TAX PLANNING GUIDE FOR INDIVIDUALS

2013

This 2013 Tax Planning Guide highlights important federal tax law provisions that could affect your personal tax planning. It also presents a variety of potential strategies that could help reduce your tax burden. Since the general strategies discussed in this guide do not consider the details of your specific tax situation, you'll want to obtain professional advice before acting on any of the planning ideas presented.

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What’s New

Here are some of the key federal tax changes for 2013:

- For individual taxpayers, a 39.6% tax rate applies to income over a specified amount: $400,000 for single filers; $450,000 for married taxpayers filing jointly; $425,000 for head-of-household filers; and $225,000 for married individuals filing separately. The 10%, 15%, 25%, 28%, 33%, and 35% tax rates remain in place.
- The long-term capital gains rate generally increases from 15% to 20% for taxpayers with incomes exceeding $400,000 ($450,000 for married taxpayers filing jointly). The top rate stays at 15% for most other taxpayers (0% for those in a 10% or 15% regular tax bracket).
- Qualified dividends continue to be taxed at the lower rates that apply to long-term capital gains on stock sales (instead of at ordinary income-tax rates as originally scheduled).
- Certain higher income taxpayers are subject to reductions in personal exemptions and itemized deductions.
- A new surtax on investment income and an additional Medicare tax on earnings are introduced. Both new taxes apply only to higher income taxpayers.
- The top estate- and gift-tax rate increases from 35% to 40%, but the exemption amount stays at $5 million (indexed for inflation).

For Individuals

Tax Rates

Because the tax rate schedules are graduated, you generally won't pay the same rate of tax on all your income. As you can see in the tax rate schedules below, the lowest rate for 2013 is 10% and the highest rate is 39.6%, almost five percentage points greater than the 2012 top rate of 35%.

The rate schedules are broken into several ranges of income — called income brackets — that are different for different filing statuses. The more taxable income you have, the higher your marginal tax rate may be. Marginal tax rates are often used for planning purposes.

> **Example:** Maryanne expects to have taxable income of $84,850 in 2013 and is a single taxpayer. Her marginal tax rate is 25%. If she earns an additional $5,000, she'll jump into the 28% bracket. A 25% tax rate will apply to $3,000 of those additional earnings and the remaining $2,000 will be taxed at the higher 28% rate. Deferring taxes on the $2,000 — perhaps by contributing the earnings pretax to a 401(k) plan — or finding an additional $2,000 of deductible expenses would save Maryanne $560 of income tax ($2,000 x 28%).

Individual Tax Rate Schedules

FILING STATUS	RATE (%)	TAXABLE INCOME ($) BRACKETS
Single	10	0 – 8,925
	15	8,926 – 36,250
	25	36,251 – 87,850
	28	87,851 – 183,250

	33	183,251 – 398,350
	35	398,351 – 400,000
	39.6	Over 400,000
Head of Household	10	0 – 12,750
	15	12,751 – 48,600
	25	48,601 – 125,450
	28	125,451 – 203,150
	33	203,151 – 398,350
	35	398,351 – 425,000
	39.6	Over 425,000
Married Filing Jointly (and surviving spouses)	10	0 – 17,850
	15	17,851 – 72,500
	25	72,501 – 146,400
	28	146,401 – 223,050
	33	223,051 – 398,350
	35	398,351 – 450,000
	39.6	Over 450,000
Married Filing Separately	10	0 – 8,925
	15	8,926 – 36,250
	25	36,251 – 73,200
	28	73,201 – 111,525
	33	111,526 – 199,175
	35	199,176 – 225,000
	39.6	Over 225,000

Look Beyond Rates

When you are reviewing the tax rate schedules, remember that focusing only on tax rates can be somewhat deceiving. Why? Certain tax law provisions effectively raise the rates that higher income taxpayers pay.

Personal Exemption Phase-out

The deduction for personal exemptions is an example. Each personal exemption you're entitled to *fully* deduct (for yourself, your spouse, and your dependents) will reduce your taxable income by as much as $3,900. However, a tax law provision phasing out higher income taxpayers' exemptions has been reinstated for 2013. The exemption phase-out starts once adjusted gross income (AGI) exceeds $250,000 (single), $300,000 (married filing jointly), $275,000 (head of household), and $150,000 (married filing separately). For each $2,500 of AGI over the threshold, personal exemptions are reduced by 2%. If you're subject to it, the exemption phase-out can increase your effective tax rate.

- ❖ Consider whether you should forgo claiming a dependency exemption for a child in college. You might come out ahead if your income is too high to claim an education credit (see EDUCATION CREDITS) for tuition payments. Assuming your child has enough taxable income, consider having your child pay the tuition (even if the money comes from you) and take the education credit on his or her return. You'll have to pass up the exemption for your child, but, dollar for dollar, the credit may save more taxes for your family — especially if your exemptions are subject to the phase-out.

Itemized Deduction Limitation

Along with any deduction for personal exemptions you're entitled to, you may claim either itemized deductions or a standard deduction, whichever is larger. As you plan for 2013, however, consider whether you will be subject to the newly reinstated limitation on itemized deductions. Like the personal exemption phase-out, this limitation essentially increases the effective tax rates paid by affected individuals.

The limitation applies to taxpayers with AGI over a threshold amount: $250,000 (single), $300,000 (married filing jointly), $275,000 (head of household), or $150,000 (married filing separately). Basically, deductions are reduced by 3% of the amount by which AGI exceeds the threshold. However, deductions for medical expenses, investment interest, casualty and theft losses, and gambling losses are not subject to the limitation. And you can't lose more than 80% of the itemized deductions that *are* affected.

Additional Medicare Tax on Earnings

Individual taxpayers who earn more than $200,000, married taxpayers filing jointly who earn more than $250,000, and married taxpayers filing separately who earn more than $125,000 will face higher taxes on a portion of their wages and self-employment earnings in 2013. An *additional* 0.9% Medicare tax applies to earnings over the relevant threshold.

Tips for Investors and Homeowners

The new surtax on investment income and the higher rates on capital gains and dividends that apply to some investors make it all the more important to focus on *after-tax* returns and to consider available opportunities for deferring taxes on investment earnings.

Capital Gains/Losses

When you sell investments, any capital gain generally is included in income. However, you can deduct capital losses dollar for dollar against your capital gains. An additional $3,000 of capital losses ($1,500 if married filing separately) are deductible against other income, such as wages, interest, and dividends. (Any unused capital losses are carried forward for deduction in later tax years, subject to the same limits.)

The tax rates on net capital gain — the excess of net long-term capital gain over net short-term loss — are still significantly lower than those applicable to ordinary income. Gain or loss is treated as long term if you held the asset for more than one year before sale. The table shows the various tax rates that may apply to your sale transactions.

Capital Gains Tax Treatment

HOLDING PERIOD	YOUR TAX BRACKET	CAPITAL GAIN RATE*
More than 1 year	10% – 15%	0%
	25% – 35%	15%
1 year or less	39.6%	20%
	10% – 39.6%	Same as your ordinary tax rate

* *Long-term capital gain on the sale of collectibles or depreciable real estate is taxed differently. A maximum rate of 28% applies to collectibles gain and a maximum rate of 25% applies to real estate gain to the extent of prior allowable depreciation.*

The significant difference between long- and short-term capital gains rates can make it worthwhile to watch the calendar when you are weighing an investment sale. However, as an investor, it's never a good idea to allow tax considerations to take priority over your better judgment.

Dividends

Like long-term capital gains, qualified dividends receive favorable tax treatment. They're taxed at a maximum rate of 15% for most individual taxpayers. For those in the 39.6% bracket, a 20% maximum rate applies. Individuals whose tax bracket is below 25% are not taxed on qualified dividends. (The tax rate is 0 %.)

New Surtax

As mentioned, investors have a new tax to contend with starting in 2013. If your modified AGI is more than $200,000 (unmarried), $250,000 (married filing jointly), or $125,000 (married filing separately), you'll be required to pay a 3.8% tax on the *lesser* of (1) the year's net investment income or (2) the excess of your modified AGI over the relevant threshold for your filing status.

> **Example:** Carrie's modified AGI is $250,000 and she's a single taxpayer. In 2013, she has $40,000 of net investment income. Since $40,000 is less than $50,000 ($250,000 modified AGI – $200,000 threshold), Carrie's liability for the 3.8% tax is $1,520 (3.8% x $40,000).

The definition of net investment income for surtax purposes includes gross income from interest, dividends, annuities, royalties, rents, net capital gain, and income earned from passive trade or business activities. It does not include tax-exempt municipal bond interest.

- Taxable distributions from qualified retirement plans and IRAs also are not included in net investment income for surtax purposes. However, such distributions will increase your AGI, which could increase your surtax exposure.
- Increasing involvement in profitable trade or business activities may allow you to show material participation in the activities so that your income from them won't be considered "passive" — and won't be subject to the surtax.

Home Sale Profit

If you have a capital gain on the sale of your principal residence, you may qualify to exclude up to $250,000 ($500,000 if married filing jointly) of the gain from your income. Capital gain excludable under this provision also escapes the 3.8% surtax. Any capital gain in excess of your available exclusion is included in the computation of your net capital gain for the year as well as your net investment income for surtax purposes.

Generally, the capital gain exclusion on a principal residence sale is available only once every two years, and you must have owned *and* used the home as your principal residence for at least two of the five years immediately before the sale. (Exceptions apply.)

- ❖ Keep taxes in mind if you are considering renting out your home instead of selling it. When you sell a former principal residence you've been renting out, the capital gain exclusion generally won't be available unless the rental activity was temporary and the sale takes place while you still meet the ownership and use tests. Even then, capital gain is taxable to the extent of all depreciation that was (or could have been) claimed on the property.

Installment Sales

When you finance a buyer's purchase of your property and will receive payments in more than one year, you probably have an installment sale. You report any gain on an installment sale only as you actually receive payments — an obvious advantage, since you aren't taxed on all your gain at one time. (Installment sale treatment does not apply to sales of publicly traded securities.)

Estate and Gift Tax Update

As part of your 2013 tax planning, consider how recent changes in the areas of federal estate, gift, and generation-skipping transfer (GST) taxes could affect you and your family now and in the future.

Tax Rates

For 2013 and later years, the highest federal gift- and estate-tax rate is 40%, somewhat higher than the 35% top rate that applied for 2012.

Exemption Amount

Every individual is entitled to a unified credit that offsets gift and estate tax on a certain amount of lifetime gifts and transfers at death. A $5.12 million exemption applied for 2012. Thanks to the American Taxpayer Relief Act of 2012, the exemption will stay at $5 million, as adjusted for inflation. In addition, estate representatives may make an election permitting any unused exemption to be carried over to the decedent's surviving spouse.

Gift-Tax Annual Exclusion

You may make annual gifts of up to $14,000 per recipient to as many individuals as you wish without triggering gift tax or using up any of your unified credit. Married couples may give $28,000 per recipient. (These limits are periodically adjusted for inflation.)

- ❖ You also avoid gift taxes if you pay tuition directly to a qualifying educational organization for someone else (your grandchild, for example). Payments you make directly to a medical care provider as payment for someone else's medical care (or for medical insurance) also are excluded. These unlimited exclusions are available to youin addition to the gift-tax annual exclusion.

GST Tax

An additional federal transfer tax can come into play when you transfer significant amounts to your grandchildren or other individuals more than a generation younger than you. When it applies, the GST tax is levied in addition to any gift or estate tax on the transfer. The GST-tax rate is equal to the highest federal gift- and estate-tax rate, 40% in 2013. A GST-tax exemption gives you the ability to transfer up to $5.25 million of assets (the estimated inflation-adjusted exemption amount for 2013) to your grandchildren or others free of GST tax.

Disclaimer

The general information in this publication is not intended to be nor should it be treated as tax, legal, or accounting advice. Additional issues could exist that would affect the tax treatment of a specific transaction and, therefore, taxpayers should seek advice from an independent tax advisor based on their particular circumstances before acting on any information presented. This information is not intended to be nor can it be used by any taxpayer for the purpose of avoiding tax penalties.