

2013 Cost-of-Living Limits

IRA Contribution Limit \$5,500

IRA 50 & Over Catch-up

Contribution \$1,000

401(k) Deferral Limit \$17,500

401(k) 50 & Over Catch-up

Contribution \$5,500

SIMPLE Deferral limit \$12,000

SIMPLE 50 & Over Catch-up

Contribution \$2,500

Annual Compensation limit \$255,000

Defined Contribution IRC Sec 415

limit \$51,000

Compensation limit for SEP eligibility

\$550

IRC Section 179 \$500,000

Estate Tax Exclusion

\$5,250,000

Gift Tax Annual Exclusion

\$14,000

Social Security Wage Base \$113,700

[2013 & Prior Years' Limits](#)

2013 Standard Mileage Rates:

Business mileage rate **\$0.565**

Medical & Moving mileage rate **\$0.24**

Charitable mileage rate **\$0.14/mile**

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JENNIFER A. JONES, CPA, LTD.

Volume 14, Issue 1

Client Newsletter

May 2013

Tax Update for 2013: Here's a quick rundown of the most important things that have changed along with reminders about longstanding tax breaks that were extended through this year.

[Tips for Handling Payroll Properly: Overtime & W-4 issues](#)

VA Sales Tax Increases July 1, 2013: Effective July 1, 2013, the Retail Sales and Use Tax rate for most purchases will increase to 5.3 percent statewide. In addition to the statewide increase, there is a 0.7 percent increase in the localities that make up the **Northern Virginia** and **Hampton Roads** regions. The tax on purchases of qualifying food for home consumption remains unchanged. The regional rate increase in Northern Virginia applies to the Cities of Alexandria, Fairfax, Falls Church, Manassas, and Manassas Park, and the Counties of Arlington, Fairfax, Loudoun, and Prince William. Along with the rate changes, the factors for calculating the Dealer's Discount for timely filing and payment have been adjusted. The new factors will be used on returns beginning with the return for the month of July 2013 (for quarterly filers, the return for the quarter ending September 30, 2013).

Home Office Deduction: The IRS announced a simplified safe harbor method that individuals may use to compute the home office deduction. The safe harbor is an alternative to the calculation and allocation of actual expenses otherwise required under IRC Sec. 280A. The new optional deduction is limited to \$1,500 per year based on a rate of \$5 multiplied by the square footage of the home used for business purposes (up to 300 square feet). Under the safe harbor, (1) no depreciation or Section 179 deduction for the portion of the home used in a business is allowed for the year, (2) disallowed amounts carried over from a prior tax year where the taxpayer calculated and substantiated actual expenses may not be deducted in a year in which the safe harbor was used, (3) taxpayers may elect the method from year to year, and (4) all requirements of Section 280A must continue to be satisfied in determining eligibility to claim a deduction. In 2010, approximately 3.4 million taxpayers claimed home office deductions. This procedure is effective for tax years beginning after 12/31/12. Rev. Proc. 2013-13, 2013-6 IRB; News Release IR-2013-5.

Hot Topics at the VA Tax Roundtable (November 2012):

- **Hiring Freeze & Retirements.** The Virginia Tax Department continues to be under a severe hiring freeze and has been experiencing a number of retirements of long-time employees, while the number of appeals continues to rise. Thus, expect slower & possibly fewer tax audits.

- **Technology, E-filing & Debit Cards.** In an effort to deal with staff shortages, expect more technology & remote audits. 2012 brought in mandatory e-filing of most sales tax returns & payments. Beginning in 2013 most corporate tax returns & payments must be e-filed as well. Beginning in 2013 taxpayers will be issued refunds electronically, either as direct deposits or prepaid debit cards.

- **Incomplete Facts on Appeal.** The Tax Department continues to have problems with incomplete facts in appeals cases. A practical tip – be sure that the factual record is carefully & fully developed during the audit to make the appeal easier & faster.

- **Residency is Still Hot.** Virginia continues to look for recent “non-residents” and challenge their change of residence, particularly when it looks like the “change” is being done just for tax avoidance. A tough burden of proof is on the taxpayer. [For More Info](#)

- **Out of State Affiliates & Nexus in Virginia.** The State & counties keep looking at inter-jurisdiction presence of companies in an effort to be sure they get their proper share of tax. Out-of-state dealers using affiliates in Virginia might be enough to create nexus here for tax purposes (e.g., sales & delivery, distribution centers, etc.). The state is looking for any nexus that it can find. Once nexus is present, then the taxpayer is subject to Virginia tax, and the argument can begin over apportionment factors & how much tax is owed. [For More Info](#)

- Officer Liability. The Tax Department is looking at those left standing when it finds defunct businesses. The former managers basically need to prove that they lacked sufficient “control” in order to avoid having to pay the tax.

The tax officials continue to be told by the General Assembly & local County Boards that the legislative bodies can't change or raise taxes, while at the same time being told to look at any possible source of revenue within the existing law. See [More #1](#), and [More #2](#).

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IRS Will Require EIN Holders to Update Information: On May 3, 2013, the IRS issued final regulations requiring taxpayers that obtain employer identification numbers (EINs) to update their information with the IRS ([T.D. 9617](#)). The regulations, which will apply beginning Jan. 1, 2014, to give the IRS time to publish the relevant form and instructions, adopt without change proposed regulations that were issued last year ([REG-135491-10](#)).

The IRS issues EINs (which take the form 00-0000000) to employers, sole proprietors, corporations, partnerships, nonprofit associations, trusts, estates, government agencies, certain individuals, and other business entities for tax filing and reporting purposes. Apparently, many EINs are issued to nominees that act on the applicant's behalf but then are no longer authorized to represent the applicant.

To address this problem, the IRS revised [Form SS-4, Application for Employer Identification Number](#), to require the disclosure of the applicant's “responsible party” and that person's Social Security number, individual taxpayer identification number, or EIN. The definition of responsible party depends on the type of entity applying for the EIN and is listed in the instructions to Form SS-4.

The final regulations require any person that has been issued an EIN to provide updated information to the IRS in the manner and frequency required by the forms, instructions, or other appropriate guidance. According to the preamble, following the publication of the final regulations (scheduled for May 6, 2013), the IRS will publish a form for persons issued an EIN to use to disclose the correct application information to the IRS. The relevant form will require these persons to update application information about the name and taxpayer identifying number of the responsible party within the applicable time frame. The regulations apply to all persons possessing an EIN on or after Jan. 1, 2014 (which means the rules apply retroactively and not only to persons that applied for or were issued EINs after the effective date).

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Proposal for New Lifetime Income Disclosures: An advance notice of proposed rulemaking released by the DOL's Employee Benefits Security Administration (EBSA) would require all defined contribution plans to project a participant's account balance to normal retirement age and then convert the amount to an estimated lifetime income stream. The proposal offers several lifetime income illustrations, dependent on the use of reasonable assumptions, that may be required as part of a participant's pension benefit statement. An interactive online calculator that uses the assumptions provided in the advanced notice is at www.dol.gov/ebsa/regs/lifetimeincomecalculator.html. The goal of the proposed disclosure is to open participant's eyes to their retirement preparedness and promote further savings. EBSA encourages the public to comment by 7/8/13 to ensure meaningful rules are enacted; comments can be emailed to e-ORI@dol.gov.

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Unclaimed Property Laws and Audits: Businesses holding unclaimed property are required to file annual reports and remit the property to the state. Given the current environment, many states may see unclaimed property as an untapped revenue source. Businesses should therefore be aware of the applicable laws, which vary considerably by state. Unclaimed property compliance may be a challenge, but it can be mastered. Early tracking and notification, along with diligent record-keeping, will ensure that issues are resolved before they attract the attention of a state administrator. All states have statutes that require all businesses holding items deemed to be unclaimed property to file annual reports and remit the property to the state. In our area, the due date is generally November 1st. Any financial asset, tangible or intangible, that remains unclaimed for a certain length of time is considered to be unclaimed property. Typical examples include:

Uncashed vendor checks

Uncashed payroll checks
Uncashed refund checks to patients/customers
Unredeemed gift certificates

Failure to comply with state statutes can result in huge audit assessments, significant interest accumulations, and civil and criminal penalties. These ramifications are not limited to a single state if a company has vendors, customers, or shareholders in multiple states. It is estimated that only 10% to 20% of businesses currently comply with unclaimed property laws. The others are at substantial risk, because states facing revenue shortfalls recognize this as an easy source of untapped revenue, and the penalties for noncompliance can be steep.

For more information on the local laws, see:

Virginia <http://www.trsvirginia.gov/UCP/overview.aspx>
Maryland http://compnet.comp.state.md.us/Compliance_Division/Unclaimed_Property/
DC <http://cfo.dc.gov/cfo/cwp/view,a,1326,q,590684,.asp>

It is recommended that you review your policies and procedures to be sure you have a system established and properly utilized to insure compliance with these state laws. Some states recommend or require filing the annual report even when there is no unclaimed property to turn over to the state.

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Consumer Use Tax: This tax is the "other half" of the Virginia Sales and Use Tax Act passed by the 1966 Virginia General Assembly. When you purchase goods, other than magazines or newspaper subscriptions, from a business that does not add the Virginia sales and use tax to your bill or you purchase goods tax-free while outside Virginia, you may be liable for the tax and required to file [Form CU-7](#) to report and pay the tax. This tax is 5% of what you paid for the item ("cost price") except for food purchased for home consumption. 'Cost price' does not include separately stated shipping or delivery charges but it does include a 'shipping and handling' charge if listed as a combined item on the sales invoice.

Who Should File This Form: If the total amount of purchases was from out-of-state mail order catalog(s) only, and \$100 or less for the entire year, you do not have to pay the use tax. If the purchases were from out-of-state mail order catalog(s) and exceed \$100, or the purchases were of any amount from sources other than mail order catalogs, then you must report these purchases and pay consumer's use tax on the total amount of all untaxed purchases from all sources made during the calendar year. Nonprescription drugs and proprietary medicines purchased for the cure, mitigation, treatment, or prevention of disease in human beings are exempt from consumer use tax.

If you meet the above criteria, you must file an annual consumer's use tax return, [Form CU-7](#). This form is for use by individuals only. Businesses, including partnerships and sole proprietorships, must report such purchases on Form ST-7 or Form ST-9, whichever is appropriate.

Filing Alternative: You can report and pay this tax on [Schedule ADJ](#) with [Form 760](#), or [Schedule 760PY ADJ](#) with Form [760PY](#).

When And Where To File: If filing based on the calendar year, file your return as soon as possible after January 1, but not later than May 1. If you are filing on a basis other than a calendar year, you must file your return by the 15th day of the 4th month after the close of your taxable year. Penalty and interest will apply if the return is filed late. Pay the balance due as computed on [Form CU-7](#) by the due date. Payment must be attached to the form when filed. Make your check or money order payable to the Virginia Department of Taxation.

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Doing Business in Another State? It's harder to tell than you may think. Most states don't offer companies clear guidance in this area. With state budgets strained, states are facing greater pressure to crack down as they struggle to close significant budget gaps. States are looking into businesses that have a presence in their state and are subject to state and local income and sales taxes. Companies have been found liable for state corporate tax "when the only connection to that state was that they had an employee telecommuting in that state."

In March 2010, for instance, the Tax Court of New Jersey ruled that a company whose main offices are in Maryland was "doing business" in New Jersey because an employee telecommutes from there. The company, TeleBright Software Corp., is appealing the

decision, arguing that having one employee in the state who develops software from home falls short of the statutory definition of "doing business." The company asserted that it doesn't solicit customers or make sales in New Jersey.

Just how much of a tax hit companies face depends on state rules. Some impose income tax based on an out-of-state company's sales in the jurisdiction. Others also take into account the company's payroll and property in the state. However they figure the bill, lots of states seem to be on the same page as New Jersey. In a survey issued in April, 35 states, the District of Columbia and New York City said an employee who telecommutes from a home in the state would create "nexus"—a connection that warrants imposing income tax on an out-of-state employer.

A potential solution has been offered by advisors: Have the telecommuting employee resign, form a C or S corporation and invoice the ex-employer for work. The former employer would have to pay the former employee more to cover new expenses and lost benefits. And, although it would be a challenge, states could still make a case for taxing the former employer.

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Changing One's Domicile -- More Complicated Than You Think: You might think that changing one's domicile would be a simple thing to do. However, if you think you are going to fool the IRS with living half the time in one state and half the time in another state, think again. The IRS has had plenty of experience with people who try to mix the advantages of living in two different states. So what must be done to change one's domicile? It can vary from state to state, so it probably would be helpful to start with a definition of domicile. Black's Law Dictionary defines domicile as: "The place at which a person has been physically present and that the person regards as home; a person's true, fixed, principal, and permanent home, to which that person intends to return and remain even though currently residing elsewhere."

Probably, the best advice for anyone contemplating changing their domicile is: be consistent about your records. Make sure if you change your driver's license, place of voting, etc. that you also file your tax return from the state that you are claiming as your domicile. The IRS or the state in question will look at inconsistencies such as this. It is also recommended that you disengage, as much as possible, from the previous state by resigning from club memberships, obtaining a healthcare provider in the new state, and opening bank accounts in the new state. This is the level of consistency that will be necessary to establish domicile from one state to another. It is called establishing "one's center of affairs" vs. "documentary evidence." (Francis B. Brogan, Jr. and Brandon A. S. Ross, "Changing State of Domicile Is Easier Said Than Done, *Estate Planning*, July 2012.)

While this may seem absurd, there are court cases in which these very things were not done. For example, there is an Illinois case in which someone tried to establish Florida residency. Although he continued to work in Illinois, he did own a condominium in Florida. When he filed his federal tax return, however, he used his Illinois address. Also, when registering for a Florida driver's license and registering to vote, he used his parents' address in Florida, rather than the address of his condominium. Not surprisingly, the Illinois Department of Revenue found contradictory evidence for someone trying to change his state of domicile. It was ruled that he was an Illinois domiciliary. (Brogan and Ross, see above)

So in deciding whether or not to change one's state of domicile, one may want to consult an attorney to weigh the advantages and disadvantages of such a move. States such as Florida and Virginia do offer the benefit of permitting an irrevocable trust to be decanted into another trust. This allows assets from an irrevocable trust that is no longer working as intended to be transferred to an existing or new trust. Florida, however, does not recognize same-gender marriage. States like Massachusetts and New York do. In Florida, then, one of the partners of a same-gender couple would not be able to serve as a personal representative of their partner's estate after the spouse's death. (Brogan and Ross, see above) Some states have income or death taxes, while others do not. In conclusion, one should carefully weigh the costs and benefits of moving to a new state, especially toward the end of life.

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Handling Payroll Properly

Here's one example from a past issue by AIPB Advisory Board member Debera J. Salam, CPP, Director, Payroll Information and Process Services, Ernst & Young, LLP:

- **Can an employee submit any number of W-4s in a single year?** In terms of IRS regs, yes; in practice, not necessarily. You are required to implement a new W-4 by the start of the first payroll period ending on or after the 30th day from the date you received it. Thus, the amount of time required to implement a new W-4 can effectively limit how many new ones one employee can submit in one year. [IRC §3402(f)(3)(B)(3); Circular E, Employer's Tax Guide, p. 14, Rev. 2010]

Example: On July 10, Alice gives you a new W-4. She is paid on the 15th and the last day of the month. You must implement the new W-4 by August 15, the first payroll period following August 10 (30 days from July 10).

- **Is there a time limit on how long a W-4 remains in effect?** No. Unless an employee submits a new one, the current W-4 is in effect up to and including termination, even on payments after termination from which you withhold FIT.

Exception: An employee who claimed exempt from FITW must submit a new W-4 by Feb. 15 of the next year. If you don't get a new W-4 by then, withhold at single with zero allowances. [IRC §3402(f)(3)(B)(4)]

- **Suppose I think that a W-4 is not valid?** An employer must reject a W-4 that it *knows* is not valid [Treas. Reg. §31.3402(f)(5)(1)] and must continue to withhold based on the previous W-4. If the invalid W-4 is the first one you get (e.g., from a new hire), withhold at single with zero allowances. A W-4 is not valid if it lacks required information and/or a signature or if any of the form's wording is deleted, "defaced" or added to.

Overtime pay: Overtime pay is easy for anyone to understand—except the person responsible for deciding when an employee is v. is not entitled to it.

For example, how many hours of overtime must you pay an employee who works 48 hours in a workweek that includes 8 hours for July 4 (or Christmas, New Years, etc.)? No overtime pay is due.

Say that Alice works 40 hours in the workweek, then takes a paid vacation day (8 hours). Does federal law require you to include the paid holiday in determining overtime pay? No.

Suppose Al works all day Sunday, for a total of 40 hours in the workweek. Does federal law require that you pay overtime rates or premiums for the Sunday work? No.

You are the new bookkeeper at ABC Co. which has a 35-hour workweek. One week Jeff works 40 hours and Jane works 41 hours. How much overtime pay does federal law require you to pay each one? Jeff, none; Jane, one.

These are pretty basic. How do you handle overtime for employees paid a per diem? Must you include the per diem when calculating overtime pay?

Although the following court case took place in 2002, it still causes problems for employers:

The case: Berry, an electrician, was paid \$20/hour plus \$150/week per diem regardless of expenses, the same allowance as the company's other electricians. Berry sued his employer, claiming that the FLSA (Fair Labor Standards Act) requires that the per diem be counted as regular pay rather than reimbursement, raising his hourly wage and time-and-a-half overtime rate.

Berry lost both the case and the appeal.

What the court said: The per diem might have affected overtime calculations if it were excessive—i.e., if it were really pay disguised as a per diem—but found that \$150/week was not excessive, given that he lived some distance from the job site. [*Berry v. Excel Group*, 5th Cir. 4/19/02]

What experts say causes overtime problems:

Presuming that employees will work overtime without recording the hours on their timesheets.

Varying the workweek from the usual 5 days, 40 hours.

Failing to realize that if you have on-call time that severely restricts an employee's personal activities, it is eligible for overtime pay.

Nondiscretionary cash bonuses. These are bonuses required under a contract, agreement or promise, express or implied (such as a bonus for faster or higher production, improved quality or to get someone to stay with the company or take a job), or bonuses that employees have come to expect with the exception of holiday bonuses. A nondiscretionary bonus given to hourly employees must be added to gross pay for the week in which it is earned and included when calculating their pay for overtime purposes. [29 CFR 7788.209]

Example: Joan enters orders for \$9/hour. One week Joan works 43 hours and earns a \$24 bonus because the company gives prorated bonuses for higher production.

Joan's regular pay: \$387 for the week ($\$9/\text{hour} \times 43 \text{ hours}$) + \$24 bonus = \$411 straight-time (including the nondiscretionary bonus)

Joan's overtime pay: \$411 earned for the week/43 hours worked = \$9.56 regular rate of pay x 50% premium rate = \$4.78 x 3 hours' overtime = \$14.34 premium pay.

Joan's gross pay: \$411 straight time pay + \$14.34 premium pay = \$425.34 gross pay for the week.

Important: There are different rules for *discretionary* cash bonuses. These bonuses are *not* required under a contract, agreement or promise and are *not* part of a pattern that leads employees to expect them and therefore do not affect employee overtime pay rates. [29 CFR 778.211] **Exception:** A holiday bonus can be discretionary even if it is given each year, leading employees to expect it. [29 CFR 778.211]

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What's New for 2013

Here's a quick rundown of the most important things that have changed along with reminders about longstanding tax breaks that were extended through this year.

Changes Taking Effect in 2013

Payroll Tax Holiday Is Gone. For 2011 and 2012, the Social Security tax withholding rate on your salary was temporarily reduced by 2%, from the normal 6.2% to 4.2%. If you're self-employed, the Social Security tax component of the self-employment tax was reduced by 2%, from the normal 12.4% to 10.4%. However, the payroll tax holiday was not extended through this year. For 2013, the Social Security tax can hit up to \$113,700 of salary and self-employment income. Many salaried workers have noticed their paychecks are lower this year, and the end of the payroll tax holiday is probably the most common culprit.

Higher Tax Rates for Upper-income Individuals. For most individuals, the federal income tax rates on ordinary income (such as wages, self-employment income, and interest) for this year are unchanged. Specifically, the 10%, 15%, 25%, 28%, 33%, and 35% tax rates you've grown accustomed to in the past are still in force for this year. However, the *maximum* rate on ordinary income collected by higher-income individuals is now 39.6% (up from 35% last year). This rate hike only affects singles with taxable income above \$400,000, married joint-filing couples with income above \$450,000, heads of households with income above \$425,000, and married individuals who file separate returns with income above \$225,000.

The federal income tax rates on long-term capital gains and qualified dividends are also unchanged from last year for most individuals. Specifically, the 0% rate still applies to long-term gains and dividends that fall within the 10% and 15% ordinary income tax brackets, and the 15% rate still applies to most other long-term gains and dividends. However, the maximum rate for higher-income folks is now 20% (up from 15%). Again, this rate hike only affects singles with taxable income above \$400,000, married joint-filing couples with income above \$450,000, heads of households with income above \$425,000, and married individuals who file separate returns with income above \$225,000.

Personal and Dependent Exemption Phase-out Rule for Upper-income Individuals. After being gone for 2010–2012, the phase-out rule for personal and dependent exemption deductions is back in force for this year. Phase-out starts at Adjusted Gross Income (AGI) of \$250,000 for singles, \$300,000 for married joint-filing couples, \$275,000 for heads of households, and \$150,000 for married individuals who file separate returns.

Itemized Deduction Phase-out for Upper-income Individuals. After being gone for 2010–2012, the phase-out rule for some of the most common itemized deductions is also back in force for this year. As a result, higher-income folks can potentially lose up to 80% of their write-offs for mortgage interest, state and local income and property taxes, charitable contributions, and miscellaneous itemized deductions. Phase-out starts at AGI of \$250,000 for singles, \$300,000 for married joint-filing couples, \$275,000 for heads of households, and \$150,000 for married individuals who file separate returns.

Alternative Minimum Tax Relief. Congress finally gave us some permanent relief from the dreaded Alternative Minimum Tax (AMT). The relief mainly consists of larger and inflation-indexed AMT exemption amounts and allowing various personal tax credits to offset the AMT. As a result, about 30 million households a year will be kept out of the AMT zone. For 2013, the inflation-indexed AMT exemption amounts are \$51,900 for unmarried individuals, \$80,800 for married joint-filing couples, and \$40,400 for married individuals who file separate returns.

Relatively Favorable Estate and Gift Tax Rules. For this year and beyond, we have a unified federal estate and gift tax exemption of \$5 million—adjusted annually for inflation—and a 40% tax rate (up from last year's 35% rate). For 2013, the inflation-adjusted exemption amount is \$5.25 million. The right to leave your unused federal estate and gift tax exemption to your surviving spouse (the so-called portable exemption deal) is now permanent.

New 0.9% Medicare Tax on Earned Income. Before this year, the Medicare tax rate on salary and/or Self-employment (SE) income was a flat 2.9%. For employees, 1.45% was withheld from paychecks, and the other 1.45% was paid by the employer. Self-employed individuals paid the whole 2.9% themselves. Starting this year, an extra 0.9% Medicare tax is due on salary and/or net SE income above \$200,000 for an unmarried individual, \$250,000 for a married joint-filing couple, and \$125,000 for those who use married filing separate status.

New 3.8% Net Investment Income Tax. Starting this year, all or part of the net investment income, including long-term capital gains and dividends, collected by higher-income folks can get socked with a new 3.8% Medicare contribution tax, referred to as the Net Investment Income (NII) tax. The NII tax will not affect you unless your modified AGI (MAGI) exceeds \$200,000 for an unmarried individual, \$250,000 for a married joint-filing couple, or \$125,000 for those who use married filing separate status. The NII tax will only apply to the *lesser* of: (1) your net investment income or (2) the amount of your MAGI in excess of the applicable threshold.

New Higher Threshold for Medical Expense Deductions. Before this year, you could claim an itemized deduction for medical expenses paid for you, your spouse, and your dependents, to the extent those expenses exceeded 7.5% of your AGI. Starting this year, however, a higher 10%-of-AGI threshold applies to most individuals.

Exceptions: Through 2016, special rules apply to taxpayers age 65 and older. If you or your spouse is 65 or older in 2013, the new 10%-of-AGI threshold will not apply to you until 2017. If you or your spouse will turn 65 in 2014, the new 10%-of-AGI threshold applies for 2013, but not for 2014–2016. If you or your spouse will turn 65 in 2015, the new 10%-of-AGI threshold applies for 2013 and 2014, but not for 2015 and 2016. If you or your spouse will turn 65 in 2016, the new 10%-of-AGI threshold applies for 2013–2015, but not for 2016. The new 10%-of-AGI threshold applies to everyone after 2016.

New \$2,500 Cap on Healthcare FSA Contributions. Before this year, there was no tax-law limit on contributions to your employer's healthcare Flexible Spending Account (FSA) plan (although many plans

imposed their own limits). Amounts you contribute to the FSA plan are subtracted from your taxable salary. Then, you can use the funds to reimburse yourself tax-free to cover qualified medical expenses. Starting this year, the maximum annual healthcare FSA contribution for each employee is capped at \$2,500.

Breaks Extended through This Year

The recent fiscal cliff legislation extended several existing tax breaks through 2013 and even made some permanent. Here's a summary of key individual tax breaks that will stay the same for this year.

Child Tax Credit. The \$1,000 maximum credit for each eligible under-age-17 child was made permanent. Provisions that allow the child credit to be refundable for more households were extended through 2017.

Child and Dependent Care Tax Credit. In recent years, most parents have been able to claim a credit of up to \$600 for costs to care for one under-age-13 child, or up to \$1,200 for costs to care for two or more under-age-13 kids, so the parents can work. Lower-income parents have been able to claim larger credits of up to \$1,050 and \$2,100, respectively. The fiscal cliff legislation made these relatively generous credit amounts permanent.

American Opportunity Higher Education Tax Credit. The American Opportunity credit, which can be worth up to \$2,500 and can be claimed for up to four years of undergraduate education, was extended by the fiscal cliff legislation through 2017.

Higher Education Deductions. The college tuition deduction, which can be as much as \$4,000 or \$2,000 depending on your AGI, was extended through this year. Additionally, the student loan interest deduction, which can be as much as \$2,500, was scheduled to fall under less-favorable rules for this year and beyond. The fiscal cliff legislation made permanent the more-favorable rules that have applied in recent years. Both of these deductions are available whether you itemize or not, but they are phased out for higher income folks.

Option to Deduct State and Local Sales Taxes. In recent years, individuals who paid little or no state income taxes were given the option of instead claiming an itemized deduction for state and local general sales taxes. The fiscal cliff legislation extended this break through this year.

Charitable Donations from IRAs. In recent years, IRA owners who had reached age 70½ were allowed to make tax-free charitable donations of up to \$100,000 directly out of their IRAs. This break expired at the end of 2011, but the fiscal cliff legislation retroactively restored it for 2012 and extended it through this year. To take advantage of the retroactive deal, you can treat donations from your IRA made in January of this year as having been made in 2012.

Forgiven Principal Residence Mortgage Debt. For federal income tax purposes, a forgiven debt generally counts as taxable Cancellation of Debt (COD) income. However a temporary exception applied to COD income from cancelled mortgage debt that was used to acquire a principal residence. Under the temporary exception, up to \$2 million of COD income from principal residence acquisition debt that was cancelled in 2007–2012 was treated as a tax-free item. The fiscal cliff legislation extended this break to cover eligible debt cancellations that occur this year.

\$250 Deduction for K-12 Educator Expenses. The \$250 deduction for teachers and other K-12 educators for school-related expenses paid out of their own pockets was extended through this year.

\$500 Energy-efficient Home Improvement Tax Credit. In past years, taxpayers could claim a tax credit of up to \$500 for certain energy-saving improvements to a principal residence. The fiscal cliff legislation extended this deal through this year.

Mortgage Insurance Deduction. In recent years, premiums for qualified mortgage insurance on debt to acquire, construct, or improve a first or second residence could potentially be treated as deductible home mortgage interest. The fiscal cliff legislation extended this break through this year. Note that the deduction phased out for higher-income individuals.

Conclusion

This is only intended as a quick summary of key individual tax changes that take effect this year and key individual tax breaks that were extended through this year. Please contact us if you have questions or want more detailed information.

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