Individual Tax Planning Strategies

Increase in Medicare Payroll Tax

The Medicare payroll tax will increase by 0.9 percent for individuals earning more than $200,000 and married/joint filers earning more than $250,000. Currently this tax is 2.9 percent on wages with the employee and employer paying 1.45 percent each. With the increase, only the employee’s share of the tax will increase to a total of 2.35 percent of earned income. The tax will also be applicable to net self-employment income the taxpayer earns (i.e. on Schedule C).

Example 1: Bob has W-2 income of $300,000. He files jointly with his wife. She has a W-2 of $350,000. They will owe a combined additional Medicare tax on earned income above the $250,000 of $3,600 (.9% of $400,000). Their employers will withhold the additional tax from their income only to the extent that they individually pass the threshold. By default, their employers would have likely only withheld $1,350 because he is $50,000 and she is $100,000 over the limit individually. They would owe the difference in tax of $2,250 on their tax return (or have a reduced refund). There will be a need to increase withholding or to review income tax estimates with their tax preparer.

Example 2: Bob has W-2 income of $200,000. He files jointly with his wife. She has a W-2 of $150,000. They will owe a combined additional Medicare tax on earned income above the $250,000 of $900 (.9% of $100,000). Their employers most likely will not withhold the additional tax from their income as neither individually are above the limit. Since their employers would have likely not withheld any additional taxes, they will owe the tax with their tax return (or have a reduced refund). There will be a need to increase withholding or to review income tax estimates with their tax preparer.

New Medicare Tax on Investment Income

Beginning in 2013, high-income individuals will also be subject to a 3.8 percent Medicare tax on net investment income. This income includes taxable interest, dividends, capital gains, annuity distributions, rents, royalties, and passive activity income. Net investment income will not include tax-exempt interest, distributions from employer plans, nonqualified deferred compensation, municipal bond interest or income from a flow-through business activity which you actively participate in the operations. The 3.8 percent tax applies to individuals with a modified adjusted gross income (MAGI) in excess of $200,000 (single) and $250,000 (married filing jointly). This 3.8 percent tax will apply to the lower of a taxpayer's net investment income or the amount that their MAGI exceeds the applicable threshold.

Note: MAGI is defined as the sum of adjusted gross income plus the net foreign income exclusion amount.

Example 1: Bob and Margaret file jointly and have MAGI of $300,000. They have net investment income of $30,000 from interest in dividends. They will pay 3.8% tax on the $30,000 (the amount that exceeds the $250,000 threshold but limited to total net investment income) and owe an additional $1,140 in Medicare tax.
Example 2: Bob and Margaret file jointly and have MAGI of $275,000. They have net investment income of $50,000 from interest and dividends. They will pay 3.8% tax on $25,000 (the amount that exceeds the $250,000 threshold) and pay an additional $950 in Medicare tax. There will typically not be any additional taxes withheld by their employer associated with this tax on investment income. There will be a need to discuss the impact of this tax and changes to estimated tax payments with their tax preparer.

This new Medicare tax on investment income will also apply to estates and trusts. It will apply to the lower of (1) the undistributed net investment income for the taxable year or (2) the excess of the estate or trust's AGI for the taxable year over the dollar amount at which the highest tax bracket begins for estates and trusts.

Example 1: In 2013 a trust earns $50,000 of investment income and incurs $10,000 of fees. The trust's taxable income is $40,000. If the highest marginal tax rate for 2013 began at $12,000 (the anticipated amount adjusted for inflation from 2012), the trust would owe a Medicare surtax of $1,064 (3.8 percent x the lower of (1) $40,000 undistributed taxable income or (2) the excess of the trust's AGI ($40,000) over the $12,000 threshold).

Planning points for 2012: Tax planning for 2012 may need to take a strategy that is the opposite of what is generally advised for year-end tax planning. If taxpayers expect to have AGI near $250,000 in 2013 ($200,000 for single taxpayers), there may be arguments for accelerating income into 2012 or deferring expenses to 2013 in effort to keep income below the thresholds for these additional taxes. Generally, in years past, year-end tax strategies have focused on accelerating deductions into the current year and deferring income to the next year in order to reduce the current year's tax bill. Taxpayers will need to carefully analyze their situations for both 2012 and 2013 to see which strategy will serve them best.

Flexible Spending Account

Increase the amount you set aside for next year in your employer's health flexible spending account (FSA) if you set aside too little for this year. Keep in mind that beginning next year, the maximum contribution to a health FSA will be $2,500. And don't forget that you can no longer set aside amounts to get tax-free reimbursements for over-the-counter drugs, such as aspirin and antacids.

Health Savings Account

If you become eligible to make health savings account (HSA) contributions late this year, you can make a full year's worth of deductible HSA contributions even if you were not eligible to make HSA contributions for the entire year. This opportunity applies even if you first became eligible in December. In brief, if you qualify for an HSA, contributions to the account are deductible (within IRS-prescribed limits), earnings on the account are tax-deferred, and distributions are tax free if made for qualifying medical expenses.
Harvesting Losses in Your Investment Portfolio

Realize losses on stock while substantially preserving your investment position. There are several ways this can be done. For example, you can sell the original holding, and then buy back the same securities at least 31 days later. It would be advisable for us to meet to discuss year-end trades you should consider making.

Harvesting Gains in Your Investment Portfolio

If you are thinking of selling assets that are likely to yield large gains, such as inherited, valuable stock, or a vacation home in a desirable resort area, try to make the sale before year-end, with due regard for market conditions. This year, long-term capital gains are taxed at a maximum rate of 15%, but the rate is expected to be 5% higher, or 20%, next year. Capital gains could be taxed at an even higher rate if your adjusted gross income (as specially modified) exceeds certain limits ($250,000 for joint filers or surviving spouses, $125,000 for a married individual filing a separate return, and $200,000 for all others). Taxpayers with AGI in excess of these limits that recognize gains next year (along with other types of unearned income, such as dividends and interest) will be exposed to an extra 3.8% tax (the so-called “unearned income Medicare contribution tax”). The combined overall increase in the capital gains tax rate may approach 10% considering these two changes summarized above and the phase out of itemized deductions discussed below.

Phase-out of Itemized Deductions

The phase out of itemized deductions is back, effective January 1, 2013. Therefore, if there is opportunity to “bunch” itemized deductions into 2012, it may be advantageous to do, so that they are not limited in 2013. The itemized deductions phase out begins at AGI of $178,150 for married taxpayers and $89,075 for single taxpayers.

Sale of Personal Residence

If you are in the process of selling your main home, and expect your long-term gain from selling it to substantially exceed the $250,000 home-sale exclusion amount ($500,000 for joint filers), try to close before the end of the year (again, with due regard to market conditions). This can save capital gains taxes considering the increase in rates explained earlier.

Lock in Tax at Lower Rate on Appreciated Stock

You may own appreciated-in-value stock and you want to lock in a 15% tax rate on the gain, but you think the stock still has plenty of room to grow. In this situation, consider selling the stock and then repurchasing it. You'll pay a maximum tax of 15% on long-term gain from the stock you sell. You also will wind up with a higher cost basis for tax purposes in the repurchased stock. If capital gain rates go up after 2012 and you sell the repurchased stock down the road at a profit, the total tax on the 2012 sale and the future sale could be lower than if you had not sold in 2012 and had just made a single sale in the future. This move definitely will reduce your tax bill after 2012 if you are also subject to the extra 3.8% tax on unearned income.
Conversion of IRA to Roth IRA

If you believe a Roth IRA is better than a traditional IRA, consider converting traditional IRAs to Roth IRAs this year to avoid a possible hike in tax rates next year. Also, although a 2013 conversion won't be hit by the 3.8% tax on unearned income, it could trigger that tax on your non-IRA gains, interest, and dividends. The reason is the taxable conversion may bring your modified adjusted gross income (AGI) above the relevant dollar threshold (e.g., $250,000 for joint filers). But conversions should be approached with caution because they will increase your AGI for 2012. And if you made a traditional IRA to Roth IRA conversion in 2010, and you chose to pay half the tax on the conversion in 2011 and the other half in 2012, making another conversion this year could expose you to a much higher tax bracket.

Required Minimum Distributions

Remember to take required minimum distributions (RMDs) from your IRA or 401(k) plan (or other employer-sponsored retired plan) if you have reached age 70½. An employee’s required beginning date for receiving distributions from a qualified plan is normally April 1 of the year following the later of the calendar year the employee (1) reaches age 70½ or (2) retires (from the employer sponsoring the plan) [IRC Sec. 401(a)(9)(C)(i)]. However, distributions from IRAs (including those established in conjunction with a SEP or SIMPLE IRA plan) and distributions from qualified plans to more-than-5% owners must begin no later than April 1 of the year following the calendar year such individual turns age 70½ (even if not retired). Failure to take a required withdrawal can result in a penalty equal to 50% of the amount of the RMD not withdrawn. If you turn age 70-½ this year, you can delay the first required distribution to 2013, but if you do, you will have to take a double distribution in 2013—the amount required for 2012 plus the amount required for 2013. Think twice before delaying 2012 distributions to 2013—bunching income into 2013 might push you into a higher tax bracket or bring you above the modified AGI level that will trigger a 3.8% extra tax on unearned income such as dividends, interest, and capital gains. However, it could be beneficial to take both distributions in 2013 if you will be in a substantially lower bracket in 2013, for example, because you plan to retire late this year or early the next.

Also, keep in mind that the special provisions to allow a RMD or a portion of an IRA account balance (up to $100,000) to be directly distributed to a charitable organization without recognizing taxable income on the distribution expired in 2011. Taxpayers cannot take advantage of this strategy in 2012 to reduce taxes on distributions from IRA accounts.

Income Tax Withholding Planning

Take an eligible rollover distribution from a qualified retirement plan before the end of 2012 if you are facing a penalty for underpayment of estimated tax and the increased withholding option is unavailable or won’t sufficiently address the problem. Income tax will be withheld from the distribution and will be applied toward the taxes owed for 2012. You can then timely roll over the gross amount of the distribution, noting you will have to fund the tax that was withheld, to a traditional IRA. No part of the distribution will be includible in income for 2012, but the withheld tax will be applied pro rata over the full 2012 tax year to reduce previous underpayments of estimated tax.
2013 Estimated Tax Planning

With the introduction of the new Medicare taxes, as well as expected higher regular tax and capital gains tax rates, planning for 2013 estimated taxes may be a challenge. Individuals who are subject to the .9% Medicare tax will need to review their payroll tax withholdings to see if enough taxes are being withheld. Individuals subject to the 3.8% Medicare tax may want to adjust estimated tax payments to include the expected tax. For many individuals, computing safe-harbor estimates based on 2012 income is likely the best strategy. With this approach, it will be necessary to monitor income through 2013 to ensure no significant surprises in April 2014 when 2013 returns are filed.