A Look at the 2014 Federal Income Tax Structure

# Tax Planning Now May Reduce Your Bill

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**We recommend that clients do their tax planning in the fall, while there's still time to take remedial action to reduce their tax bills. It's often difficult to plan tax events, but it's more possible with a basic knowledge of the tax system. In this article, we'll explain the different taxes and rates, some of which aren't obvious. There are different types of income and, therefore, different types of income taxes. In the next article, we'll try to incorporate this information into usable strategies.**

To start year-end tax planning, you should look at what your taxable income has been for the year to date, what tax deductions you might have and then estimate what your income and deductions might be for the rest of the year. From this information you can make an estimate of what your taxable income might be for this year. A guideline for determining your deductions is to look at last year's tax return and see how your deductions for this year may compare. With this information, you can then do some tax planning to see how you might be able to minimize your tax bill for this year.

Although this process seems pretty straightforward, as you'll see in this article, there are different kinds of income that are treated different ways by the Internal Revenue Service. In addition, there are different tax rates that apply!

## Earned Income

The most prevalent form of income is earned income from your job; this could be working for someone else or being self-employed. If you're self-employed, you'll have to pay self-employment tax. This is basically both the employee and employer halves of the FICA tax and normal Medicare tax. Some higher-income earners will also have to pay the new 0.9 percent Medicare surtax.

## Investment Income

Other taxes at different rates are imposed on capital gains and qualified dividends derived from investments. Even the sale of your home resulting in a gain above the limits discussed in our prior articles could be considered investment income. Note that short-term capital gains and nonqualified dividends are taxed at normal ordinary income rates, so these don't appear in our charts.

## Passive Income

This is most commonly created by rental real estate but could come from limited partnerships or other sources. As we recently covered the passive income rules for rental real estate, we're ignoring this for now. First, let's review the basic current income tax rates.

## Federal Tax Rates

Federal income tax rates in 2014 range from 10 percent to 39.6 percent. *(See chart below.)* You can see that the higher your taxable income, the higher tax rate you pay.

Note that taxable income is what's left after deducting personal exemptions and itemized deductions. Where it gets tricky is that at higher income levels, both personal exemptions and itemized deductions are phased out.

## Pease and PEP

The Pease rule, named after Congressman Donald Pease, limits itemized deductions. Although this is referred to as a limitation on itemized deductions, it's actually calculated based on income over a certain threshold.

As a result, the Pease limitation is essentially a roughly 1 percent surtax on income once a married couple's adjusted gross income is above $305,050 or a single filer's adjusted gross income is above $254,200. These are the 2014 thresholds and are adjusted annually for inflation.

The Pease limitation triggers an itemized deduction limitation that's the lesser of:

**2014 Federal Income Tax Rates**

| IF TAXABLE INCOME IS | | INCOME TAX IS | | | |
|---|---|---|---|---|---|
| More Than | But Not More Than | This amount | + | This % | Of Amount in Excess of |
| **Married Filing Jointly** | | | | | |
| — | 18,150 | — | + | 10.0% | — |
| 18,150 | 73,800 | 1,815.00 | + | 15.0 | 18,150 |
| 73,800 | 148,850 | 10,162.58 | + | 25.0 | 73,800 |
| 148,850 | 226,850 | 28,925.00 | + | 28.0 | 148,850 |
| 226,850 | 405,100 | 50,765.00 | + | 33.0 | 226,850 |
| 405,100 | 457,600 | 109,587.50 | + | 35.0 | 405,100 |
| 457,600 | — | 127,962.50 | + | 39.6 | 457,600 |
| **Single Individuals** | | | | | |
| — | 9,075 | — | + | 10.0% | — |
| 9,075 | 36,900 | 907.50 | + | 15.0 | 9,075 |
| 36,900 | 89,350 | 5,081.25 | + | 25.0 | 36,900 |
| 89,350 | 186,350 | 18,193.75 | + | 28.0 | 89,350 |
| 186,350 | 405,100 | 45,353.75 | + | 33.0 | 186,350 |
| 405,100 | 406,750 | 117.541.25 | + | 35.0 | 405,100 |
| 406,750 | — | 118.118.75 | + | 39.6 | 406,750 |
| **Estates and Trusts** | | | | | |
| — | 2,500 | — | + | 15.0% | — |
| 2,500 | 5,800 | 907.50 | + | 25.0 | 2,500 |
| 5,800 | 8,900 | 5,081.25 | + | 28.0 | 5,800 |
| 8,900 | 12,150 | 18,193.75 | + | 33.0 | 8,900 |
| 12,150 | — | 45,353.75 | + | 39.6 | 12,150 |

- **3 percent of the adjusted gross income** that's above the threshold amount or
- **80 percent** of the allowed itemized deductions.

At least you still get 20 percent of your itemized deductions no matter what.

The personal exemption phase-out uses the same thresholds as the Pease limitation but reduces the allowed personal exemptions, each worth $3,950 in 2014. Unlike the Pease rule, the effect of personal exemptions can be completely eliminated. If a married couple's adjusted gross income reaches $427,550 or a single filer's AGI is $376,700, those taxpayers will lose all personal exemptions.

## Medicare Surtax

The thresholds for this tax on wages and self-employed income are $250,000 of Medicare wages for married couples filing jointly and $200,000 of Medicare wages for single filers. The tax is an additional 0.9 percent of wages earned above that amount. It's important to note that unlike the regular Medicare tax, this tax is on the employee only and there's no employer contribution.

## Long-Term Capital Gains and Qualified Dividends

Here the IRS gives us a bit of good news. The taxes on this type of unearned investment income can be lower than earned income. Note that long-term capital gains are for assets held more than one year. If the holding period is shorter, regular income rates apply.

Also note that the alternative minimum tax can affect the taxes on both earned and unearned income. In 2014, long-term capital gains and qualified dividends are taxed as shown on the chart on this page.

## Medicare Net Investment Income Surtax

An additional 3.8 percent federal Medicare tax applies to individuals on the lesser of net investment income or modified adjusted gross income in excess of $200,000 (single filers) or $250,000 (married filing jointly). This also applies to any trust or estate on the lesser of undistributed net income or AGI in excess of the dollar amount at which the estate or trust pays income taxes at the highest rate.

Note that this means there's actually no longer the simple 20 percent capital gains rate. The actual capital gains rate in that tax bracket is at least 23.8 percent owing to the Medicare Net Investment Income Surtax.

**Long-Term Capital Gains Tax and Tax on Qualified Dividends**

| Income Tax Bracket | Tax Rate on Long-Term Capital Gains and Qualified Dividends | Medicare 3.8% Net Investment Rate |
|---|---|---|
| 10.0% | 0% | No |
| 15.0 | 0 | No |
| 25.0 | 15 | No |
| 28.0 | 15 | No |
| 33.0 | 15 | Probably |
| 35.0 | 15 | Yes |
| 39.6 | 20 | Yes |

## Alternative Minimum Taxes

In 2014, the alternative minimum tax exemptions are $82,100 for a married couple filing jointly and $52,800 for a single filer. Alternative minimum taxable income phase-outs begin with income above $156,500 for married filing jointly and $117,300 for single filers.

There are two AMT rates, 26 percent below AMT income of $182,500 and 28 percent above that level. AMT income is based on removing the effect of deductions and exemptions.

This may have the effect of your capital gains being taxed at a rate higher than you anticipate. An important exercise is to look at Line 45 of your 2013 Form 1040 and see whether you filed a Form 6251.

Assuming your tax structure is very similar to 2013's, this will give you an indication of whether you may be subject to AMT in 2014 and for about how much. If you follow Form 6251, you can see how complex AMT is and the specifics for your situation.

## Now What?

This article is meant as a general tax primer to show how there can be hidden taxes because of the complexity of our tax structure. It shows we can't simply follow the basic tax bracket calculations that may have been more useful in the past. The next article will review some examples of tax strategies that may help you reduce your tax bill.

Please note that this information is meant to educate and inform but not to convey specific tax advice. Specific tax advice should involve your tax counsel and your specific tax information. ■

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