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OBSERVATIONS

INDIVIDUAL TAX LAW CHANGES: 2013

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The last fiscal crisis resulted in a compromise that was (tongue-in-cheek?) entitled the American Taxpayer Relief Act of 2012. This followed tax changes contained within the Patient Protection and Affordable Care Act (PPACA or Obamacare), numbers 5 and 6 below. The focus of the tax changes were upper income taxpayers and a combination of déjà vu reversions to older laws and entirely new taxes.

1. Personal Exemption: Under the old rules, the personal exemption was phased out for taxpayers with adjusted gross income over \$300,000; that rule was suspended for several years, and has now been brought back.
2. Itemized Deductions Reduced by 3% AGI: The old rule is back; itemized deductions are reduced by an amount equal to 3% of adjusted gross income, if the adjusted gross income is over \$300,000.
3. Tax Rates: Taxable income over \$450,000 will now be subject to a tax rate of 39.6%.
4. Capital Gains (Qualified Dividends): If you are in the 39.6% tax bracket, then the capital gains rate is now back to 20% rather than 15%.
5. High-Income Hospital Insurance Tax (new): There are two Obamacare taxes; one on earned income and one on investments. The earned income tax is an additional 0.9% Medicare tax on earnings over \$250,000. It is only assessed on the employee so the company does not have to match the tax. If the wages exceed \$250,000, there will be withholding but there is no withholding on lesser amounts. This could be a surprise for married couples that individually earn less than \$250,000, and therefore not subject to withholding, but who earn more than \$250,000 jointly and therefore will be subject to the tax.

6. Medicare Investment Income Tax (new): This is an additional 3.8% tax on net investment income (interest, dividends, capital gains, and passive income). If the total Modified Adjusted Gross Income (essentially gross income reduced by IRA contributions, alimony, and certain self-employed expenses) exceeds \$250,000, then the lesser of net investment income or MAGI over the threshold is taxed at 3.8%.

The biggest surprises will come to individuals with large capital gains, where the tax changes result in a net rate of at least 23.8% (and probably higher). A later article will discuss capital gains in more detail.

The future concern is the two Obamacare taxes. Once a concept is enacted, changing rates and thresholds are just refinements. For now, April of 2014 could be a cruel month for some taxpayers, mixing memory of lower tax rates with the desire for a better economy.

RJM

*References: The Waste Land. T.S. Eliot 1922.

*All discussions assume taxpayers filing joint tax returns; single, married filing separate and head of household taxpayers may have different rates and/or limitations.

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