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ValueLine

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From the desk of Vic Hausmaninger, CEO….

"Taxmageddon – Plan for Potentially Higher Taxes Starting Next Year"

Through the end of this year, we can continue to enjoy relatively low federal taxes since the so-called Bush tax cuts are still in place. But next year, all bets are off. That's because the Bush tax cuts will automatically expire at the stroke of midnight on December 31 -- unless Congress takes action.

But that's not all. The 2 percent Social Security tax rate reduction, often called the payroll tax holiday, is also scheduled to expire at year-end.

And there's more. More people will be liable for the federal estate tax. And the controversial 2010 healthcare legislation, recently upheld by the Supreme Court, will impose:

1. An additional 0.9 percent Medicare tax on salaries and self-employment income earned by higher-income individuals.

2. A 3.8 percent Medicare surtax on investment income earned by higher-income folks. Finally, the healthcare legislation includes two other unfavorable changes that will affect many individuals, starting next year.

The tax-hiking impact of the expiration of the Bush tax cuts combined with these other unfavorable changes has been dubbed Taxmageddon. To reiterate, Taxmageddon will strike at the beginning of next year unless Congress acts to make changes. Here's the story.

How Much Will It Cost You?

At the end of 2012, approximately $500 billion in tax breaks expire at once. How much will it cost each American? Of course, the exact amount depends on your income and tax situation. But one study estimated that the average American household would face a tax increase of **$3,800** if Congress does not act to extend some, or all, of the tax breaks.

In addition to the expiring tax breaks covered in this article, there are also numerous tax breaks for businesses and individuals that expired at the end of 2011, including enhanced depreciation deductions, an enhanced higher education tax break, and more.

Impact of the Scheduled Demise of Tax Cuts

The Bush tax cuts have more components than you may think, and almost all individual taxpayers benefit from at least one of them. Here is what to expect if these five important components are allowed to expire at year end.

1. Higher Tax Rates for All. Some people believe that only those individuals who occupy the top two federal income tax brackets will face higher federal income taxes if the Bush cuts expire as scheduled on December 31, 2012. Not true! Unless Congress takes action and the president goes along (whoever he is at the time), rates will go up for everyone. Specifically:

- The existing 10 percent bracket will go away, and the lowest "new" bracket will be 15 percent.
- The existing 25 percent bracket will be replaced by a 28 percent bracket.
- The existing 28 percent bracket will be replaced by a 31 percent bracket.
- The existing 33 percent bracket will be replaced by a 36 percent bracket.
- The existing 35 percent bracket will be replaced by a 39.6 percent bracket.

2. Higher Capital Gains and Dividends Taxes for All. Right now, the maximum federal rate on long-term capital gains and dividends is only 15 percent. Starting next year, the maximum rate on long-term gains is scheduled to increase to 20 percent (or 18 percent on gains from assets acquired after December 31, 2000 and held for more than five years), and the maximum rate on dividends will skyrocket to a whopping 39.6 percent.

Currently, the maximum federal rate on short-term capital gains is 35 percent. Starting next year, it is scheduled to increase to 39.6 percent.

In addition, there is currently an unbeatable 0 percent rate that applies to long-term gains and dividends collected by individuals in the lowest two rate brackets (the 10 percent and 15 percent brackets). Starting next year, taxpayers in the lowest two brackets (the 15 and 28 percent brackets) will pay:

- A 10 percent rate on long-term gains (or 8 percent on gains from assets acquired after December 31, 2000 and held for more than five years).
- A 15 percent and 28 percent rate on dividends (compared to 0 percent now).
- A 15 percent and 28 percent rate on short-term gains (compared to 10 percent and 15 percent now).

Bottom Line: Tax rates in general, and taxes on capital gains and dividends, are scheduled to go up for everyone -- not just "the rich."

3. A Harsher Marriage Penalty. The Bush tax cuts included several provisions to ease the so-called marriage penalty, which can cause a married couple to pay more in taxes than when they were single. Here are the specifics:

- Right now, the bottom two tax brackets for married joint-filing couples are exactly twice as wide as for singles. This helps keep the marriage penalty from biting lower and middle-income couples. Starting next year, the joint-filer tax brackets will contract, causing higher tax bills for many folks.
- Currently, the standard deduction for married joint-filing couples is double the amount for singles. Starting next year, the joint-filer standard deduction will fall back to about 167 percent of the amount for singles.

Bottom Line: If Congress doesn't act, lots of middle-income income couples will face higher tax bills due to a harsher marriage penalty.

4. Return of the Phase-Out Rule for Itemized Deductions. Before the Bush tax cuts, a nasty phase-out rule could eliminate up to 80 percent of a higher-income individual's itemized deductions for mortgage interest, state and local taxes, and charitable donations. The rule was gradually eased and finally eliminated in 2010. Next year, however, the phase-out will be back with full force unless Congress takes action and the president approves. So if you itemize and have 2013 adjusted gross income above about $179,000 (or about $89,500 if you use married filing separate status), get ready for this phase-out rule to take a bite out of your wallet.

5. Return of Phase-Out Rule for Personal Exemptions. Before the Bush tax cuts, another nasty phase-out rule could eliminate up to 100 percent of a higher-income individual's personal exemption deductions (for 2012, personal exemption deductions are $3,800 each). The rule was gradually cut back and finally eliminated in 2010. But it will be back with a vengeance next year unless Congress takes action and the president approves. So you need to be ready for yet another bite out of your wallet if you are a married joint-filer with 2013 adjusted gross income above about $269,000. If you're single, the magic number will be about $179,000. If you use head of household filing status, watch out if your 2013 adjusted gross income exceeds about $224,000. If you use married filing separate status, the magic number will be about $134,000.

Impact of the Scheduled Demise of Payroll Tax Holiday

For 2012, the so-called payroll tax holiday cut the Social Security tax rate on salaries and net self-employment income by 2 percent. The maximum tax-saving benefit for one person is $2,202 (2 percent times the $110,100 ceiling on salary and self-employment income for Social Security tax purposes for 2012). A married couple can potentially save twice as much (up to $4,404) if they both work.

As things currently stand, the payroll tax holiday is scheduled to end on December 31, 2012. For 2013, the Social Security Administration projects that the Social Security tax ceiling on salary and self-employment income will be $113,700. (For 2014 and 2015, the projected ceilings are $117,900 and $123,000, respectively.)

New 0.9 percent Medicare Tax on Higher-Income Individuals

Right now, the Medicare tax on salary and/or net self-employment (SE) income is 2.9 percent. If you're an employee, 1.45 percent is withheld from your paychecks, and the other 1.45 percent is paid by your employer. If you're self-employed, you pay the whole 2.9 percent yourself. Starting in 2013, an extra 0.9 percent Medicare tax will be charged on:

1. Salary and/or net SE income above $200,000 for an unmarried individual;

2. Combined salary and/or net SE income above $250,000 for a married joint-filing couple; and

3. Salary and/or net SE income above $125,000 for those who use married filing separate status.

For self-employed individuals, the additional 0.9 percent Medicare tax hit will come in the form of a higher SE bill, but it will not qualify for the deduction for 50 percent of your SE tax bill. If you owe the extra 0.9 percent Medicare tax, it should be taken into account in determining if you need to make quarterly estimated tax payments.

New 3.8 Percent Medicare Surtax on Investment Income Collected by Certain Individuals

Currently, the maximum federal income tax rate on long-term capital gains and dividends is only 15 percent. Starting in 2013, the maximum rate on long-term gains is scheduled to go up to 20 percent and the maximum rate on dividends is scheduled to increase to 39.6 percent as the Bush tax cuts expire. But that's not all. Also starting in 2013, all or part of the net investment income, including long-term capital gains and dividends, collected by higher-income individuals can get socked with an additional 3.8 percent "Medicare contribution tax." Therefore, the maximum federal rate on long-term gains for 2013 and beyond will actually be 23.8 percent (versus the current 15 percent) and the maximum rate on dividends will be a whopping 43.4 percent (versus the current 15 percent).

Fortunately, you will not owe the new 3.8 percent Medicare surtax unless your modified adjusted gross income (MAGI) exceeds:

- $200,000 if you are unmarried,
- $250,000 if you are a married joint-filer, or
- $125,000 if you use married filing separate status.

For this purpose, MAGI means regular AGI from the last line on page 1 of your Form 1040 plus certain tax-free income from foreign sources. For most people, MAGI will be the same as regular AGI. In any case, MAGI is before any subtractions for personal exemption deductions, the standard deduction if you claim it, or itemized deductions if you claim them.

The surtax will apply to the *lesser* of your net investment income or the amount of your MAGI in excess of the applicable threshold. Net investment income includes gains from assets held for investment (like stock, other securities, and real estate), interest, dividends, royalties, annuities, rents, income from passive business activities, and income from trading in financial instruments or commodities. Net investment income also includes taxable gains from personal residence sales. (Gains from assets held for business purposes are not subject to the surtax.)

For example, a married joint-filing couple with MAGI of $275,000, including $55,000 of net investment income, would pay the 3.8 percent surtax on $25,000 (the amount of their excess MAGI). If the same couple has MAGI of $350,000, they would pay the 3.8 percent surtax on $55,000 (100 percent of their net investment income).

Finally, if you owe the 3.8 percent Medicare tax, it should be taken into account in determining if you need to make quarterly estimated tax payments.

New $2,500 Cap on Healthcare FSA Contributions

Right now, there's no tax-law limit on contributions to your employer's healthcare flexible spending account (FSA) plan (although many plans impose 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 next year, the maximum annual FSA contribution for each employee will be capped at $2,500.

New Higher Threshold for Itemized Medical Expense Deductions

Right now, you can claim an itemized deduction for medical expenses paid for you, your spouse, and your dependents, to the extent the expenses exceed 7.5 percent of AGI. Starting next year, the hurdle is raised to 10 percent of AGI.

Exception: If either you or your spouse is age 65 or older as of December 31, 2013, the 10 percent-of-AGI threshold will not take effect for you until the 2017 tax year (in other words, the 7.5 percent-of-AGI threshold will continue to apply until 2017). Also, if you or your spouse will turn 65 in 2014, 2015, or 2016, the 10 percent-of-AGI threshold will not take effect for you until the 2017 tax year. For 2017 and beyond, the 10 percent-of-AGI threshold will apply to everyone, regardless of age.

Tax Planning Implications

You may want to take some steps this year to decrease your exposure to these unfavorable tax changes. For instance:

- Roth IRA conversions done this year will probably be taxed at lower rates than those done next year.

- Investment gains recognized this year instead of next year will be taxed at today's favorable rates.
- Exercising an in-the-money employer stock option this year instead of next year might be a tax-smart move.

However, triggering income or gains this year will generally result in an accelerated tax bill. Consult us to discuss planning options and the various tax considerations that apply to your specific situation.

Keep in mind that depending on how the November 6th election turns out, it's possible that *none* of the aforementioned unfavorable tax changes will take effect. However, the prudent approach is to:

- Plan for the worst while hoping for the best and
- Be prepared to make some tax planning moves after the November election results are known but before year-end. Once again, contact us for assistance in determining the best action plan for you.

For more information about the changes in the estate tax and investment rates scheduled for next year, please contact us at your earliest convenience.

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