally, a lifetime gift tax exemption exists at an amount of \$5.12 million per donor or \$10.24 million per married couple. This exemption can be used to offset gift taxes or by the estate to offset estate taxes upon the decedent's death. Uncertainty surrounds the status of the lifetime gift tax exemption, as, without the passage of any new legislation, it is set to revert back to its pre-EGTRRA level of \$1 million per donor or \$2 million per married couple in 2013.

Lifetime Gift Tax Exemption

	2012	2013
Single Donor	\$5.12 million	\$1 million
Married Couple Donors	\$10.24 million	\$2 million

Patient Protection and Affordable Care Act of 2010

The second important new piece of tax legislation is the Patient Protection and Affordable Care Act ("PPACA"), which became law in March of 2010. Though some of the provisions are set to become effective after 2012, PPACA has already begun to overhaul the healthcare industry in the United States. Yet, the reach of the Act is much further. The most famous provision of PPACA is its mandate of health insurance coverage for individuals. This requirement has been the topic of much debate and some scholars believe that the mandate may be unconstitutional. Nonetheless, beginning in 2014, those without qualifying health insurance coverage will be required to pay the greater of 1% of adjusted gross income ("AGI") or \$95 for one adult, the greater of 1% of AGI or \$190 for two adults, and the greater of 1% of AGI or \$285 for three or more adults. These rates will increase in 2015 and again in 2016.

Health Insurance Coverage Mandate for Those Without Qualifying Coverage

	2014		2015		2016 and Beyond	
	Greater of:		Greater of:		Greater of:	
1 Adult	1% AGI	\$190	2% AGI	\$325	2.5% AGI	\$695
2 Adults	1% AGI	\$190	2% AGI	\$650	2.5% AGI	\$1,390
3+ Adults	1% AGI	\$285	2% AGI	\$975	2.5% AGI	\$2,085

Along with requiring individuals to carry health insurance, beginning in 2014, employers with 50 or more employees must either offer health insurance coverage or pay an additional non-deductible tax of \$2,000 for each employee. Further, if a company's employee seeks coverage through the health insurance exchange, which is a set of government-regulated standardized health plans, the company's tax rises to \$3,000 for that employee. Additionally, employers will be taxed if they require a waiting period for employees to enroll in their health insurance plans - \$400 per employee if the waiting period is 30 to 60 days and \$600 per employee if the waiting period is 60 days or longer.

Medicare Tax Rates

PPACA calls for an increase in the amount of Medicare tax paid by employees. Beginning in 2013, the employee portion of the Medicare tax, which is a part of the Federal Insurance Contributions Act ("FICA"), will be increased for employees above certain earnings thresholds. The increase will only apply to the employee portion of the tax and the employer Medicare tax rate will remain at 1.45%. For those employees making \$200,000 or more and those married couples filing jointly making \$250,000 or more, the Medicare tax will increase from 1.45% to 2.35% for income above these amounts.

Medicare Tax Contribution Rates

	2012		2013	
	Employer	Employee	Employer	Employee
First \$200,000 (Single) and \$250,000 (Married)	1.45%	1.45%	1.45%	1.45%
All Remaining Wages	1.45%	1.45%	1.45%	2.35%

New "Unearned Income" Tax

Additionally, beginning in 2013, taxpayers will be saddled with a new 3.8% surtax, known as the Unearned Income Medicare Contributions Tax ("UIMCT") on the lesser of (a) net investment income or (b) the excess of AGI over the same threshold amounts as for the Medicare tax increase (\$200,000 for single filers and \$250,000 for married couples). For those in the highest tax brackets, net investment income may be the lesser, and thus taxable, amount. The investment income taxed will include capital gains; dividends; any gross income from interest, annuities, royalties, or rents; and passive income from partnerships of Subchapter-S Corporations. Fortunately, business income and distributions from qualified retirement plans, such as employer-sponsored defined benefit plans, profit sharing plans, money purchase plans, employee stock ownership plans ("ESOPs"), 401(k) plans, 403(b) plans, and 457(b) plans will not face the new 3.8% surtax. Furthermore, investment income does not include distributions from tax-exempt municipal bonds or distributions from individual retirement accounts ("IRAs").

Unearned Income Medicare Contributions Tax (2013)

	3.8% Tax on Lesser of:	
Single Filer	Net Investment Income	AGI Over \$200,000
Married Couples Filing Jointly	Net Investment Income	AGI Over \$250,000

Tax on Certain Insurance Providers

PPACA will reduce the amount of compensation that certain insurance providers can deduct for any officer, director, or other employee. The insurance providers affected by the provision are those with at least 25% of gross premium income derived from health plans that meet the minimum requirements of the Act. Thus, most providers will be affected. PPACA will amend Section 162(m) of the Internal Revenue Code, effectively lowering the deductible compensation limit from \$1,000,000 to \$500,000 for these providers. In addition, the exception for performance-based pay will be entirely eliminated; therefore, all forms of compensation will be counted toward the \$500,000 limitation. Moreover, the deduction limitation is applicable to compensation paid in 2013, along with deferred compensation that is currently being earned but that will not be paid until 2013. Thus, the provision may already be affecting certain insurance providers with deferred compensation plans.

Compensation Deduction Limitation Per Executive (For Certain Insurance Providers Only)

2012	2013
\$1,000,000 (Not Including Deferred Compensation)	\$500,000

Other Provisions

There are two other miscellaneous provisions of PPACA that you should be aware of. Beginning in 2013, the 7.5% of AGI threshold for medical expense itemized deductions will be raised to 10% of AGI. Thus, a smaller portion of medical expenses will be deductible. Further down the road, taxpayers who are insured under top-of-the-line medical insurance plans can expect a major tax increase. In 2018, a 40% excise tax will be placed on “Cadillac” health insurance plans that cost more than \$10,200 for individuals and \$27,500 for families.

Treasury Regulations, Subchapter C, Section 31.3121(v)(2)

With tax rates set to increase in coming years, companies’ deferred compensation plans are likely to see more contributions. However, participants of deferred compensation plans should be mindful that, even if compensation is deferred for income tax purposes, FICA taxes may still need to be paid. Regulation 31.21(v)(2)-1(a)(2)(ii) explains that nonqualified deferred compensation plans have a special timing rule for FICA tax purposes. Deferred compensation is subject to FICA tax when the compensation is “no longer subject to a substantial risk of forfeiture.” Generally, this occurs when an employee has earned the deferred compensation and it will not be forfeited as a result of termination of employment. Thus, if no additional vesting requirement exists for which the employee must continue service with the company, FICA tax will be owed, even if the compensation has not yet been received. In some cases, the compensation may vest in increments over time. Only the portion that vests in each year is subject to FICA tax in that year. Fortunately, per Regulation 31.21(v)(2)-1(a)(2)(iii), once deferred compensation is made subject to FICA tax, neither the eventual payment of the compensation nor any income attributable to the compensation will be subject to additional FICA taxation. Thus, deferred compensation is only subject to FICA tax once.

Conclusion

The following tables summarize the tax rates that can be expected both in 2012 and in 2013 for executives in the highest tax brackets if no further legislation is passed.

Year	Ordinary Income Tax Rate	Qualified Dividend Tax Rate	Long-term Capital Gains Tax Rate	Social Security Contribution Rate	Medicare Tax Contribution Rate	Unearned Income Medicare Contributions Tax
2012	35%	15%	15%	6.2%	1.45%	N/A
2013	39.6%	39.6% (+3.8% "unearned income" Medicare tax)	20% (+3.8% "unearned income" Medicare tax)	6.2%	1.45% on First \$200,000 (Single) and \$250,000 (Married); 2.35% on Remaining Wages	3.8% Tax on Lesser of (a) Net Investment Income; or (b) AGI Over \$200,000 (Single) and AGI Over \$250,000 (Married)

As highlighted in this article, the tax law has seen significant changes in the recent past. Undoubtedly, new changes will follow in the coming months. Given the increasing and oftentimes uncertain nature of most of these tax law changes, it is financially paramount that taxpayers stay informed. The tax world is volatile and tax increases are never welcome, but adequate planning and understanding can soften the blow.



Tony Meyer

Tony is a Consultant and Bob is a Partner and Senior Consultant at Meridian Compensation Partners, LLC. Meridian is an independent executive compensation consulting firm.



Robert A. Romanchek