



Federal Tax

Individual Update

Session Leader and Author:

Vincent J. O'Brien, CPA

FPA of Long Island's 14th Annual Symposium & Exhibition 2013
Friday, November 1, 2013 • Crest Hollow Country Club • Woodbury, New York

About the Author

VINCENT J. O'BRIEN, CPA, provides accounting, tax and consulting services to businesses and individuals, and serves as a technical consultant to CPA firms. He is the President of Vincent J. O'Brien, CPA, P.C., located at 205 Hempstead Avenue, Lynbrook, New York, 11563.

Mr. O'Brien is also a renowned lecturer. He is the owner and principal lecturer of M+O=CPE, Inc., a company that provides its annual year-end tax update each December and January for CPAs and other tax professionals. This annual update has become the definitive way to prepare for tax season for practitioners. These practitioners rely on Mr. O'Brien's custom-written textbook throughout the year to manage the increasingly complex rules of taxation and compliance. As a practicing CPA, Mr. O'Brien provides practical and useful insights into how to apply tax rules in the real world.

Mr. O'Brien is the author of numerous CPE books, and is a regular contributor to *CCH Federal Tax Weekly* and other CCH publications. He has taught CPA review and has taught Advanced Accounting at Hofstra University. Mr. O'Brien graduated as Valedictorian of Hofstra University, and was awarded the prestigious Elijah Watt Sells Award for scoring one of the highest grades in the nation on the CPA Exam. He was also a Senior Accountant at KPMG Peat Marwick.

Mr. O'Brien is available for consultations; for fees and scheduling, call 516-594-9273.

Mr. O'Brien will be the seminar leader for M+O=CPE, Inc.'s Individual Tax Year-End Workshop, which will be presented on December 5, 2013 and repeated on December 12, 2013, January 9, 2014, and January 16, 2014. These seminars are held at the Chateau Briand, located at 440 Old Country Road in Carle Place, New York, 11514. For more information, visit www.mocpe.com.

Table of Contents

<u>Topic</u>		<u>Page</u>
New 2013 Rates and Provisions for Some Taxpayers	1
2013 Medicare Tax Changes for Some Taxpayers	4
Appendix: Other Items of Note	7

IMPORTANT NOTICE

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New 2013 Rates and Provisions for Some Taxpayers

Background

- To avoid the so-called “fiscal cliff” that loomed in late December of 2012, the U.S. Congress passed and the President signed into law the American Taxpayer Relief Act of 2012.
- This law, which was enacted on January 2, 2013, changes income tax rates and certain other income tax provisions for taxpayers who have incomes above certain thresholds.

Higher Ordinary Income Tax Rates for Some Taxpayers

- If the new law had not been enacted, the income tax rates for all taxpayers were scheduled to increase in 2013. However, the new law eliminated these tax rate increases for many taxpayers and allowed the tax rates to increase only for certain taxpayers.
- The following tables compare the ordinary income tax rates¹ for 2012 and 2013.

Married Individuals Filing Joint Returns and Surviving Spouses

<u>2012 Taxable Income</u>	<u>2012 Rate on that Portion</u>	<u>2013 Taxable Income</u>	<u>2013 Rate on that Portion</u>
Not over 17,400	10%	Not over 17,850	10%
Over 17,400 but not over 70,700	15%	Over 17,850 but not over 72,500	15%
Over 70,700 but not over 142,700	25%	Over 72,500 but not over 146,400	25%
Over 142,700 but not over 217,450	28%	Over 146,400 but not over 223,050	28%
Over 217,450 but not over 388,350	33%	Over 223,050 but not over 398,350	33%
Over 388,350	35%	Over 398,350 but not over 450,000	35%
		Over 450,000	39.6%

¹ As a reminder of the income tax formula used to determine a taxpayer’s liability, start with gross income, and minus certain deductions (e.g., certain IRA contributions), and the result is adjusted gross income. From adjusted gross income, subtract itemized deductions and personal and dependent exemptions, and the result is taxable income.

Unmarried Individuals (Other Than Heads of Households and Surviving Spouses)

<u>2012 Taxable Income</u>	<u>2012 Rate on that Portion</u>	<u>2013 Taxable Income</u>	<u>2013 Rate on that Portion</u>
Not over 8,700	10%	Not over 8,925	10%
Over 8,700 but not over 35,350	15%	Over 8,925 but not over 36,250	15%
Over 35,350 but not over 85,650	25%	Over 36,250 but not over 87,850	25%
Over 85,650 but not over 178,650	28%	Over 87,850 but not over 183,250	28%
Over 178,650 but not over 388,350	33%	Over 183,250 but not over 398,350	33%
Over 388,350	35%	Over 398,350 but not over 400,000	35%
		Over 400,000	39.6%

Higher Tax Rate for Long-Term Capital Gains and Qualified Dividend Income for Some Taxpayers

- If the new law had not been enacted, the income tax rates for long-term capital gains and qualified dividend income were scheduled to increase for all taxpayers. However, the new law allowed the tax rates to increase only for certain taxpayers.
- In 2012, the maximum rate for long-term capital gains and qualified dividend income was 15% for all taxpayers².
- For 2013
 - The 15% rate applies for taxpayers with taxable income at or below the threshold for the 39.6% rate, discussed in the previous section (e.g., \$450,000 for married couples filing joint returns and \$400,000 for unmarried individuals)³.
 - However, the rate increases to 20% for taxpayers with taxable income above the threshold for the 39.6% rate⁴.

² Special rates apply to gains from depreciable realty, collectibles and the non-excluded portion of gain from qualified §1202 small business stock. These same rules apply for both 2012 and 2013.

³ Taxpayers with ordinary income that is less than the endpoint of the 15% ordinary income tax bracket are subject to a maximum rate of 0% on some or all of their qualified dividends and/or long-term capital gains. This provision also applied in 2012 and was made permanent by the new law.

⁴ Taxpayers with taxable income over this threshold may still benefit from the lower 15% rate on long-term capital gains/qualified dividends, to the extent that their ordinary income is less than the threshold at which the 39.6% bracket begins.

Phaseout of Itemized Deductions and Personal Exemptions for Some Taxpayers

- Prior to 2010, taxpayers with income over certain thresholds faced a reduction (referred to as a phaseout) of their otherwise allowable itemized deductions and exemptions. For the 2010 to 2012 tax years, this phaseout had been eliminated for all taxpayers.
- Beginning in 2013, the phaseout returns for taxpayers with adjusted gross income that exceeds the following applicable thresholds⁵.
 - \$300,000 for married filing jointly
 - \$250,000 for single individuals (other than heads of households and surviving spouses)

Threshold for Deduction of Medical Expenses

- In 2012, and earlier tax years, medical expenses were deductible for regular income tax purposes only to the extent that they exceeded 7.5% of a taxpayer's adjusted gross income⁶.
- *The Patient Protection and Affordable Care Act of 2010*, enacted on March 23, 2010, and the *Health Care and Education Reconciliation Act of 2010*, enacted on March 30, 2010 (these two laws are collectively referred to as "the healthcare legislation") contain several provisions with delayed effective dates⁷.
- The healthcare legislation includes a provision that changes the threshold for deductibility of medical expenses, effective with the 2013 tax year.
 - Generally effective after December 31, 2012, the threshold for regular tax purposes will be raised to 10% of a taxpayer's adjusted gross income.
 - However, a special rule applies to taxpayers who are age 65 or older.
 1. For calendar-year taxpayers in 2013 through 2016, the change in the rule for regular tax purposes will be deferred.
 2. During any of these tax years, if a taxpayer (or such taxpayer's spouse) has attained the age of 65 before the close of such tax year, the taxpayer is permitted to continue to use the 7.5% threshold for regular tax purposes for that tax year.

⁵ These thresholds will be indexed for inflation after 2013.

⁶ However, for alternative minimum tax purposes, the deduction is available only to the extent that such expenses exceed 10% of a taxpayer's adjusted gross income.

⁷ The United States Supreme Court upheld the constitutionality of this legislation in a decision announced on June 28, 2012. See *National Federation of Independent Business, et al. v. Sebelius, Secretary of Health and Human Services, et al.*

2013 Medicare Tax Changes for Some Taxpayers

Background

- The healthcare legislation, discussed in the previous section, also contains provisions that dramatically change the Medicare tax for certain taxpayers.
- Prior to 2013, the Medicare tax had two portions: the employee portion and the employer portion. The current rate for each portion was 1.45%, and the tax applied to all wages and/or self-employment earnings, without any dollar limit.
- The healthcare legislation raises the rate of the Medicare tax, and makes it applicable to a wider scope of income, for some taxpayers.
- These changes are effective in 2013 for taxpayers with income over certain thresholds.

Increase in the Wage Portion of the Tax

- Effective for tax years beginning after December 31, 2012, the employee portion of the Medicare tax is increased by 0.9% for individual taxpayers with income in excess of certain thresholds⁸.
 - As a result, for some taxpayers, the total employee portion of the Medicare tax will be 2.35% (1.45% + 0.9%). Since the employer portion will remain at 1.45%, the total Medicare tax will be 3.8% (2.35% for the employee portion plus 1.45% for the employer portion).
 - The additional tax will apply to the excess of wages (and/or self-employment earnings) over \$200,000 for unmarried taxpayers, \$250,000 for married taxpayers filing joint returns⁹, and \$125,000 for married taxpayers filing separate returns. These thresholds are not subject to indexing for inflation.
 - Employers are required to withhold the additional portion of the Medicare tax only when an employee's compensation for the year exceeds \$200,000, regardless of the filing status of the employee¹⁰.
 - To the extent that the additional portion of the Medicare tax is not withheld by the employer (e.g., for spouses who each earn just below the \$200,000 threshold), taxpayers

⁸ The employer portion of the Medicare tax remains at 1.45% for such taxpayers, and both the employer and employee portions of the Social Security tax remain unchanged for wages up to the level of the Social Security wage base for a given year.

⁹ For the purpose of the threshold, the combined wages and self-employment income of both spouses are compared to the \$250,000 threshold. The threshold applies once per joint return, NOT per spouse.

¹⁰ The IRS website has guidance for employers regarding these new withholding rules. See <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Questions-and-Answers-for-the-Additional-Medicare-Tax>.

must pay any such tax that applies to their wages as part of the tax due with their federal income tax returns (reported on Form 8959, *Additional Medicare Tax*).

New Tax on Net Investment Income

- In addition, effective for tax years beginning after December 31, 2012, the entire Medicare tax (i.e., 3.8%) will apply to the net investment income of individual taxpayers with income in excess of certain thresholds¹¹.
 - The threshold¹² at which the tax applies is \$200,000 for unmarried taxpayers, \$250,000 for married taxpayers filing joint returns, and \$125,000 for married taxpayers filing separate returns¹³. These thresholds are not subject to indexing for inflation.
 - For the purpose of the new tax, net investment income includes the following.
 1. Income from interest, dividends, annuities, royalties and rents
 2. Income from a trade or business that is passive for the taxpayer
 3. Net gain attributable to the disposition of property¹⁴
 4. Income from a trade or business that consists of trading financial instruments or commodities
 5. All of these sources of income are reduced by expenses related to the production of the income, and the tax is applied to the NET investment income.

¹¹ This marks a fundamental change in the applicability of the Medicare tax from solely a payroll/self-employment tax to a broader tax.

¹² This threshold is based on the taxpayer's modified adjusted gross income. For this purpose, modified adjusted gross income is adjusted gross income plus any foreign earned income excluded from gross income under Internal Revenue Code §911(a)(1).

¹³ Net investment income that is received by estates and trusts will also be subject to the new tax. This new tax will be computed on Form 1041, *U.S. Income Tax Return for Estates and Trusts*. Estates and trusts will be subject to the new tax on the lesser of their undistributed net investment income or the excess of their adjusted gross income over the highest income tax bracket for estates and trusts for the tax year. (For the 2013 tax year, the highest income tax bracket begins at \$11,950.)

¹⁴ For the purpose of disposition of property, if the property is held in a trade or business that is passive for the taxpayer, or one that consists of trading financial instruments or commodities, then the gain will be subject to the new tax on net investment income. If property is held in an active trade or business (i.e., nonpassive activity) conducted as a sole proprietorship, S corporation, partnership or limited liability company that is taxed as a partnership, the gain will be excluded from the net investment income. If a taxpayer sells his or her ownership interest in an S corporation, partnership or limited liability company that is taxed as a partnership, any gain is subject to the new tax on net investment income only if the activity conducted by the entity is passive for the taxpayer. If the entity conducts an activity that is nonpassive for the taxpayer, then any gain on a sale of the ownership interest in that entity is not subject to the new tax net investment income.

- Items Excluded from the Definition of Net Investment Income
 1. Net investment income excludes items that are excluded from gross income for income tax purposes, such as tax-exempt interest and excluded gain from the sale of a principal residence.
 2. Net investment income also excludes distributions from qualified retirement plans, alimony and Social Security benefits.
- Computing the Tax
 1. Subtract the threshold discussed above from the taxpayer's modified adjusted gross income¹⁵. The result is "Excess MAGI." If the Excess MAGI is zero or less, the taxpayer is not subject to the Medicare tax on unearned income.
 2. Compare the Excess MAGI to the taxpayer's net investment income, and choose the lesser amount. The result is the amount subject to tax.
 3. Multiply the amount subject to tax by 3.8%.
- The Medicare tax on net investment income is reported on Form 8960, *Net Investment Income Tax – Individuals, Estates and Trusts*.

¹⁵ For this purpose, modified adjusted gross income is adjusted gross income plus any foreign earned income excluded from gross income under Internal Revenue Code §911(a)(1).

Appendix: Other Items of Note

Other Upcoming Changes from the Healthcare Legislation

Penalty on Certain Individuals Who Do Not Have Health Insurance

- Effective after December 31, 2013, the healthcare legislation penalizes individuals who do not have health insurance coverage for themselves (and for their dependents, if applicable), unless an exception applies.
- The penalty is expected to be computed as part of the individual's Form 1040.

Penalty on Businesses that Do Not Offer Health Insurance to Employees

- Originally effective after December 31, 2013, the healthcare legislation imposes a penalty on certain businesses who either do not offer health insurance to their employees, or who offer it at a cost that makes the employees eligible for the refundable credit for health insurance premiums. However, in September 2013, the IRS announced that the effective date of this penalty will be deferred until after December 31, 2014.
- To be subject to the penalty, the business must generally have employed an average of more than 50 actual or equivalent full-time employees during the preceding calendar year¹⁶.
- Future regulations will establish the method of reporting and paying this penalty.

Estate and Gift Tax

Federal Rules

- Certain provisions related to the federal gift and estate tax were scheduled to expire after December 31, 2012. The American Taxpayer Relief Act of 2012, which was enacted on January 2, 2013, made changes to some estate and gift tax rules.

¹⁶ If the business was not in existence in the prior year, use the average number of employees reasonably expected to be employed during the current year. For this purpose, full-time means employees who average at least 30 hours of service per week. The number of hours per month of part-time employees must be totaled and divided by 120 hours to determine the number of full-time equivalent employees represented by the part-time workers. For the purpose of the 50-employee test, count both actual full-time workers and equivalent full-time workers. A business that employs more than 50 seasonal workers for 120 or fewer days during a calendar year is treated as being below the threshold of more than 50 full-time employees.

- *Gifts*
 - The annual gift tax exclusion amount for 2013 is \$14,000 (up from \$13,000 in 2009 through 2012).
 - In 2013, the gift tax applies to cumulative lifetime gifts that exceed \$5,250,000 (up from \$5,120,000 in 2012), and the maximum rate is 40% (up from 35% in 2012)¹⁷.
 - The generation-skipping tax also uses the \$5,250,000 lifetime exclusion amount for 2013 (up from \$5,120,000 in 2012), and the maximum rate is also 40% (up from 35% in 2012).

- *Estates*
 - The estate tax applies to estates with taxable values in excess of \$5,250,000 (up from \$5,120,000 in 2012).
 1. The maximum estate tax rate is 40% (up from 35% in 2012).
 2. The generation-skipping tax also uses the \$5,250,000 million lifetime exclusion amount, and the maximum rate is also 40%.
 3. The basis of the property inherited by heirs is the fair value as of date of the decedent's death (or alternative valuation date, if applicable), and the holding period of such property is automatically treated as long-term.

- *Portability Provision*
 - The new law makes permanent the “portability” feature that was previously scheduled to expire.
 - The now-permanent portability provision can increase the applicable exclusion amount for a surviving spouse if one spouse dies after December 31, 2010.
 1. If a married individual dies after December 31, 2010, and his or her estate does not use the full lifetime exclusion applicable for the year of death, the decedent's spouse (or the estate of the decedent's spouse) can use the remaining exclusion in the future.
 - a) For Gift Tax:
 - If spouse 1 dies after December 31, 2010, and spouse 2 makes a gift after the date of death of spouse 1, spouse 2 can use the remaining unused exclusion amount from spouse 1.
 - The remaining unused exclusion from spouse 1 is in addition to the separate exclusion already applicable to spouse 2 on his or her own.

¹⁷ The new law includes a provision whereby the lifetime exclusion for gift, generation-skipping and estate tax purposes is now scheduled to increase periodically for inflation indexing.

- b) For Estate Tax:
- If spouse 1 dies after December 31, 2010, upon the death of spouse 2, the estate of spouse 2 will be able to use the remaining unused exclusion amount from the estate of spouse 1¹⁸.
 - The remaining unused exclusion from spouse 1 is in addition to the separate exclusion already applicable to spouse 2 on his or her own.
2. The executor of the estate of the first spouse to die must elect the portability provision on a timely-filed Form 706 for the first spouse's estate¹⁹.
- a) Beginning with the 2012 versions of Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return*, and Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*, there are new sections that relate to the portability election²⁰.
 - b) The election, if made, is irrevocable.
 - c) Even though the estate of the first spouse to die is not be required to file Form 706, since the estate value is below the federal exemption level, the estate must still file a timely Form 706 to make this election.
3. If one spouse dies and the second spouse remarries, only the unused exclusion amount from the last predeceased spouse can be used.
4. The portability election applies to the unused portion of the exclusion for the gift and estate taxes, but it does not apply to any unused portion of the exclusion for the generation-skipping tax.
5. The IRS has the authority to review the first spouse's gift and estate tax returns solely to determine the validity of the claim for the unused portion of the credit for that decedent made by the surviving spouse. This is true, even if the statute of limitations has expired for the decedent.

New York State Rules

- New York State has not made any recent changes related to the estate tax rules for decedents.
- The New York State estate tax continues to apply to estates with a taxable value of more than

¹⁸ If spouse 2 made gifts and used any portion of the remaining exclusion from the estate of spouse 1 toward those gifts, then the exclusion available for the estate of spouse 2 will be reduced by the amount of such gifts.

¹⁹ Timely-filed includes the extended due date for the form, if the extension request was properly filed by the original due date. The IRS has issued guidance on the portability provision in both temporary and proposed regulations. See Treasury Decision 9593 and REG-141832-11. (Earlier guidance related to the 2011 tax year was contained in IRS Notice 2011-82.)

²⁰ Form 706 also includes a checkbox by which a decedent's estate can elect not to apply the portability provision to any unused exemption from the estate of the decedent. Most likely, very few estates would elect out of the portability provision.

\$1,000,000²¹.

- New York State has not enacted a portability provision for married individuals. Therefore, any portion of the \$1 million exclusion for New York State estate tax purposes that is not used by the first spouse to die is unavailable for the surviving spouse, even if the estate of the surviving spouse benefits from the federal portability provision discussed earlier.

²¹ New York State repealed its gift tax as of January 1, 2000. However, when determining if an estate is required to file Form ET-706, compare the value of the decedent's assets at the date of death plus the value of lifetime gifts that were made by the decedent to the \$1,000,000 filing threshold. If these combined amounts exceed the threshold, the estate is required to file the return.