Password 2013 - how will my tax situation change? Prepare now before the "big surprise"

June 10, 2013 - Design / Build

When one first glances at the title of this article, it almost sounds like the blending of a Stanley Kubrick movie with one's Facebook profile. Unfortunately this article will not be as entertaining, but it does promise to be interesting as it will provide a clear illustration of how the new tax legislation will affect two types of upper income families in New York, by comparing their 2012 and 2013 tax liabilities using identical income and deduction items.

Prepare now before the
"Big Surprise" in April 2014

For the past 6 months we have been hearing or reading about the following:

* The endless series of scandals in Washington, D.C. (will this ever end?);
* The 1% or 2% wealthiest Americans and their fair share of taxes;
* The call for additional Income Tax Reform: limiting tax deductions and implementing the Buffet Rule;
* Additional changes to the estate & gift tax rules; and
* Adjusting the federal corporate income tax rate to allow U.S. companies to be competitive internationally.

With the passage of the American Tax Relief Act of 2012, as well as certain provisions of the Patient Protection and Affordable Care Act becoming effective, it is no surprise that many are unsure of how recent legislation will affect them. This article will attempt to simplify what the big changes are going to be for tax years beginning January 1, 2013 in order to offer some clarity on your situation.

Let's start with June 28, 2012, when the United States Supreme Court upheld the constitutionality of the 2010 health care reform legislation, the Patient Protection and Affordable Care Act, on the basis that Congress had the power to impose a tax on individuals without health insurance. Aside from the obvious, the requirement for applicable individuals to carry minimum essential health coverage for themselves and their dependents or pay a shared responsibility tax (penalty) for each month of noncompliance; the act also created the following 2 new Medicare taxes which will effect upper income taxpayers for years beginning after December 31, 2012 and beyond.

1.) 0.9% Medicare tax imposed on wages and self-employment income of higher income level wage earners and self-employedâ€”Single filers above $200,000, Married filing jointly (MFJ) above $250,000 and Married filing separately (MFS) above $125,000. There is no employer match for this additional Medicare tax, their portion remains unchanged at 1.45% of wages and self-employment income. Employers must withhold the additional 0.9% Medicare tax from wages paid to any individual in excess of $200,000 without regard to the individual employee's filing status or other compensation.

2) 3.8% surtax imposed on net investment income - Single filers above $200,000, MFJ above

$250,000 and MFS above $125,000. Net investment income is defined as gross income from interest, dividends, annuities, royalties and rents (other than derived in a trade or business); net gain attributable to the disposition of property (not related to a trade or business); any trade or business income that is a passive activity with respect to the taxpayer; and a trade or business of trading in financial instruments or commodities. The general nature of this tax is once a taxpayer's income exceeds the above thresholds, any net investment income of the taxpayers will be subject to this 3.8% surtax. The specific nature is that this surtax will only be imposed on the lesser amount of the taxpayer's net investment income for the tax year, or the excess of the taxpayer's modified adjusted gross income for the tax year over the threshold amount. The stated information on the surtax on net investment income is very broad in nature and before paying this surtax one should review the rules and regulations of IRC Sec 1411 or consult with their tax advisor.

On January 2nd, President Obama signed the American Taxpayer Relief Act of 2012 into law, also known as the tax side of the fiscal cliff. The highlight of this legislation was to extend the Bush-Era income tax rates for 2013 and beyond for all taxpayers, except for higher income taxpayers based on taxable income (Single filers above $400,000, MFJ above $450,000, $425,000 for HOH and MFS above $225,000). These taxpayers would see the maximum individual income tax rate increase from 35% to 39.6% and the tax rate on long-term capital gains and qualified dividend income increase from 15% to 20% on taxable income above the mentioned thresholds. The legislation also revives the phase-out of personal exemptions and the limitation on itemized deductions based on the following threshold amounts (Single filers above $250,000, MFJ above $300,000, $275,000 for HOH and MFS above $150,000). Indirectly, this legislation allowed the temporary 2% payroll tax reduction (4.2% from 6.2%) of Social Security tax for all wage earners to expire as of the end of 2012. Other provisions in this tax legislation include the increase in the estate/gift tax rate from 35% to 40% as well as the extension of certain business taxes and credits; the discussion of these is better left for another article.

So with all that being said let's take a comparative look at how these new laws will affect the following New York families. The first family has one child with two working parents - a wage earner and the other self-employed. The second family is a self-employed business owner, who receives a salary from their company and has a spouse and five children.

See the table for an analysis of their income and deductions.

Upon looking at the table, you will notice that 2013 contains a reduction in itemized deductions equivalent to three percent of the taxpayer's adjusted gross income and the benefit for personal exemptions has been completely phased-out for both scenarios. When comparing the payroll and income tax liabilities for each year, the following increases in tax are apparent:

* The expiration of the 2% reduction in payroll taxes up to the social security limit
* The additional 0.9% Medicare payroll tax on earned income in excess of $250,000
* The tax on net investment income of 3.8%
* The additional taxes due related to the reduction in itemized deductions
* The 5% tax rate increase on long-term capital gains and qualified dividends

A very simplistic analysis shows the following:

* The first family will see their payroll and income tax liabilities increase by almost $9,900 due to the new surtaxes authorized under the Patient Protection and Affordable Care Act, the expiration of the 2% payroll tax reduction and the reduction in itemized deductions, which translates to an increase of 5.3% of their 2012 tax liability.

* The second family will see their payroll and income tax liabilities increase by almost $114,300 due to the above mentioned items as well as the increase in ordinary and long-term capital gain tax rates under American Taxpayer Relief Act of 2012. The additional taxes are an increase in their 2013 tax liability over 2012 of 16.5%.

When upper income taxpayers actually sit down and put pencil to paper regarding their own 2013 individual tax situation the results may be very surprising. Therefore it is more important now, than ever before to understand what your tax 2013 tax situation may be like now, rather than waiting until April 2014 when you are trying to get your tax completed.

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