

## CHANGES TAKING EFFECT IN 2013

Right now, you may be waiting to hear exactly how much you'll owe with last year's Form 1040 or the size of your refund. That's understandable, but don't forget that we are now well into 2013, and a host of tax changes kick in this year. Here's a quick rundown of the most important things that have changed along with reminders about longstanding tax breaks that were extended through this year.

### **Payroll Tax Holiday is Gone**

For 2011 and 2012, the Social Security tax withholding rate on your salary was temporarily reduced by 2%, from the normal 6.2% to 4.2%. If you're self-employed, the Social Security tax component of the self-employment tax was reduced by 2%, from the normal 12.4% to 10.4%. However, the payroll tax holiday was not extended through this year. For 2013, the Social Security tax can hit up to \$113,700 of salary and self-employment income. Many salaried workers have noticed their paychecks are lower this year, and the end of the payroll tax holiday is probably the most common culprit.

### **Higher Tax Rates for Upper-Income Individuals**

For most individuals, the federal income tax rates on ordinary income (such as wages, self-employment income, and interest) for this year are unchanged. Specifically, the 10%, 15%, 25%, 28%, 33%, and 35% tax rates you've grown accustomed to in the past are still in force for this year. However, the maximum rate on ordinary income collected by higher-income individuals is now 39.6% (up from 35% last year). This rate hike only affects singles with taxable income above \$400,000, married joint-filing couples with income above \$450,000, heads of households with income above \$425,000, and married individuals who file separate returns with income above \$225,000.

The federal income tax rates on long-term capital gains and qualified dividends are also unchanged from last year for most individuals. Specifically, the 0% rate still applies to long-term gains and dividends that fall within the 10% and 15% ordinary income tax brackets, and the 15% rate still applies to most other long-term gains and dividends. However, the maximum rate for higher-income folks is now 20% (up from 15%). Again, this rate hike only affects singles with taxable income above \$400,000, married joint-filing couples with income above \$450,000, heads of households with income above \$425,000, and married individuals who file separate returns with income above \$225,000.

### **Personal and Dependent Exemption Phase-Out Rule for Upper-Income Individuals**

After being gone for 2010–2012, the phase-out rule for personal and dependent exemption deductions is back in force for this year. Phase-out starts at Adjusted Gross Income (AGI) of \$250,000 for singles, \$300,000 for married joint-filing couples, \$275,000 for heads of households, and \$150,000 for married individuals who file separate returns.

### **Itemized Deduction Phase-Out for Upper-Income Individuals**

After being gone for 2010–2012, the phase-out rule for some of the most common itemized deductions is also back in force for this year. As a result, higher-income folks can potentially lose up to 80% of their write-offs for mortgage interest, state and local income and property taxes, charitable contributions, and miscellaneous itemized deductions. Phase-out starts at AGI of \$250,000 for singles, \$300,000 for married joint-filing couples, \$275,000 for heads of households, and \$150,000 for married individuals who file separate returns.

### **Alternative Minimum Tax Relief**

Congress finally gave us some permanent relief from the dreaded Alternative Minimum Tax (AMT). The relief mainly consists of larger and inflation-indexed AMT exemption amounts and allowing various personal tax credits to offset the AMT. As a result, about 30 million households a year will be kept out of the AMT zone. For 2013, the inflation-indexed AMT exemption amounts are \$51,900 for unmarried individuals, \$80,800 for married joint-filing couples, and \$40,400 for married individuals who file separate returns.

### **Relatively Favorable Estate and Gift Tax Rules**

For this year and beyond, we have a unified federal estate and gift tax exemption of \$5 million—adjusted annually for inflation—and a 40% tax rate (up from last year's 35% rate). For 2013, the inflation-adjusted exemption amount is \$5.25 million. The right to leave your unused federal estate and gift tax exemption to your surviving spouse (the so-called portable exemption deal) is now permanent.

### **New 0.9% Medicare Tax on Unearned Income**

Before this year, the Medicare tax rate on salary and/or Self-employment (SE) income was a flat 2.9%. For employees, 1.45% was withheld from paychecks, and the other 1.45% was paid by the employer. Self-employed individuals paid the whole 2.9% themselves. Starting this year, an extra 0.9% Medicare tax is due on salary and/or net SE income above \$200,000 for an unmarried individual, \$250,000 for a married joint-filing couple, and \$125,000 for those who use married filing separate status.

### **New 3.8% Net Investment Income Tax**

Starting this year, all or part of the net investment income, including long-term capital gains and dividends, collected by higher-income folks can get socked with a new 3.8% Medicare contribution tax, referred to as the Net Investment Income (NII) tax. The NII tax will not affect you unless your modified AGI (MAGI) exceeds \$200,000 for an unmarried individual, \$250,000 for a married joint-filing couple, or \$125,000 for those who use married filing separate status. The NII tax will only apply to the lesser of: (1) your net investment income or (2) the amount of your MAGI in excess of the applicable threshold.

### **New Higher Threshold for Medical Expense Deduction**

Before this year, you could claim an itemized deduction for medical expenses paid for you, your spouse, and your dependents, to the extent those expenses exceeded 7.5% of your AGI. Starting this year, however, a higher 10%-of-AGI threshold applies to most individuals.

**Exceptions:** Through 2016, special rules apply to taxpayers age 65 and older. If you or your spouse is 65 or older in 2013, the new 10%-of-AGI threshold will not apply to you until 2017. If you or your spouse will turn 65 in 2014, the new 10%-of-AGI threshold applies for 2013, but not for 2014–2016. If you or your spouse will turn 65 in 2015, the new 10%-of-AGI threshold applies for 2013 and 2014, but not for 2015 and 2016. If you or your spouse will turn 65 in 2016, the new 10%-of-AGI threshold applies for 2013–2015, but not for 2016. The new 10%-of-AGI threshold applies to everyone after 2016.

### **New \$2,500 Cap on Healthcare FSA Contributions**

Before this year, there was no tax-law limit on contributions to your employer's healthcare Flexible Spending Account (FSA) plan (although many plans imposed their own limits). Amounts you contribute to the FSA plan are subtracted from your taxable salary. Then, you can use the funds to reimburse yourself tax-free to cover qualified medical expenses. Starting this year, the maximum annual healthcare FSA contribution for each employee is capped at \$2,500.

## **Breaks Extended Through This Year**

The recent fiscal cliff legislation extended several existing tax breaks through 2013 and even made some permanent. Here's a summary of key individual tax breaks that will stay the same for this year.

### **Child Tax Credit**

The \$1,000 maximum credit for each eligible under-age-17 child was made permanent. Provisions that allow the child credit to be refundable for more households were extended through 2017.

### **Child and Dependent Care Tax Credit**

In recent years, most parents have been able to claim a credit of up to \$600 for costs to care for one under-age-13 child, or up to \$1,200 for costs to care for two or more under-age-13 kids, so the parents can work. Lower-income parents have been able to claim larger credits of up to \$1,050 and \$2,100, respectively. The fiscal cliff legislation made these relatively generous credit amounts permanent.

### **American Opportunity Higher Education Tax Credit**

The American Opportunity credit, which can be worth up to \$2,500 and can be claimed for up to four years of undergraduate education, was extended by the fiscal cliff legislation through 2017.

### **Higher Education Deductions**

The college tuition deduction, which can be as much as \$4,000 or \$2,000 depending on your AGI, was extended through this year. Additionally, the student loan interest deduction, which can be as much as \$2,500, was scheduled to fall under less-favorable rules for this year and beyond. The fiscal cliff legislation made permanent the more-favorable rules that have applied in recent years. Both of these deductions are available whether you itemize or not, but they are phased out for higher income folks.

### **Option to Deduct State and Local Taxes**

In recent years, individuals who paid little or no state income taxes were given the option of instead claiming an itemized deduction for state and local general sales taxes. The fiscal cliff legislation extended this break through this year.

### **Charitable Donations from IRAs**

In recent years, IRA owners who had reached age 70½ were allowed to make tax-free charitable donations of up to \$100,000 directly out of their IRAs. This break expired at the end of 2011, but the fiscal cliff legislation retroactively restored it for 2012 and extended it through this year. To take advantage of the retroactive deal, you can treat donations from your IRA made in January of this year as having been made in 2012.

### **Forgiven Principal Residence Mortgage Debt**

For federal income tax purposes, a forgiven debt generally counts as taxable Cancellation of Debt (COD) income. However, a temporary exception applied to COD income from cancelled mortgage debt that was used to acquire a principal residence. Under the temporary exception, up to \$2 million of COD income from principal residence acquisition debt that was cancelled in 2007–2012 was treated as a tax-free item. The fiscal cliff legislation extended this break to cover eligible debt cancellations that occur this year.

### **\$250 Deduction for K-12 Educator Expenses**

The \$250 deduction for teachers and other K-12 educators for school-related expenses paid out of their own pockets was extended through this year.

### **\$500 Energy-Efficient Home Improvement Tax Credit**

In past years, taxpayers could claim a tax credit of up to \$500 for certain energy-saving improvements to a principal residence. The fiscal cliff legislation extended this deal through this year.

### **Mortgage Insurance Deduction**

In recent years, premiums for qualified mortgage insurance on debt to acquire, construct, or improve a first or second residence could potentially be treated as deductible home mortgage interest. The fiscal cliff legislation extended this break through this year. Note that the deduction phased out for higher-income individuals.

## **Conclusion**

This is only intended as a quick summary of key individual tax changes that take effect this year and key individual tax breaks that were extended through this year. Please contact us if you have questions or want more detailed information.

#### Industries Served:

- Manufacturing
- Distribution
- Not for Profit
- Construction
- Professional Services
- Retail and Restaurants
- Closely-Held or Family-Owned Businesses
- High Net Worth Individuals

#### Service Offerings:

##### Accounting and Bookkeeping

##### Reviews, Audits and Compilations:

- Financial Statements
- Employee Benefit Plans - Defined Contribution Plans, 401(k), 403(b), Defined Benefit Plans, Health and Welfare Plans
- Internal Audits

##### Taxes:

- Business
- Individuals
- Estates, Gifts and Trusts
- International Tax
- State and Local Tax
- Tax Credits and Deductions (R&D and Cost Segregation)
- Tax Planning

##### Fraud Awareness and Prevention:

- Efficiency and Internal Controls Evaluations
- Financial Literacy
- 24/7 Fraud Hotline Services

##### Business Consulting and Succession Planning:

- Business Valuations
- Cost Segregation Studies
- CFO for Hire
- Mergers and Acquisitions

##### Employee Benefit Plan Administration:

- Consulting on Benefit Plans
- Plan Administration, 401(k) and SEP's

##### IT Consulting:

- Disaster Planning and Recovery
- Accounting, Manufacturing and Distribution Software
- Sage Mas90 and Mas 200
- Microsoft Dynamics SL
- Quickbooks
- Custom Programming
- Software Evaluation and Selection

##### Process Efficiency

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