Tax Newsletter
Winter 2013

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2013 Brings Many Tax Law Changes -- Tax Reform Act 2012

Congress' solution to the "fiscal cliff" was the Taxpayer Relief Act of 2012 (TRA 2012) which brought us many beneficial tax law changes, including a permanent retention of the lower Bush-era income tax rates, retention of the 15% maximum qualified dividend and capital gains tax rates (for most people) and a permanent inflation-adjusted $5,000,000 estate tax exclusion. Among the not so beneficial changes brought to us by the TRA 2012 are a return for employees to a full 6.2% social security withholding from their gross pay (a two percentage point increase), a phase-out of the tax benefits provided by itemized deductions and the exemption credits for high income individuals, and the new 39.6% tax bracket for high income individuals. (See articles for details.)

Affordable Care Act 2010

The Patient Protection and Affordable Care Act of 2010 (ACA 2010) contains more than $400 billion in revenue raisers, as well as new health-care provisions for individuals and employers. For the previous two years I was happily ignoring this abominable monstrosity -- expecting congress to wake up and repeal it or the Supreme Court to strike it down. But the Senate did not repeal (even though the House did); and the United States Supreme Court upheld the individual mandate and essentially declared ACA 2010 to be the law of the land. For 2013 ACA 2010, brings us the 0.9% additional Medicare tax on earned income exceeding certain thresholds; and a 3.8% tax on net investment income exceeding certain similar thresholds (See articles for details.); and a 10% instead of a 7.5% threshold limitation on the medical expense itemized deduction (for non-seniors) and a phase out of itemized deductions and exemptions for higher income taxpayers.

California Proposition 30

On November 7, 2012 the voters approved California proposition 30, which brought with it three new California tax brackets retroactively applied back to January 1, 2012. *So here we have new higher tax rates applied against income earned sometimes, nearly a year before the tax act is approved and finalized!* (See article for detail.)

What about 2013 Income Tax Rates, and Who Do They Apply to?

For the most part, the low Bush-era tax rates and brackets, (adjusted for inflation) were retained for 2013 **and future years**! Because of this change, our tax rates are now pegged for future years, not just a period of time ending on a specific date (as in "fiscal cliff") but tax rates can now be depended upon for tax planning purposes. Only last year, you, I and planners of all types were not able to assume a specific tax rate for income in any specified future

What about 2013 Income Tax Rates, and Who Do They Apply to? – Continued from front page.
year; this big unknown has been a drag on our economy, and it is a great relief that this great burden has been lifted! However, beginning now, a new higher top tax rate of 39.6% (up from 35%) will be imposed on individuals with taxable income of more than $400,000 a year, $425,000 for head of household, and $450,000 for married filing joint taxpayers. It is a good thing that all these threshold tax brackets including the lower threshold rates are indexed for inflation. It is also very good that the low tax rates that we have enjoyed in recent years have been retained for the vast majority of our nation's earners.

Phase-out of Deductions/Exemptions
These low rates however, are effectively increased because of the phase out of itemized deductions and exemptions for higher income taxpayers also beginning this year. The phase-outs of these important deductions begin for married taxpayers filing jointly with adjusted gross income of $300,000, or $275,000 for taxpayers filing as head of household, or $250,000 for taxpayers filing single and $150,000 for married taxpayers filing separate returns.

Medicare Tax on High Wages
The ACA 2010 imposes a .9% Medicare tax (possibly but not necessarily withheld) on wages beyond and starting at $250,000 for married persons filing jointly, and wages starting at $125,000 for married taxpayers filing separately, and wages starting at $200,000 for all other filing statuses. I have included this here because this new Medicare tax amounts to another income tax on wages imposed over and above the high top tax rates described above. This new Medicare tax has the effect of turning the 35% tax bracket into 35.9% and the new 39.6% top tax bracket into 40.5%.

California Tax Rates Also Rise
California income tax rates and brackets remain the same for the majority of Californians. However, beginning in January 2012, a new higher tax rate of 10.3% (up from 9.3%) has been imposed on individuals with taxable income of more than $250,001 a year, $340,001 for head of household, $500,001 for married filing joint taxpayers and a new higher tax rate of 11.3% (up from 9.3%) has been imposed on individuals with taxable income of more than $300,001 a year, $408,001 for head of household, and $600,001 for married filing joint taxpayers and also a new higher top tax rate of 12.3% (up from 9.3%) has been imposed on individuals with taxable income of more than $500,001 a year, $680,001 for head of household, and $1,000,000 for married filing joint taxpayers. Naturally, the 1% mental health surcharge on income over $1,000,000 was not repealed, leaving Californians with a maximum California tax rate of 13.3%.

Tax Rate Summary
My California clients having taxable income of less than $250,000 will not be substantially affected by the new higher income tax rates applicable to 2013 income, for either federal or California taxes. However, if my California clients have taxable income exceeding $250,000, they will have a significant increase in their tax burden; and a substantial increase in their tax burden as their taxable income approaches or exceeds $400,000. All taxpayers (California or not) with taxable income exceeding $400,000 will have their tax burden greatly increased because of two new Obamacare taxes on wages and investment income and the new high 39.6% tax bracket.

Why did My January Net Wage Payment Drop so Significantly?

For the previous two years there had been a bipartisan agreement that there was a need to stimulate the economy by providing a temporary reduction of the Social Security taxes. This reduction resulted in a two percentage point decrease in the tax withheld from employee's checks and a two percentage point decrease in the self-employment tax paid by independent business persons. Employers were provided no such benefit. Since the social security system began employers have contributed 50% to the Social Security funds through their equal matching contributions. This

Why Did My January Net Wage Drop So Significantly? - continued

two percentage point reduction for employees did change the tax system such that employers were no longer providing half, but instead were providing most of the Social Security tax contributions during that two-year period. With the passing of TRA 2012 congress determined to not continue the tax reduction stimulus, so old law prevails, the former social security rates of tax return, the historical 50% employer contribution participation returns, and you are no longer being "stimulated"! That is the reason for your net pay reduction unless you are a "high income individual".

Obamacare Brings New Taxes in 2013

A New 0.9% Additional Medicare Tax
ACA 2010 brings for tax year 2013 a 0.9% additional Medicare tax on earned income exceeding $250,000 for individuals filing a joint tax return and exceeding $125,000 for married individuals filing separately and exceeding $200,000 for all other filing statuses.

The same threshold amounts apply to self-employment income generally. Self-employment income often comes from Schedule C (business or professional income) Schedule F (farm income) or Partnership Schedule K-1(form 1065). So income from these sources would often also be subject to the new Medicare tax.

An Illustrative Example:

In 2013, Sandra's salary is $220,000. She has $180 additional Medicare tax withheld (0.9% x $20,000). She files a joint return with her husband, Jim, who is self employed and earns $100,000. They file a joint tax return. Their combined earned income totals $320,000 but since their threshold is $250,000 their 0.9% Medicare tax is on $ 70,000. Therefore $70,000 is subject to the 0.9% additional Medicare tax (0.9% x $70,000) or $630. An additional $450 (0.9% x 70,000 = $630 - $180) of Medicare tax must be paid on their 2013 joint return, because of Jim's self employment earnings and Sandra's limited withholding for the Medicare tax.

A New 3.8% Tax on Net Investment Income

ACA 2010, also brings for tax year 2013 a 3.8% net investment income tax on such income exceeding $250,000 for individuals filing a joint return, $125,000 for married individuals filing separately and $200,000 for all other filing statuses.

(Caution, with regard to the 0.9% tax described above and this new 3.8% tax now described -- these thresholds are coordinateed such that taxpayer(s) using up their $250,000 threshold for the 0.9% tax described above is not allowed another $250,000 threshold with regard to the 3.8% tax.)

What is Net Investment Income? Net investment income is investment income reduced by deductions properly allocable to such income. Investment income includes: Gross income from dividends, interest, annuities, royalties, and rents, less allocable deductions and net taxable gain attributable to the disposition of property. Thankfully, some things are not "net investment income" including tax exempt bond interest, veteran's benefits, business income generally, distributions from retirement plans and IRAs, net income from an S Corporation and the gain that is excludable from the sale of a principal residence. Nevertheless, some surprising income items are included in the new definition of net investment income including all capital gains, net rental income, business income treated as a passive activity and income earned in the trading of financial instruments or commodities. Deductions are available against investment income, including investment interest, and investment expenses that exceed 2% of adjusted Gross income.

An Illustrative Example:

Sam files single. In 2013, he has net capital gain income of $200,000, tax-free municipal bond interest of $25,000, taxable interest income of

Obamacare Brings New Taxes In 2013
3.8% Tax on Net Investment Income - continued

$50,000, net rental income (passive) of $10,000. Sam has investment interest expense of $15,000 and deductible investment expenses (reduced by 2% of adjusted gross income) of $5000. Sam has net investment income subject to this tax of $240,000 (200,000+$50,000 +$10,000 -$15,000-$5000). Sam is allowed a $200,000 threshold from his net investment income and will be taxed on $40,000 ($240,000-200,000). So Sam will add $1,520 (3.8% x $40,000) to his 2013 tax obligations because of the new 3.8% net investment income tax. This new obligation is in addition to taxes that he will owe for his capital gains, taxable interest and net rental income.

Federal Estate Tax Is Here to Stay

Years ago, congressional Republicans desired to remove from our tax law, the tax on the estate of individuals (the hated "death" tax). The Republicans succeeded in their desire such that over a period of years, larger and larger estates were treated as exempt until 2010 when there was effectively no federal inheritance tax. *It was very mysterious, how it was that 2010 was such a popular year for dying, especially among the very wealthy!* By the time 2012 arrived, new Congresses had compromised, restored and reduced the estate tax, providing for a $5,120,000 estate exclusion and a maximum 35% tax rate. TRA 2012, permanently provides for an estate tax rate of 40% for persons dying in 2013 and thereafter, the act also provides for an estate exclusion of $5,250,000, adjusted annually for inflation. In recent years there was a temporary provision that allowed a married couple to take advantage of each spouses exemption allowing the couple for example in the 2011 year a full $10,000,000 exemption! TRA 2012 makes this beneficial election available permanently.

Capital Gain and Dividend Tax Rates Increase

For many years, investors have been encouraged by the tax laws to put their capital at risk. This encouragement is good for our economy and does have a beneficial effect on industry and employment. Most recently, this tax encouragement to investors has been accomplished by a low rate of tax applied to gains from the sale of stocks, bonds or real estate held for longer than one year (i.e. long term capital gains) as well as a low rate of tax applied against dividend income (dividends are distributions of income to shareholders from corporations). The TRA 2012 increased for 2013 the rate at which capital gains are taxed from 15% to 20% and also increased the rate at which most dividends are taxed from 15% to 20%. Furthermore, the concept of taxing dividends at low rates was made a permanent part of our federal tax law! California does not treat a gain from the sale of a capital asset or the receipt of dividends as being subject to special reduced tax rates.

Giving Gifts
What's taxable?

When you give cash or property to an individual, the gift is not taxable to that individual. However, if you give away some items or more than certain limits you may have to report the gift. It is very unlikely, but possible that you will need to pay gift tax. The tax law allows you to give each individual up to $14,000 cash during the year without requireing you to report the gift or file a gift tax return. In addition, certain gifts do not count toward the $14,000 annual exclusion, such as amounts paid directly to qualifying educational institutions for tuition or medical expenses (including health insurance) paid directly to the person or the medical organization. Your gift will be reportable to the extent the amount given exceeds $14,000. However, you can give up to $5,250,000 in reportable gifts during your lifetime without paying gift tax. If you give more than $14,000 cash to one individual during the year, or if you give valuable property such as real estate to anyone you must file a gift tax return to report such reportable gifts.