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Sticker shock awaits many taxpayers on their 2013 tax return

A lot of tax changes will come into effect in the 2013 tax year. For many taxpayers, most of these changes will increase their tax burden. The tax landscape has shifted —precipitously so for those who will now find themselves on the wrong side of the new divide between "middle class" and "higher earners." Higher earners are now subject to an array of brand new taxes, higher tax rates, and increasingly stringent deduction limits.

All of this increases the importance of tax awareness, and tax planning.

The Affordable Care Act ("Obamacare") calls for a higher payroll tax and a surtax on the unearned income of higher-income individuals. The American Taxpayer Relief Act of 2012 applies higher tax rates to ordinary income, capital gains and dividends. At the same time, limitations are imposed on the use of the personal exemption and itemized deductions. Below we highlight and summarize the changes that are most likely to affect your 2013 taxes.

■ **Increased payroll tax for high-earning workers and self-employed taxpayers.** An additional 0.9% Medicare tax is now imposed on wages in excess of: $250,000 for joint return filers; $200,000 for singles and heads of household; and $125,000 for married taxpayers filing a separate return.

■ **The additional 0.9% tax also applies to self-employment income** for the tax year in excess of the above figures.

■ **Surtax on unearned income of higher-income individuals.** An unearned income Medicare contribution tax is imposed on individuals, estates and trusts. For an individual, the tax is 3.8% of the lesser of: (1) net investment income or (2) the excess of modified adjusted gross income over the threshold amount ($250,000 for a joint return or surviving spouse, $125,000 for a married individual filing a separate return, and $200,000 for all others). For surtax purposes, gross income doesn't include excluded items, such as interest on tax-exempt bonds, veterans' benefits, and excluded gain from the sale of a principal residence.

■ **Higher individual income tax rates apply to higher-income taxpayers.** The income tax rates for most individuals will remain 10%, 15%, 25%, 28%, 33% and 35%, as in 2012. However, a new 39.6% rate applies for tax year 2013 for income above $450,000 (joint filers and surviving spouses); $425,000 (heads of household); $400,000 (single filers); and $225,000 (married taxpayers filing separately). These dollar amounts will be inflation-adjusted for tax years after 2013.

■ **Capital gain and dividend rates rise for higher-income taxpayers.** The top rate for capital gains and dividends rose to 20% for tax year 2013 (up from 15% in 2012) for taxpayers with incomes exceeding $450,000 (joint filers and surviving spouses); $425,000 (heads of household); $400,000 (single filers); and $225,000 (married taxpayers filing separately). By comparison, for taxpayers whose ordinary income is generally taxed at a rate below 25%, capital gains and dividends are subject to a 0% rate. For taxpayers who are generally subject to a 25% or greater rate on ordinary income, but whose income levels fall below the above thresholds, capital gains and dividends are now subject to a 15% rate. Further, the capital gains and qualified dividends rate under the alternative minimum tax ("AMT")—a tax system separate from the regular tax designed to limit certain tax benefits—also rises from 15% in 2012 to 20% in 2013 for capital gains and qualified dividends that would otherwise be subject to the 39.6% regular tax rate.

■ **Personal exemption is limited for high earners.** There is a personal exemption phase-out (PEP) for 2013 with a starting threshold of $300,000 for joint filers and surviving spouses; $275,000 for heads of household; $250,000 for single filers; and $150,000 for married taxpayers filing separately. Under the phase-out, the total amount of exemptions that can be claimed by a taxpayer is reduced by 2% for each $2,500 (or portion thereof) by which the taxpayer's adjusted gross income exceeds the above threshold. These dollar amounts are inflation-adjusted for tax years after 2013.

■ **Itemized deductions are limited for high earners.** There is a limit on itemized deductions for 2013 (i.e., the "Pease" limitation) with a starting threshold of $300,000 for joint filers and surviving spouses; $275,000 for heads of household; $250,000 for single filers; and $150,000 for married taxpayers filing separately. Therefore, for taxpayers subject to the "Pease" limitation, itemized deductions will now be reduced by 3% of the amount by which the taxpayer's adjusted gross income exceeds the threshold amount, with the reduction not to exceed 80% of the otherwise allowable itemized deductions. These dollar amounts are inflation-adjusted for tax years after 2013.

While there is a real prospect that high earners will pay more taxes this year, taxpayers should keep in mind that it's almost never too late to better one's tax situation, minimizing taxes to the greatest extent possible. Year-end tax planning may be especially productive by December 31st because timely action could nail down a host of "extender" tax breaks—individual and business tax provisions that are due to expire at year end. In addition, other tax moves may be prove advantageous. Many taxpayers can still better their tax position by acting now to: make the most of enhanced expensing and depreciation; keep adjusted gross income (AGI) down to avoid reduction (or elimination) of the many tax breaks that phase out over higher levels of AGI; make the best tax use of losses; and take full advantage of the available tax credits.

Thank you.
Best regards,

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