Some Deductions May Disappear as Brackets Change

Planning for Potential Tax Changes

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"In this world nothing can be said to be certain, except death and taxes." — Benjamin Franklin, 1789

Well, at least death is still certain. Taxes are in a state of flux. Although it's certain they'll still exist in the future, we think they'll be in a different form than they are today. Current legislation dictates tax changes at the end of 2012. As we approach the year's end, we thought it'd be a good time to examine some of the currently legislated changes.

High Income Earners (HIEs)

There's been much talk about "taxing the rich" in the future. The "rich" are defined as those joint filers earning more than $250,000 a year and single filers earning more than $200,000 a year. According to current legislation, this high income earner group (HIEs) will be paying higher income taxes along with two new Medicare taxes.

The new Medicare taxes: HIEs will see a 0.9 percent increase in the Medicare tax on their earnings. One point of caution here: If one or both of a couple earns less than $200,000, and their total joint earned income exceeds $250,000, that employee will not have the additional tax automatically withheld. This means a married, jointly filing couple with household income above $250,000 and with neither earning in excess of $200,000 individually will be responsible for the tax, but they'll have to pay it on their own when they file.

Unearned income: HIEs could see a 3.8 percent tax applied to unearned income such as interest, dividends, capital gains, annuities, royalties and rents. Even the gain on the sale of one's house would be subject to this flat tax, but only on the gain of the sale beyond the $250,000 single or $500,000 married exclusion. This 3.8 percent tax depends on the level of unearned income. The 3.8 percent tax may not be on all your investment income; the tax would apply to whichever is less, your investment income or the amount that your modified adjusted gross income (AGI) exceeds the high-income threshold. (We didn't say these rules were easy to understand!)

The new proposed tax rates will eliminate the lowest 10 percent bracket, replacing it with a 15 percent bracket. Although the existing 15 percent and 25 percent brackets remain pretty much intact, the top income threshold on the 28 percent bracket is slated to be raised to a higher level, and the 33 percent bracket basically goes to 36 percent. The existing 35 percent bracket is then eliminated and replaced with a 39.6 percent bracket. When we refer to brackets, this is the marginal rate on the next dollar of income rather than the overall percentage of tax divided by income. HIEs will also see the return of the limitation on itemized deductions and personal exemptions that'll increase the tax rate even more. (Please see the tables b)elow.

Qualified dividends currently taxed at capital gains rates in 2012 are scheduled to be taxed as ordinary income in the marginal brackets. Long-term capital gains are scheduled to go from 15 percent in 2012 to 20 percent in 2013 and higher thereafter.

It looks as if this new tax structure would affect only those with high incomes from earnings and investments, but this is not at all the case.

In 2012, a 0 percent rate applies to long-term gains and dividends collected by those in the lowest two brackets of 10 percent and 15 percent. Starting in 2013, those in the lowest bracket will pay 10 percent on long-term gains or 8 percent on gains from assets acquired after Dec. 31, 2000, and held for more than five years. Dividend income now at 0 percent for the lowest two brackets in 2012 goes to income rates of 15 percent and 28 percent.

An important caveat for many: The tax on Social

2012 Tax Rates by Income

2012 TAX RATE	SINGLE	MARRIED JOINT
10 percent	Up to $8,700	Up to $17,400
15 percent	$8,701 - $35,350	$17,001 - $69,000
25 percent	$35,351 - $85,650	$69,001 - $139,350
28 percent	$85,651 - $178,650	$139,351 - $212,300
33 percent	$178,651 - $388,350	$212,301 - $379,150
35 percent	more than $388,350	more than $388,350

2013 Tax Rates by Income

2013 TAX RATE	SINGLE	MARRIED JOINT
10 percent	Eliminated	Eliminated
15 percent	Up to $34,900	Up to $69,800
25 percent	$34,901 - $84,500	$69,801 - $140,850
28 percent	$84,501 - $195,950	$140,851 - $237,700
36 percent	$195,951 - $383,350	$237,701 - $383,350
39.6 percent	$383,350 and up	$383,350 and up

Security income is based on the amount of investment and earned income you receive. Social Security Retirement Income is taxable to joint filers at three different levels: 0 percent, 50 percent and 85 percent. This tax depends on both your Social Security Retirement Income and other components of your modified adjusted gross income, so make sure any projections show Social Security income if it applies.

Other Tax Changes for This Year and Next:

Tax changes for tax year 2012:

- Personal tax credits applied against income tax no longer apply
- $250 schoolteacher expense deduction ends
- Mortgage insurance premium deduction expires
- State and local sales tax deductions expire
- Tuition and related fees deduction ends
- Qualified direct contributions from an IRA to a charity stop

Tax changes projected to expire at the end of 2012:

- Marriage penalty equalization ends
- Child care deduction limit of $3,000 reverts to $2,400
- Child credit reduces from $1,000 per child to $500 per child
- Refundable adoption credit expires and deduction reduced
- American Opportunity college education credit expires
- Major reduction in earned income credits and refunds
- Income tax exemption for debt forgiven on home foreclosures and repossessions
- Deduction for student loan interest ends
- Education IRA limit drops from $2,000 to $500

The Alternative Minimum Tax (AMT) is a separate tax schedule originally enacted to prevent high-income taxpayers from using deductions to avoid paying taxes. Although the intricacies of the AMT would require a separate article, it's important to understand that the lack of annual patching in 2012 and in the future could have a significant negative effect on many taxpayers. Currently, no AMT patch is slated for 2012 or 2013.

Taking Capital Gains/Losses

Traditionally, taxpayers have been advised to accelerate deductions and postpone income in an attempt to pay less income tax. Although the AMT has made this difficult in prior years, the adage of postponing recognition of income and accelerating deductions was fairly standard tax advice. Depending on your particular circumstances, it may make sense to do the opposite: Recognize more income in 2012 and take less deductions or losses.

One of the best examples of a change in tax philosophy can be shown in harvesting capital losses. In the past when tax rates were level, taxpayers might sell an investment at a loss, wait 30 days and repurchase it on the 31st day (the required Internal Revenue Service waiting period). The loss can be applied to future gains, or carried over if unused, with a $3,000 annual limit of offsetting current income ($1,500 if married filing separately). At the end of each year, sales of investments producing gains can be offset by the current or prior losses.

If, however, taxes on future investment gains are higher, it may be better to actually take gains and pay the lower capital gains tax in 2012 rather than at a higher future rate. For those in the lowest capital gain tax brackets, the capital gains rate of 0 percent in 2012 would be preferable to the higher rate in 2013. Although the IRS requires you to wait 31 days to repurchase an investment when you take a loss, there's no such requirement when you take a gain. In that case, you can immediately repurchase the investment.

The advice might be different for those who have significant existing carry-over losses. In this case, normally one would sell a position with a gain and use the carry-over loss to offset the newly realized gain. If, however, gains are taxed at a higher rate in the future, you may not want to take gains to offset losses in this current tax year. Instead, you might want to keep your losses to use in future higher tax years.

Most importantly, the best thing for each person to do is examine how the application of any strategies would affect their specific situation. For instance, taking capital gains at a lower rate in 2012 may inadvertently drive up the level of tax on Social Security income. Additionally, creating capital gains can affect a taxpayer's AMT.

This article is intended to alert you to tax changes that might happen next year and possible remedial action you can take. Having said all this, there's the "elephant in the room" caveat: What if the legislature kicks the can down the road and these changes don't happen as described? As always, we strongly recommend you consult your tax adviser/financial planner before taking any action. B

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