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TAX AND BUSINESS ADVISOR

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TAX AND BUSINESS Alert™

April 2013

Impact of Higher Individual Federal Tax Rates

Media outlets have focused a great deal of attention on the topic of increased individual federal tax rates, especially on high-profile athletes. Yes, tax rates have increased for some, but not for everyone. While most wage earners have seen their take-home pay shrink due to higher payroll taxes, high-income taxpayers are really feeling the pain of higher tax rates in addition to new taxes.

Let's take a look at the reasons for the higher federal tax rates on ordinary income and investment gains. First, the Patient Protection and Affordable Care Act (2010 Health Care Act) added a new 3.8% net investment income tax (NIIT). This new tax is paid, in addition to other taxes, on the lesser of (1) net investment income or (2) the excess of modified adjusted gross income (MAGI) over specific threshold amounts. Those thresholds are $250,000 (joint filers), $125,000 (married separate filers), and $200,000 (single and HOH filers).

Next, the American Taxpayer Relief Act of 2012 (2012 Taxpayer Relief Act) added a new 39.6% rate for taxpayers with taxable income of at least $450,000 (joint filers), $250,000 (married separate filers), $425,000 (HOH filers), and $400,000 (single filers). Finally, the 2012 Taxpayer Relief Act also added a new 20% capital gains rate on gains in excess of the threshold amounts listed above.

What this means is that, starting this year, a tax-payer's marginal tax rate on ordinary income could increase from 35% in 2012 to 39.6% in 2013. In addition, the tax rate on long-term investment gains could increase from a maximum of 15% in 2012 to 20% in 2013. When coupled with the NIIT, the marginal rate on ordinary income could be as high as 43.4% compared with a maximum of 35% last year. And, unfortunately, the tax rate on long-term investment gains could be as high as 23.8% (20% + 3.8% NIIT) in 2013 vs. 15% in 2012.

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The 2010 Health Care Act also added the Additional 0.9% Medicare Tax. This tax is assessed on wages and self-employment income in excess of specific MAGI threshold amounts: $250,000 (joint filers), $125,000 (married separate filers), and $200,000 (single and HOH filers).

So, now more than ever, effective tax planning is necessary to minimize your tax bill. There are many ways to reduce the impact of federal taxes. Please contact us to discuss the appropriate measures to lower your tax bill.

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Tax Calendar

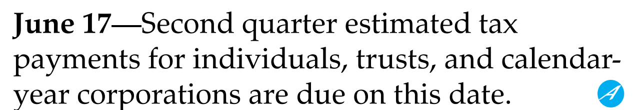
April 15—Besides being the last day to file (or extend) your 2012 personal return and pay any tax due, 2013 first quarter estimated tax payments for individuals, trusts, and calendar-year corporations are due on this date; SEP and Keogh contributions are also due if your return is not being extended.

—If you need to file a 2012 gift tax return, it also must be filed or extended by this date.

—If you paid cash wages of $1,800 or more in 2012 to a household employee, you must file Schedule H by this date. You may also have to report any federal unemployment tax paid and any income tax you withheld for your household employees.

April 30—If you have employees, a federal unemployment tax (FUTA) deposit is due if the FUTA liability through March 31 exceeds $500.

—Most employers must file Form 941 (Employer's Quarterly Federal Tax Return) to report Medicare, social security, and income taxes withheld in the first quarter of 2013. (If your tax liability is less than $2,500, you can pay it in full with a timely filed return.) If you deposited the tax for the quarter in full and on time, you have until May 10 to file the return.



June 17—Second quarter estimated tax payments for individuals, trusts, and calendar-year corporations are due on this date.

Excluding Gain on Qualified Small Business Stock

A beneficial tax provision to exclude 100% of the gain from the sale of qualified small business stock (QSBS) was recently extended for two years by the American Taxpayer Relief Act of 2012. Use of this provision allows noncorporate taxpayers to exclude from gross income 100% of gain (limits apply) from the sale or exchange of QSBS acquired after September 27, 2010, and before January 1, 2014.

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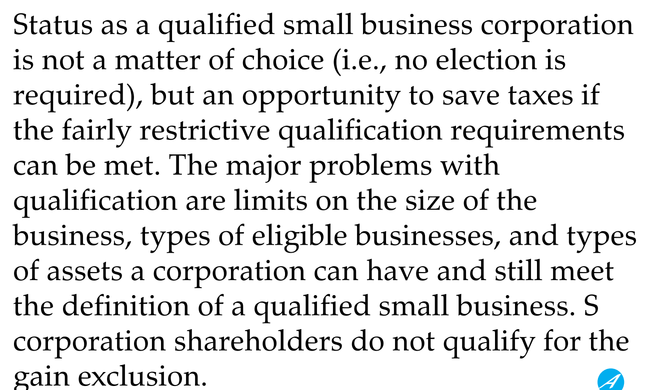
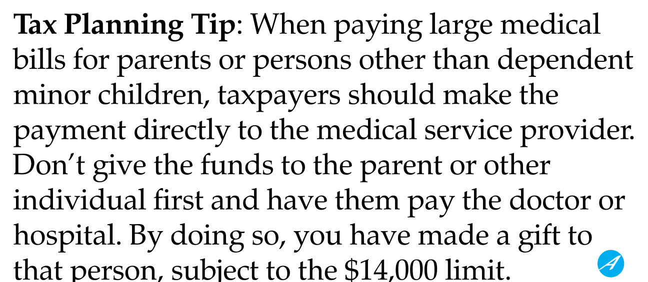


Status as a qualified small business corporation is not a matter of choice (i.e., no election is required), but an opportunity to save taxes if the fairly restrictive qualification requirements can be met. The major problems with qualification are limits on the size of the business, types of eligible businesses, and types of assets a corporation can have and still meet the definition of a qualified small business. S corporation shareholders do not qualify for the gain exclusion.

2013 Gift Tax Exclusion

The annual exclusion for gifts increased by $1,000 to $14,000 for 2013. This limit applies to the total of all gifts, including birthday and holiday gifts, made to the same individual during the year. However, any payment made on behalf of an individual as tuition directly to a qualifying educational organization or for medical expenses directly to a medical care provider (e.g., doctor, hospital, etc.) is not subject to the gift tax and, therefore, is not included in the $14,000 limit.



Tax Planning Tip: When paying large medical bills for parents or persons other than dependent minor children, taxpayers should make the payment directly to the medical service provider. Don't give the funds to the parent or other individual first and have them pay the doctor or hospital. By doing so, you have made a gift to that person, subject to the $14,000 limit.

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Residency Issues for Retirees

With 10,000 baby boomers turning 65 each day, some may decide to move to another state for a variety of reasons. These include living in a warmer climate, being closer to children or other relatives, avoiding state income tax, health reasons, or a combination thereof. But, states and municipalities are looking for every available dollar to shore up shrinking budgets. So retirees should use caution to avoid being overtaxed due to a move.

If the retiree's move is intended to be permanent, it is important that legal domicile be established in the new state. If domicile is not established, the retiree may be subject to income tax as a resident of both the old and new states. In addition, since each state has its own rules relating to residence and domicile, both states may try to impose taxes on the retiree even if he or she has established domicile in the new state, but has not adequately relinquished domicile in the previous state.

Furthermore, if the retiree dies without establishing domicile, both the old and the new states may claim jurisdiction over the retiree's estate.

The more time that elapses after the move and the more steps the retiree takes to establish domicile in the new state, the more difficult it will be for the old state to assert that the retiree resides or has domicile there.

The following steps tend to establish domicile in a new state:

- Register to vote in the new location.
- File a change of address form with the post office at the old location and change the address on documents, such as tax returns, wills, contracts, insurance policies, passports, and living trust agreements.
- Obtain a driver's license and register automobiles in the new location.
- Open and use bank accounts in the new location.
- Move items from safe deposit boxes in the old location to the new location.
- Purchase or lease a residence in the new state and sell the residence in the old state.

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- If an income tax return is required, file a resident return in the new state and a nonresident return (or no return, if appropriate) in the old state.
- File for property tax relief under a homestead exemption (if any) in the new state.

For many purposes, the location of property is determined by reference to state law, and legally may be deemed to be somewhere other than where the property is physically located. The state in which the property is deemed to be located may assess income taxes (if any) on income or gains relating to the property. The state may also assess death and succession taxes, and that state will be where probate proceedings will occur when the individual dies. Furthermore, rules of that state will be used to determine whether testamentary instruments are valid and whether the terms of the instruments (such as the powers of a trustee) are legally enforceable.

The retiree's state of domicile generally determines the rules relating to the ownership and tax treatment of intangible personal property. Thus, if the retiree established domicile in a new state, that state's laws generally will apply to his or her intangible assets, such as bank accounts, stocks, bonds, notes, partnership interests, trust income rights, and insurance contracts. Interest income from a savings account, for example, will normally be taxed by the state of domicile, rather than the state in which the account is located.

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New Simplified Home Office Deduction

The IRS recently announced a simplified option that many owners of home-based businesses and some home-based workers may use to figure their deductions for the business use of their homes. The new optional deduction, capped at $1,500 per year based on $5 a square foot for up to 300 square feet, will reduce the paperwork and recordkeeping burden on small businesses. The new option is available beginning in 2013.

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Though homeowners using the new option cannot depreciate the portion of their home used in a trade or business, they can claim allowable mortgage interest, real estate taxes, and casualty losses on the home as itemized deductions on Schedule A, if they choose to itemize their deductions. These deductions need not be allocated between personal and business use, as is required under the regular method.

Business expenses unrelated to the home, such as advertising, supplies, and wages paid to employees, can still be fully deductible. Current restrictions on the home office deduction, such as the requirement that a home office must be used regularly and exclusively for business and the limit tied to the income derived from the particular business, still apply under the new option.

In tax year 2010, the most recent year for which figures are available, the IRS indicates nearly 3.4 million taxpayers claimed deductions for business use of a home. Please contact us if you would like more information on the home office deduction or any other tax compliance or planning issue.

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