Preparing for the 2013 Tax Year
(Some call it "Taxmaggeden")

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Many changes are coming

- There are more tax changes slated to go into effect in 2013 than any year in history other than years when the Code was completely rewritten
- Most deal with “sunsetting” of the Bush era tax cuts
  - Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)
  - Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA)
  - Pension Protection Act of 2006 (PPA)

EGTRRA and JGTRRA

- Think of all you know about recent tax rates, they came from these two Acts. The PPA, just made them last for ten years instead of the five they were originally slated for.
- The 2010 Tax Relief Act (TRA) just extended most of the provisions for an additional two years, ending December 31, 2012; just four months away.

Most **Impactful** Changes

- Income Tax Rates will increase.
- Current tables
  - Single Taxpayer

Taxable Income	Tax Rate
< $8,700	10%
Up to $35,350	15%
Up to $85,650	25%
Up to $178,650	28%
Up to $388,350	33%
Above $388,350	35%

Married Taxpayers

Taxable Income	Tax Rate
< $17,400	10%
Up to $70,700	15%
Up to $142,700	25%
Up to $217,450	28%
Up to $388,350	33%
Above $388,350	35%

Most **Impactful** Changes

- Income Tax Rates will increase.
- 2013 tables
  - Single Taxpayer

Taxable Income	Tax Rate
< $22,100	15%
Up to $53,500	28%
Up to $115,000	31%
Up to $200,000	36%
Above $200,000	39.6%

Married Taxpayers

Taxable Income	Tax Rate
< $36,900	15%
Up to $89,150	28%
Up to $140,000	31%
Up to $250,000	36%
Above $250,000	39.6%

The "Marriage Penalty"

- Before the Bush Era tax cuts, some married couples experienced the so-called marriage penalty (see above slides).
- In 2013, the Marriage Penalty will come back into effect for more married couples.
  - Currently, taxpayers do not experience a marriage penalty until they exceed about $125,000 in combined income.
  - In 2013, the marriage penalty will show its effect on the first taxable dollar of the taxpayers.
    - Married Filing Separately will not fix this problem.

Itemized Deductions Phaseouts

- Under current law, the Pease Limitation raised limits for when a high income individual lost percentages of his itemized deductions.
  - For 2009 - 2012, this was repealed, so that every taxpayer was entitled to all itemized deductions (home mortgage interest, charitable deductions, etc.)
- In 2013, the Pease Limitation would start at AGI $173,650 for both married and single individuals. The taxpayer loses 3% of his deduction for every dollar that exceeds the threshold.
  - Meaning a person that makes $373,650 would lose his first $6,000 in itemized deductions.

Personal Exemption Phaseouts

- Under current law, every taxpayer was entitled to exclude a certain "personal exemption" for himself, a spouse and any dependents.
  - For 2012, this amount is $3,800.
- In 2013, lower income individuals will still get a personal exemption, but higher income individuals will lose theirs.
  - The amount will likely still be $3,800.
  - Higher income individuals start at $173,650 for Single and $260,500 for Married taxpayers.
  - For every $2,500, or portion thereof, above the limit, the taxpayer loses 2% of his total exemptions.

Child Tax Credit decreases

- Currently, qualified children earn their parents $1,000 through the Child Tax Credit. This is for each child and sets off tax due, dollar for dollar.
  - The CTC phases out $50 for each $1,000 the parents' AGI exceeds $110,000 (Married) or $75,000 (Single).
  - The CTC is considered "Refundable" and is not counted as income the next year, if paid back.
- In 2013, the CTC will be reduced to $500 per child.
  - There is debate whether it will stay "Refundable".
  - Phaseouts will retain the same thresholds, but smaller credits phase out faster than larger credits.

Capital Gains

- Capital gains rates are applied to gains realized on assets held for investment, are not depreciable, and held longer than one year.
  - Under current law, qualified capital gains are taxed at a maximum rate of 15%. Some taxpayers (those in the 10% or 15% brackets) even qualify for no taxes on capital gains.
  - In 2013, the capital gain rate will revert to 20% for most taxpayers (10% for taxpayers in the 15% bracket).
- Strategy: If the law does not change, most taxpayers could save 5% in taxes by selling before Dec. 31, rather than waiting until next year.

Dividends

- Under current law, the rates for "qualified dividends" was tied to the taxpayer's capital gain rate. Thus, most taxpayers paid only 15% on dividends.
  - A qualified dividend is a payment from a "C" corporation subject to the Federal Corporate Income Tax to a shareholder that is subject to the Federal Individual Income Tax.
- In 2013, dividends will again be subject to taxation at the Taxpayer's marginal tax rate.
  - This could be as high as 39.6% and could incur other surtaxes, mentioned later.
  - The Corporate tax system taxes income at both the corporate and taxpayer level, making it one of the highest tax rate systems in the world, as it is now; in 2013, it will be the highest system in the world.

Alternative Minimum Tax (AMT)

- The AMT was originally enacted because in the early 1980's there were about 2,000 taxpayers with income over $200,000 that paid no taxes. The AMT was supposed to fix that so people with income over $25,000 had to pay, essentially, at least a flat rate of 28% on their higher income. This amount was not inflation adjusted, so there are "patches" that go into effect nearly every year, so it does not affect the average taxpayer.

AMT Continued

- Currently, the "patch" raises the exemption amount to $48,450 for single filers and $74,450 for married filers.
- If allowed to expire, the AMT would have the flat rate of 28% taxed on income over the $25,000 rate.
  - Proposals by Republicans would completely do away with the AMT. Proposals by Obama would raise the exemption to $1,000,000 in income.

Payroll Tax Cut

- In 2011 and 2012, there was a Payroll Tax Holiday that allowed most workers to take an additional 2% of their paycheck home.
  - An employee (or a self-employed individual) has to pay FICA taxes from every earned paycheck. Most employees do not really think of the FICA tax's impact because it is withheld prior to them receiving their check.
  - FICA taxes are made up of four contribution amounts:
    - 6.2% withheld from Employee's share for Social Security funding
    - 6.2% matched by the Employer for the Employee's SS funding
    - 1.45% withheld from Employee's share for Medicare funding
    - 1.45% matched by the Employer for the Employee's Medicare funding

Payroll Tax Cut Continued

- For 2011 and 2012, Congress passed a modified payroll tax holiday that said the Employee only had to have 4.2% withheld from each paycheck for Social Security.
  - All other rates stayed the same.
- In 2013 and beyond, there are no holiday provisions, so all wages will be subject to the additional 2% taxation.
  - Social Security tax is limited to wages under $110,100.
  - Proposals have been made by the Administration to impose Social Security taxes on wages in excess of $250,000, but nothing is enacted at this time.

Student Loan Interest Deduction

- Taxpayers who are in the process of repayment of student loans get an income adjustment (deduction before AGI is calculated) for the portion of interest they pay each year.
- The current (and for 2013) limit is a deduction of $2,500 for each taxpayer.
  - Currently, the deduction begins phasing out when a taxpayer exceeds AGI of $60,000 (Single) or $125,000 (Married).
  - In 2013, the deduction will begin phasing out when a taxpayer exceeds AGI of $50,000 (Single) or $75,000 (Married) (another instance of the "marriage penalty" for younger couples.

Depreciation for Small Businesses

- Section 179 expense deduction
  - In 2011, a business could immediately expense up to $500,000 in new equipment purchases.
  - In 2012, the amount was adjusted to $139,000 and will start a dollar for dollar phase out when equipment purchases exceed $560,000.
  - In 2013, the amount that can be immediately expensed falls to just $25,000 and a dollar for dollar phase out starts when equipment purchases exceed $220,000.

Strategy: If you need to purchase equipment for your business, generally, doing so this year will yield you more tax advantages than waiting until next year.

Depreciation for Small Businesses

- First Year Bonus Depreciation
  - In 2011, businesses could immediately depreciate new equipment purchases and certain improvements to property (applied to both personal and real property).
  - In 2012, the accelerated first year depreciation was reduced to just 50% of qualified purchases or improvements.
  - In 2013, there are no provisions for accelerated first year depreciation. If you do not qualify for the Section 179 deduction, then regular MACRS schedule is all that is allowed.

Increases Coming into Effect in 2013

- The other provisions were increases that are a result of expiring reductions. The following taxes are actual increases enacted, mainly as part of the Affordable Care Act of 2010.
  - New 3.8% Medicare surtax on investment income when your AGI exceeds $200,000 (Single) or $250,000 (Married).
  - New 0.9% Medicare surtax on earned wages if AGI exceeds $200,000 (Single) or $250,000 (Married).
  - Itemized Medical Deductions will only be deductible to the extent they exceed $10,000 (raised from current $7,500).
  - A "penalty" tax for people who do not have proper health insurance from $695 to up to about $5,000. (Starts in 2014)
  - A 40% tax on "Cadillac Health Care Plans" provided by employers.

Sample Scenarios

IMPACT OF SUNSETS – ILLUSTRATIONS

#1: Assume a couple, two children eligible for the child tax credit, filing a joint return and taking the standard deduction, with $130K wage income, $10,000 net capital gains, and $2,000 dividend income. Their tax liability for 2013 (all figures are estimates and, for illustration, assume no inflation adjustments between 2012 and 2013):

No Sunset: .... $19,485 tax due for 2013

Full Sunset: .... $25,898 tax due for 2013

Difference: $6,413*

#2: Assume a couple, no children, filing a joint return and taking the standard deduction, with $300K wage income, $50,000 net capital gains, and $5,000 dividend income. Their tax liability for 2013 (assuming for illustration, no inflation adjustments between 2012 and 2013):

No Sunset: .... $77,721 tax due for 2013

Full Sunset: .... $89,934 tax due for 2013

Difference: $12,213*

#3: Assume a single filer, no children, taking the standard deduction, with $70K wage income, $5,000 net capital gains, and $1,000 dividend income. The individual's tax liability for 2011 (assuming for illustration, no inflation adjustments between 2012 and 2013):

No Sunset: .... $11,992.50 tax due for 2013

Full Sunset: .... $13,606.50 tax due for 2013

Difference: $1,614*

** Loss of Current 2% Payroll Tax Reduction up to Social Security Wage Base (anticipated to be $113,700 in 2013) not included.*

Wealth Transfer Taxes

- The wealth transfer taxes, I think, are the ones that are subject to the highest tax increase because individuals lose $4,000,000 in exemptions and rates increase more than 57% over current levels.
- Wealth Transfer Taxes are the following:
  - The Estate Tax
  - The Gift Tax
  - The Generation Skipping Transfer Tax (GST)

The Estate Tax

- Currently, every individual can pass $5,260,000 to any other person without any taxation. Amounts over $5,260,000 are subject to taxation at 35%.
  - An unlimited amount can be passed to a surviving spouse or any qualified charities.
  - In addition, the law currently allows "portability" between spouses, meaning that either spouse can use both taxpayers' exemption.
- In 2013, the amount an individual can pass goes back to $1,000,000. Amounts exceeding this are subject to tax rates starting at 41% up to 55%.
  - Still allowed unlimited deductions for amounts passed to surviving spouses or qualified charities.

Gift Tax and GST

- The Gift Tax follows closely to the Estate Tax, however, it applies during the donor's life rather than after his death.
  - Current "Annual Exclusion Amount" is $13,000. This is inflation adjusted, but is not likely to increase for 2013. This is the amount one person can give any other person without having to report it anywhere. Amounts above $13,000 per person per year must be reported by the Donor.
  - Current Lifetime Exclusion Amounts are $5,260,000 per Donor. These will return to $1,000,000 with the Estate Tax.
- GST is an additional tax imposed if you try to give assets to more than one generation below yourself.
  - The Government wants taxation at every generational level, so if you try to avoid estate taxation for your son, by giving to his children, the GST is imposed. It is basically the same as if your property was subject to double taxation.

What to do with this information?

Pre-plan and be aware of your options.

Anyone who works should start preparing for the loss of the Payroll Tax holiday, which will mean an automatic loss of 2% of your take-home pay. If you are paycheck-to-paycheck now, times are about to get tighter.

If you run a business and need new equipment, you will likely have better tax deduction options this year as opposed to next, so you should look at making large purchases now.

If you have large investment portfolios and you want to avoid the additional 5% capital gain rate (and 3.8% Medicare surtax), then you should look at selling now and re-purchasing the asset at a higher basis.

If you have a lot of dividend income, be aware it will jump in taxation from 15% to up to 43.4%. You may want to buy tax-free bonds to avoid this.

You should review your estate plan, if you have one, or create one if you don't because the ability to plan for passing assets to future generations has never been as favorable as now.