Potential income tax changes for 2013

Waiting on Congress

Unless a deeply divided Congress acts before the end of the year to avert some or all of the changes, many Americans could experience dramatic increases in federal income tax, employment tax and estate/gift tax rates in the near future. While many of the changes relate to the expiration of the “Bush tax cuts” that were implemented in the early 2000s, other changes are a result of more recent legislation (including health-care reform).

Key changes

Income tax rates

Beginning in 2013, the federal income tax rates on ordinary income would increase by at least 3%. The lowest bracket would increase from 10% to 15%; the highest bracket would increase from 35% to 39.6% and brackets in between (currently 25%, 28% and 33%) would each increase by 3% (to 28%, 31% and 36% respectively). Therefore, every individual who makes enough to pay federal income tax would have a higher marginal tax rate in 2013.

There would also be a significant increase in the long-term capital gains tax rates. Currently, the maximum tax rate on long-term capital gains is 15%. In 2013, the maximum tax rate on long-term capital gains (i.e., investments sold after holding for a year or more) would increase to 20%. At the same time, the distinction between ordinary and qualified dividends would expire. Therefore, the highest federal income tax rate on dividends would return to 39.6%.

With the Patient Protection and Affordable Care Act (PPACA), there could be a new tax on the investment income of high-income taxpayers. This provision (intended to raise revenue to pay for PPACA) would impose an additional 3.8% tax on investment income for taxpayers with adjusted gross income (AGI) in excess of $200,000 (for single taxpayers) or $250,000 (for married taxpayers filing jointly). This new 3.8% tax applies to capital gains (both short and long term), dividends, interest, annuities, royalties and rents.
**Adjustments to taxable income**

In 2013, the “marriage penalty” is set to return. Currently, the income threshold for moving from one tax bracket to the next for those married and filing jointly is double the income threshold for single filers (at least for the bottom two brackets). In 2013, the income thresholds for married filing jointly brackets will be less than twice the single filer income thresholds. The same is true for the standard deduction (the standard deduction for married taxpayers filing jointly will be less than twice the standard deduction for single taxpayers).

Also in 2013, itemized deductions and personal exemptions for high-income taxpayers are set to be phased out. The phase-out of itemized deductions (which can eliminate up to 80% of a taxpayer’s deductions for such items as mortgage interest, state and local taxes, charitable contributions, medical expenses and miscellaneous expenses) would affect married taxpayers (filing jointly) whose AGI is above $179,000. The phase-out of personal exemptions (which can eliminate up to 100% of the $3,800 per person personal exemption) would affect married taxpayers (filing jointly) whose AGI is above $269,000.

Two additional tax law changes may also affect individual taxpayers. The AGI threshold for claiming an itemized deduction for medical expenses is set to increase from 7.5% to 10% (although the 7.5% threshold continues to apply through 2016 for individuals age 65 or older and their spouses). In addition, for plan years beginning on or after January 1, 2013, the maximum contributions to a health flexible spending account (FSA) under a Section 125 cafeteria plan will be limited to $2,500. Currently, there is no legal limit on such contributions (although many employers’ cafeteria plans limit health FSA contributions to $5,000 or less to limit both the employer’s and the employee’s risk of loss).

**Employment taxes**

Unless Congress acts to extend the current payroll-tax holiday, the employee portion of the Social Security portion of the FICA tax (which applies solely to wages up to the Taxable Wage Base) will increase from 4.2% to 6.2%. (Because the 2012 Taxable Wage Base is $110,100, employees could pay as much as $2,200 more in FICA taxes in 2013 than in 2012.) The employer portion will remain at 6.2% up to the Taxable Wage Base. Both employees and employers will continue to pay the 1.45% Medicare tax on all wages (including amounts in excess of the Taxable Wage Base).

There will also be a new 0.9% Medicare surtax on earned income over $200,000 (for single taxpayers) or $250,000 (for married taxpayers filing jointly). Therefore, for high-income wage earners, the marginal Medicare tax rate (for income over the threshold) will be 2.35% (the basic 1.45% plus the additional 0.9% surtax). Fortunately, the surtax does not apply to qualified retirement plan or IRA distributions.
Estate tax
After 2012, the maximum amount that an individual taxpayer may leave to his or her heirs without incurring a federal estate tax (as well as the maximum amount exempt from the generation-skipping tax) would decrease from $5.12 million to approximately $1.4 million. This would significantly increase the number and percentage of taxpayers whose estates are potentially subject to federal estate tax upon their death.

Summary
The results of the Presidential and Congressional elections in November could certainly impact the forecast, but absent new tax legislation, many Americans may be facing significant increases in federal income taxes, federal employment taxes and federal estate taxes in 2013.