

# Taxes are going up, but you can limit your burden

The year-end budget deal and the Affordable Care Act will mean a bigger bite out of your earnings this year

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## POWER POINTS

- Most of the existing forms of taxes—including income, payroll, capital gains, and dividends—will be going up, and a new surtax on unearned income goes into effect to help fund parts of healthcare reform.
- Tax-advantaged retirement plans remain your best opportunity for lowering your tax bill.

**T**he start of 2013 year found Congress in frantic negotiations to avoid the so-called fiscal cliff, which it did (barely) with passage of the American Taxpayer Relief Act (ATRA) on January 1. As a result, most Americans, including physicians, will see their taxes increase. For those who earn more than \$400,000 and/or have significant investment income, the added tax bite you will feel beginning this year could be especially significant.

But ATRA is not the only source of new taxes. Others were included in the Affordable Care Act (ACA) of 2010 but are only now taking effect. Here is a summary of the major changes to the tax laws, how they will affect you, and what you can do to limit their effects.

## INCOME TAXES

The maximum rate increases from 35% to 39.6% for individuals with taxable incomes greater than \$400,000 and joint filers with taxable incomes greater than \$450,000. Rates remain the same for everyone else.

## PAYROLL TAXES

The 2-year tax holiday on payroll taxes, which are used to fund Social Security, has been allowed to expire. That means that employee contributions to the tax have risen to their pre-holiday level of 6.2% from 4.2%. The tax applies only to the first \$113,700 of earned income.

## CAPITAL GAINS AND DIVIDENDS

Federal tax rates for capital gains and dividends have increased to 20% from 15%, where they have been since the tax cuts enacted in 2003 under President George W. Bush. The rate applies if your taxable income is greater than \$450,000 if you are married and \$400,000 if you are single. Because the dividend and capital gains rates are still much lower than the tax that applies to ordinary income, including interest income, it still makes sense to invest in equities and choose growth stocks and stocks with significant dividends.

When a company pays a dividend, it is, in effect, giving a certain amount of money to its shareholders. Many growth-oriented companies issue only small dividends or none at all. Instead, they use cash either to buy back existing stock or to invest in ways that will result in rapid stock price appreciation, resulting in tax-favored capital gains when investors sell the company's stock. Before the Bush tax cuts, when dividends were taxed at the same rate as ordinary income, many investors bought only high dividend-yielding stocks for their retirement plans to avoid current ordinary income treatment.

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## SUMMARY OF 2013 TAX-RELATED CHANGES

|                                 |   |                                   |   |
|---------------------------------|---|-----------------------------------|---|
| <b>Income taxes*</b>            | The maximum rate increases from 35% to 39.6% for individuals with taxable incomes of greater than \$400,000 and joint filers with taxable incomes of greater than \$450,000. Rates remain the same for all others.  | <b>Affordable Care Act surtax</b> | A 3.8% surtax will be levied on most forms of unearned income, and a 0.9% surtax will be levied on earned income for individuals with incomes of greater than \$200,000 and joint filers with combined incomes of greater than \$250,000. Proceeds of the surtaxes will be used to help fund elements of the Affordable Care Act.   |
| <b>Capital gains/dividends*</b> | The maximum tax rate increases from 15% to 20% for individuals with taxable incomes of greater than \$400,000 and joint filers with taxable incomes of greater than \$450,000. Rates remain the same for all others.  | <b>Flexible spending accounts</b> | Maximum pre-tax contributions are reduced from \$5,000 to \$2,500.  |
| <b>Estate/gift taxes*</b>       | The tax rate increases from 35% to 40% on estates or lifetime gifts worth more than \$5.12 million in 2012. Because the exemption amount is inflation-indexed, it is expected to rise to \$5.25 million in 2013. The provisions allowing any unused exemption to be transferred to the surviving spouse is now permanent. Also, the annual gift tax exempt limit increases to \$14,000. | <b>Retirement plans</b>           | Maximum contribution for individual retirement accounts increase from \$5,000 to \$5,500. The contribution limit for individuals aged 50 years or more increases from \$6,000 to \$6,500. Elective deferral limits in 401(k) and 403(b) plans increase to \$17,500 and to \$23,500 for individuals aged 50 years or more. The contribution limit for elective deferral plans increases to \$51,000 and to \$56,500 for those aged 50 years or more. |
| <b>Payroll taxes*</b>           | Employee contributions increase from 4.2% to 6.2% of pay. The tax continues to apply only on the first \$113,700 of earned income.  | <b>401(k) and 403(b) plans</b>    | Increases from \$17,000 to \$17,500 for individuals under age 50, and from \$22,500 to \$23,000 for individuals age 50 and older.   |
| <b>Alternative minimum tax*</b> | Exemption levels for 2012 increase from \$33,750 to \$50,600 for individuals and from \$45,000 to \$78,750 for joint filers. In addition, exemption amounts are indexed to the inflation rate for the first time.   | <b>Medical expense deductions</b> | Medical expense deductions increase from 7.5% to 10% of adjusted gross income.  |

\*Included in the American Taxpayer Relief Act

### MEDICARE SURTAX

The ACA provides for government subsidies that will expand healthcare coverage to many currently uninsured lower- and middle-income families. To help pay for this coverage, the legislation contains a new 3.8% Medicare surtax on unearned income. (Previously, the Medicare tax had been levied only on earned income.)

For single taxpayers, the increase is on modified AGI in excess of \$200,000. For married couples, the modified AGI threshold is \$250,000. Thus, if your "regular" maximum capital gains tax rate is 20%,

you will pay a rate of 23.8% on dividends, capital gains, annuities, and royalty and rental income to the extent that your total income exceeds the threshold of \$200,000 for single taxpayers or \$250,000 for couples.

This means that if you are part of a couple with \$50,000 of investment income and adjusted gross income (AGI) of \$280,000, then you will pay an additional \$1,140 (3.8% of the \$30,000 that is over the \$250,000 threshold for married couples). If you are a single taxpayer with AGI of \$400,000, including \$50,000 of investment income, then you will pay an additional \$1,900.

This new tax does not affect retirement plan and individual retirement account distributions, but it does apply to trusts and estates. The good news is that you can deduct investment expenses, such as rental and royalty expenses, margin interest, and investment and brokerage fees from income that is subject to the surtax.

The ACA also includes a 0.9% Medicare surtax on earned income in excess of the \$200,000 and \$250,000 thresholds. Unlike traditional payroll taxes, however, this tax is based on household income, not individual earnings. This means that married couples may find themselves subject to it even if they each make less than \$250,000.

For two-income households, this new tax could lead to a surprise tax bill in the spring, because employers withhold payroll taxes only on their own workers. For example, if a husband and wife each earn \$200,000 for a total household income of \$400,000, neither employer will withhold the surtax, but it will be due on \$150,000, which is the amount the couple earned in excess of the \$250,000 threshold. For many physicians, the effect of these two new taxes will be to increase their marginal rate to levels higher than what politicians have been discussing over the past year.

### ALTERNATIVE MINIMUM TAX

Most physicians living in states with state and local income taxes are subject to the alternative minimum tax (AMT). The AMT often has the effect of adding thousands of dollars to a tax bill by not allowing you to deduct part of your state and local income taxes, real estate taxes, personal exemptions, and certain miscellaneous expenses from your federal taxes. (A taxpayer is required to pay the greater of his or her "regular" or AMT tax). The government now has indexed the AMT threshold with inflation, but if you've paid AMT in the past, you likely will continue to be subject to it.

Even if you are not subject to the AMT, the old law reducing or eliminating itemized deductions and personal exemptions by 3% of your AGI goes back into effect if your joint AGI is greater than \$300,000 if you are married or \$250,000 if you are single. Reducing itemized deductions adds 1% to your marginal rate and the personal exemption phase-out adds another 1% per exemption.

If these changes will affect you, immediately change your withholding tax to ensure that you withhold enough of your income. Failure to do so will lead to your not only owing the balance on your tax bill next April, but being penalized for not remitting the required amount during the course of the year.

### S CORPORATION DIVIDENDS

The Internal Revenue Service (IRS) has the power to treat S corporation distributions as wages if your compensation is not "reasonable" (high enough). Some physicians draw S corporation distributions large enough to avoid having the Medicare tax apply to a portion of their compensation. Although this practice still could be beneficial under certain circumstances, you could end up either receiving a smaller retirement plan contribution or funding more for your staff if your W-2 wages are less than \$255,000 in 2013, negating any savings on Medicare taxes.

The reason is that S corporation distributions avoid payroll taxes, but they don't count when determining your compensation for retirement plan purposes. Plan contributions could be limited if your income that counts (W-2 wages) is less than \$255,000. If your income is above this threshold, even with the new surtax, it still may be beneficial under certain circumstances to take S corporation distributions in lieu of additional wages.

For example, if your net income is \$300,000, then you might take \$255,000 as wages and the remaining \$45,000 as S corporation distributions to avoid most of the new surcharge while getting the maximum plan contributions.

### ASSOCIATES AS INDEPENDENT CONTRACTORS

Some physicians treat their part-time associates as independent contractors, which can be a violation of payroll tax rules. The IRS has targeted 2,000 companies it plans to audit in 2013 to reclassify independent contractors as employees. Misclassifying workers could result in disqualifying your retirement plan and other fringe benefit programs if employees who should have been plan participants are excluded. You also could be required to pay back payroll taxes, income taxes, and penalties for misclassifying workers.

### CAPITAL GAINS TAXES ON INHERITANCES

Most of the recent discussion concerning federal estate taxes has focused on the dollar amount of the exemption threshold. But the threshold (currently \$5.12 million and expected to increase to \$5.25 million) is so high, few people actually have to pay federal estate taxes. You should instead focus on minimizing or avoiding capital gains taxes on inheritances, which come about when adult children are added to brokerage or bank accounts of their elderly parents in an attempt to avoid probate or save on estate taxes.

When your name is added to a deed or brokerage

account, it is considered a gift to you. If the gift appreciates in value, eventually you will have to pay capital gains taxes in your bracket. Note that the step-up in basis rules apply only when the parent(s) hold the assets in his or her name, or jointly, upon their demise.

For example, if your parents bought a home for \$400,000 and it is now worth \$700,000, and they put the title in your name, when you sell the house you would have to pay capital gains taxes on the amount of the sale price that exceeded their adjusted basis. If they die while their names are still on the title, then capital gains tax would be avoided. Ownership of a brokerage account with appreciated securities produces similar results.

In short, you risk increasing your tax bill significantly by adding your name to an account or assets that may significantly appreciate. If such accounts are transferred to you, you will not enjoy the step-up in basis that would apply if your parents held the assets until their demise. It is important to analyze both the state inheritance tax and capital gains (federal and state) taxes when determining whether to retitle assets so that you don't turn a small tax bill into a large one.

### FLEXIBLE SPENDING ACCOUNTS

If your employer or practice has a flexible spending account (FSA), you can make tax-free withdrawals from the account for out-of-pocket medical and dental expenses and for qualifying child care costs. Establishing an FSA saves you the expenses equivalent to your tax bracket. For example, if you incur \$1,000 in out-of-pocket expenses and are in the 35% tax bracket, then the FSA would save you \$350.

Starting this year, the maximum contribution to a health FSA is \$2,500, down from \$5,000. The plan can allow an additional \$5,000 per year for child-care expenses, if they are included. If your practice does not maintain an FSA and you are the owner, you can easily adopt a plan and convert what would otherwise be after-tax expenses into pre-tax expenses, giving yourself and all your employees an additional opportunity to save on income taxes.

### RETIREMENT PLAN OPPORTUNITIES

Significant savings opportunities through tax-advantaged savings plans will remain for 2013. Contribution limits for individual retirement accounts (IRAs) have increased to \$5,500 per calendar year and to \$6,500 for individuals age 50 or older.

Elective deferral limits in 401(k) and 403(b) plans have increased to \$17,500 and to \$23,000 for people aged 50 years or more, whereas the overall contribution limit for profit sharing plans increased to \$51,000

and \$56,500 for those aged 50 years or more. Take advantage of these new higher contribution limits by adjusting your 401(k) or 403(b) withholding amounts if you have such a plan.

In addition, some retirement plans permit Roth contributions as elective deferrals. Although you will not enjoy the current pre-tax benefit of traditional 401(k) deferrals, if you are in the plan for at least 5 years and withdraw money after age 59½, all of your growth on the Roth funds will be tax-free (not tax-deferred).

In a traditional plan, when you save pre-tax funds, such funds eventually will be subject to ordinary income tax upon withdrawal, but Roth accounts can be tax-free. Even if your 401(k) plan does not permit Roth contributions, you can still make after-tax IRA contributions and then immediately convert them into Roth IRA funds, all with little or no negative tax consequences. Also, you are not required to begin withdrawing funds from a Roth IRA at age 70½, as you are with regular IRA and qualified plan funds. Roth funds also can be passed to the next generation while retaining their tax-free status.

If you are at least age 70½, you can give IRA funds to charities and count them toward your minimum distribution requirement, all while using pre-tax funds. This is certainly a tax-efficient way to give charitably.

### MEDICAL EXPENSE DEDUCTIONS

The threshold for deducting uninsured medical expenses is increasing from 7.5% to 10% of AGI, reducing the amount you can claim for these expenses.

### SHELTERING INCOME

Although taxes are higher in 2013 than in prior years, most physicians continue to think it is worth it to generate additional income and end up with sufficient funds to pay expenses and save for the future. Using certain investment strategies and tax planning throughout the year allow you to keep more of your income.

Funding retirement plans and FSAs and using other fringe benefits are the best tax shelters that exist. Timing the sale of investments, offsetting gains with losses, and similar tax strategies will help you minimize your tax burden and enjoy the fruits of your labor. **ME**

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