Am I Going To Pay Higher Personal Income Tax in 2013?

By John Hsiao, CPA

That's the question we've been wondering ever since the new tax law that took effect on January 1, 2013. The new tax law includes tax revenue generators such as a new high income Medicare Surtax (3.8% on net investment income and 0.9% additional Medicare tax on wages and self-employment income), a new 39.6% top income tax rate, and an increase of the long-term capital gain rate from 15% to 20%. This is in addition to the revival of the Personal Exemption Phase-out and Itemized Deductions phase-out rules that limits the tax deductions. We often refer to these limitations as the "PEP," (personal exemption phase-out) and the "Pease," named after former Ohio representative Don Pease, who authored the Congressional bill, which limited the itemized deductions. So does this mean that we are all going to hand over more of our hard earned money to Uncle Sam this year?

Even though the majority of taxpayers will probably not see much increase in their federal income tax, **many** high-income individuals will likely see their federal income tax increase in 2013. The recently enacted tax law also includes permanent extension of the Bush-era tax cuts for most taxpayers, permanent relief from the Alternative Minimum Tax (AMT), and a host of retroactively resuscitated and extended tax breaks for individual and businesses.

The following four examples (overly simplified for clarity) demonstrate how the new tax law changes, or does not change, the federal tax liability from 2012 to 2013, assuming the income and deductions are exactly the same for both years.

Example 1: A single retiree over age 60 has the following income and deductions on her 2012 tax return:

Interest Income	$	1,350		
Qualified Dividends		6,300		
Short-Term Cap Gain		3,000		
Long-Term Cap Gain		15,000		
Pension & Social Security		39,000		
Adjusted Gross Income			$	64,650
Less:				
Standard Deduction	$	7,400		
Personal Exemption		3,800		
Total Deductions				11,200
Taxable Income			$	53,450
2012 Federal Tax Due	$	6,700		
2013 Projected Federal Tax Due	$	6,500		

In this example, since her taxable income is less than the $400,000 threshold for the new tax rates, she will continue to be taxed at the same income tax rate and at the 15% long-term capital gain rate in 2013 as in 2012. Also, since her Adjusted Gross Income (AGI) is below the $200,000 threshold, the new 3.8% Medicare surtax does not apply to the interest, dividends, or capital gain (the net investment income) here. Her 2013 federal income tax will actually be slightly less than the 2012 federal income tax, as the amount of the Standard Deduction will increase to $7,600 and the amount of the personal exemptions will increase to $3,900 for 2013.

Example 2: A married couple filing a joint return (MFJ) has the following income and deductions on their 2012 tax return:

In this example, since their taxable income is below the $450,000 threshold for the MFJ filer, they will still be taxed at the same income tax rate in 2013 as in 2012. Also since the couple's combined wages and self-employment Schedule C income is less than $250,000, the additional 0.9% Medicare tax also does not apply. Their AGI is below the $300,000 PEP and Pease limitations, so their 2013 itemized deductions will not be limited. However, the couple will have to pay a slightly higher Social Security tax withholding on the wages and self-employment tax as the 2% Social Security tax holiday has expired as of 12/31/2012. But their overall 2013 federal income tax liability is still slightly less than their 2012 tax liability because of higher personal exemptions in 2013.

Husband's Wages	$	162,000		
Taxable State Refund		240		
Wife's Schedule C Earnings		8,400		
Deductible SE Tax		(640)		
Adjusted Gross Income			$	170,000
Less:				
Itemized Deductions				
State Income Tax	$	7,000		
Real Estate Taxes		8,000		
Home Mortgage		13,000		
Total Sch A		28,000		
Personal Exemptions		11,400		
Total Deductions				39,400
Taxable Income			$	130,600
2012 Federal Tax Due	$	25,800		
2013 Projected Federal Tax Due	$	25,700		

<u>Example 3</u>: A married couple filing a joint return has the following income and deductions on their 2012 tax return:

Wife's Wages	$	5,000		
Interest Income		800		
Qualified Dividends		1,300		
Capital Losses		(3,000)		
Partnership Trade or Business Income		271,000		
Deductible Adjustments		(61,000)		
Adjusted Gross Income			$	214,100
Less:				
Itemized Deductions				
State Income Tax	$	71,000		
Real Estate Tax		9,000		
Mortgage Interest		25,000		
Charitable Deductions		8,000		
Total Schedule A		113,000		
Personal Exemptions		19,000		
Total Deductions				132,000
Taxable Income			$	82,100
2012 Federal Tax Due	$	47,500		
2013 Projected Federal Tax Due	$	49,300		

In this example, their taxable income is below the $450,000 threshold, so their regular income tax rates will be the same for both 2012 and 2013. However, their combined wages and partnership trade or business income subject to the Self-Employment tax amount is greater than the $250,000 for the MFJ filer. The additional 0.9% Medicare tax will apply to them as shown below:

Although their regular income tax rates stay the same, and the PEP and Pease limitations do not apply to them in 2013 since their income is below the threshold amount, their total federal income tax will still be higher in 2013 due to (1) the additional 0.9% Medicare tax on their wages and self-employment income as demonstrated above, and (2) the expiration of the 2% Social Security tax holiday on the wages and self-employment income.

Wages	$	5,000	
Partnership Income Subject to SE Tax		250,269	($271,000 x 92.35%)
Total		255,269	
Threshold Amount		250,000	
Excess Amount		5,269	
Additional Medicare Tax Rate	x	0.9%	
Additional Medicare Tax	$	47	

Tax Planning Tip – The married couple in this Example 3 would have been able to avoid the additional 0.9% Medicare tax if the trade or business activity were operated as an S corporation instead of as a partnership. The S corporation income allocated to the individual shareholder is not subjected to the self-employment tax. One thing to keep in mind is that the S corporation shareholder/officer needs to take out a reasonable compensation from the corporation. Therefore, potentially some of S corporation earnings could still be subjected to the 0.9% additional Medicare tax as wages to the shareholder/officer. It will depend on the amount of a "reasonable" compensation taken by the owner.

Example 4: A married couple filing a joint return has the following income and deductions on their 2012 tax return:

Wages	$	146,000		
Interest Income		24,000		
Capital Loss		(3,000)		
Rental Income		96,000		
S Corporation Trade or Business Income		418,000		
Other Self-Employment Income		63,000		
Deductible Adjustments		(20,000)		
Adjusted Gross Income			$	724,000
Less:				
Itemized Deductions				
State Income Tax	$	45,000		
Real Estate & Other Taxes		27,000		
Mortgage Interest		24,000		
Investment Interest		24,000		
Charitable Deductions		26,000		
Total Schedule A Deduction		146,000		
Personal Exemptions		7,600		
Total Deductions				153,600
Taxable Income			$	570,400
2012 Federal Tax Due	$	175,100		
2013 Projected Federal Tax Due	$	186,700		

The married couple in this example will see a big jump in their 2013 federal tax liability because of the new tax law.

First, since their taxable income is over the $450,000 threshold for a MFJ filer, the new top 39.5% personal income tax rate will apply to the taxable income in excess of $450,000.

Second, their AGI is over the $300,000 threshold for the PEP and the Pease limitations. Under the PEP limitation, the total amount of personal exemptions that can be claimed by this couple would be completely phased-out in 2013. Also, certain itemized deductions on their Schedule A such as state and local taxes, mortgage interest, and charitable donations will be reduced by 3% of the amount by which the AGI exceeds $300,000. Therefore, in this example, the amount of personal exemptions would be limited to $0 in 2013 compared to $7,600 in 2012, and the deductible itemized deductions for 2013 would be limited to around $133,000 compared to $146,000 in 2012.

Third, they also have to pay the new 3.8% Medicare Surtax on their net investment income, such as interest income and rental income.

Overall, this couple's 2013 federal tax liability in this example will likely increase by roughly $11,000 compared to their 2012 federal tax liability. The good news is that they will not be subjected to the additional 0.9% Medicare tax as their combined wages and self-employment income amount is less than the $250,000 threshold amount. This example also illustrates the importance of selecting the business entity type that you use to operate your trade or business activity described in the Tax Planning Tip section. Had this couple operated their business as a partnership instead of as an S corporation, they would have to pay the additional 0.9% on their $146,000 wages, $63,000 other Self-Employment income, and $418,000 business income. (See Example 3 above.) That's about $3,000 in additional taxes.

Tax Planning Note – There is a general misconception among high income individuals that, because of this Pease limitation on Itemized Deductions, taxpayers would not get a full tax benefit on their charitable donations. Therefore, they should avoid making large charitable donations in 2013. This is simply not true. The 3% itemized deductions phase-out is calculated based on the excess of the Adjusted Gross Income over the threshold amount. The total amount of itemized deductions does not affect the amount of the itemized deductions that are phased-out. If you are planning to make a large charitable donation in 2013, you should do so. You will still get the full tax deduction, subject to the standard charitable donation limitations (i.e., 50% of your AGI for cash donations). If charitable donations exceed these standard limitations, excess donations will carry over and can be used in the following five years.

Please note that the four examples in this article are overly simplified. The tax law and the actual calculations of these new taxes in 2013 are very complicated. These examples should give you a general idea as to how the new tax law that went into effect on January 31, 2013 would, or wouldn't, increase your 2013 federal income tax liability. We will be glad to sit down with you and go over your own personal tax situation to determine how your 2013 federal tax will be impacted by the new tax law. Michael Silver & Company CPAs has a team of highly trained tax experts who are ready to assist you in devising a tax plan that will minimize your exposure to these new taxes.

John has over eighteen years of experience in public accounting. He works closely with his clients on federal and state tax compliance, planning and projection issues, and retirement planning. He also provides business advice tailored to the specific needs of each client. John's industry and service expertise includes high net worth individuals, private wealth management offices, law firms, private investment partnerships, real estate, LLCs, and U.S. expatriates in foreign countries. John is also experienced in working and negotiating with the IRS and state revenue agencies on tax audits, tax compliance issues, and tax installment payments.