Federal & CA State Update for Tax Year 2013

FEDERAL TAX UPDATE 2013

The first big tax news of the year came on January 3, 2013 when President Obama signed into law the American Taxpayer Relief Act of 2012. Provisions of this law extended many of the Bush-era tax cuts along with the enactment of several other miscellaneous provisions.

Legislation effective through 2013 includes:

- Ability to avoid paying tax on cancelled debt related to a taxpayer's qualified principal residence (must be "acquisition debt").
- $250 above-the-line educator expenses deduction.
- Mortgage insurance premiums given the same tax treatment as home mortgage interest (i.e. they're deductible).
- Deduction for state and local taxes on Schedule A.
- Above-the-line deduction for higher tuition expense.
- Section 179 expense deduction of $500,000.
- Nonbusiness energy improvements to principal residence ($500 cap).
- 50% bonus depreciation.

Credits that were extended through 2017 include:

- American Opportunity Tax Credit.
- Enhanced provisions of the Earned Income Tax Credit (for instance, maximum three qualifying children, instead of maximum two qualifying children).
- The $1,000 Child Tax Credit.
- The reduced earning threshold necessary to qualify for the Additional Child Tax Credit.

Areas of federal tax law made permanent include:

- The taxation of qualified dividends at long-term capital gain rates.
- The Adoption Credit.
- Alternative Minimum Tax yearly inflation adjustment.

Other changes:

- The maximum amount allowed in 2013 for the Adoption Credit will be $12,770.
- The estate tax exclusion is now $5,250,000.
- The tax rate for the estate tax is also increased to 40 percent.

One tax break that was not extended was the so-called "payroll tax cut." The employee share of Social Security tax will return to 6.2% of earned income up from the 4.2% rate which was in effect in 2012 and 2011. The Self-Employment Tax rate also returns to 15.3% of net profit, up from 13.3% in 2011 and 2012.

There is also a new top marginal tax rate of 39.6% which will be imposed on individuals with a taxable income of more than $400,000 a year for Single filers, $425,000 for those who file Head of Household, and $450,000 for Married Filing Jointly. Here is a nice chart of the 2013 Federal Tax Rates from our friends at

Bankrate.com. As many commentators have pointed out, the "new" 39.6% rate is actually not new, but is a return to the Clinton-era top marginal tax rate.

For the first time in more than a decade, the top personal income tax rate is higher (39.6%) than the top tax corporate tax rate (35%). This may cause some high-income S-corporation owners who receive "pass through" income from corporations to consider changing from an S-corporation to a regular corporation.

Per a recent Supreme Court Decision, same-sex couples cannot be prevented by the federal government from getting married. The so-called "Defence of Marriage Act" (DOMA), which defined marriage as a union between a man and a woman, has been declared unconstitutional. As a result of this Supreme Court decision, states that allow same-sex marriage—including California—will see extensive changes in the areas of insurance and taxes.

Same-sex couples who are married in a state that allows same-sex marriage will now, according to the latest reports, receive the following benefits: ability to file jointly on federal tax returns (California, through the Registered Domestic Partnership Program, already allowed joint filing on California tax returns); same rules on estate tax and gift tax for same-sex married couples as for other married couples (e.g. double the exemption amounts); and ability to receive spousal benefit health care coverage through employers. Clever accountants like this guy are developing a myriad of tax strategies aimed at helping same-sex couples take advantage of newly-available federal tax benefits. Of course, this topic is brand new, so expect more changes to occur...

The maximum capital long-term gains rate will increase from 15% to 20% for individuals who are in the new 39.6% tax bracket. Taxpayers who are not in the 39.6% bracket will still be able to pay the zero and 15 percent long-term capital gains rates; taxpayers in the 15 percent or lower tax bracket will be eligible for the zero percent rate. With the stock market up big over the past two years, the ability for lower and middle income taxpayers to "cash in" their appreciated stock gains at zero percent can be quite appealing, and is something you may want to keep an eye on from a tax planning perspective.

Congress and commentators continue to *talk* about making humongous changes to the income tax system. Will the mortgage interest deduction be taken away, or will the home mortgage interest deduction become a tax credit instead of a deduction? Will the "loan-out loophole" for S-corporation shareholders be closed? Do we need to "broaden the tax base," even if it means that lower income and middle income taxpayers will pay more income tax? What about corporate tax reform, should we lower the corporate tax rates to be more competitive with other countries? What about "The Buffet Rule" whereby millionaires would be forced to pay a minimum 30% income tax rate, to make sure that no CEOs are paying lower tax rates than they're secretaries? "Big ideas" are floating around the halls of Congress and the cable TV airwaves, to be sure, but as of now these huge changes have been firmly in the category of "all talk."

A good example of the kind of gum-flapping—er, discussion that is taking place in Congress would be the Senate proposal to use a "blank slate" approach to tax reform. Essentially the blank slate approach entails completely erasing the current tax code, all deductions and credits would be removed, and then Senators would have to argue for which deductions and credits "deserve" to stay. Yeah, so make sure to catch that debate on CSPAN this summer, it should be entertaining...if you're into that sort of thing! J

Another gigantic and politically-charged potential change to our tax system that may or may not be on the horizon is immigration reform. The Senate recently passed an immigration reform bill and now the U.S. House of Representatives is working on the topic. Immigration reform would have far-reaching implications for our tax system and for us as tax preparers, so this is something that you will definitely want to keep an eye on, especially if you work in a community where undocumented immigrants are common.

Meanwhile, the reputation of the IRS has suffered severely from recent scandals related to the IRS non-profit division allegedly "playing politics," and other questionable behaviour

by IRS employees. We'd suggest that you beware of jumping on this particular bandwagon, though, because it's crowded and a lot of the people "pointing fingers" are not exactly pristine themselves. Just a suggestion...

Anyhow, let's return now to some more concrete action items, let's talk about some things that have actually happened as opposed to things that people are talking about might happen:

In 2013 the Exemption Allowance will be $3,900, up from $3,800 in 2012.

The exemption phase-out and the itemized deduction phase-out have returned for 2013.

Exemption amounts phase-out by 2% for each $2,500 (or fraction thereof) by which the taxpayer's AGI exceeds the threshold amount.

Itemized deductions are reduced by the lesser of:

- 3% of the excess AGI over the threshold amount; or
- 80% of the itemized deductions otherwise allowable.

The phase-out threshold amounts are as follows:

Single	$250,000
Head of Household	$275,000
Married filing joint, surviving spouse	$300,000
Married filing separate	$150,000

2013 Standard Deduction Amounts:

Filing Status	Standard Deduction
Joint & Qualifying Widow(er)	$12,200*
Head of Household	$8,950*
Single & Married Filing Separately	$6,100*

*Additional amount for those at least 65 and/or blind

Joint & QW $1,200

All others $1,500

Dependent Standard Deduction

Base Amount	$1,000
Additional Amount*	$300

*To calculate the standard deduction for a dependent taxpayer, you would add $300 to the earned income of the taxpayer, but not to exceed the standard deduction normally applicable to the taxpayer's filing status.

The maximum amount allowed for the Earned Income Credit is now $6,044 (for taxpayers with three or more qualifying children). To qualify for the Earned Income Credit, investment income must be $3,300 or less.

The Standard Mileage Rates for 2013 are:

- 56.5 cents per mile for business driven miles
- 24 cents per mile for medical or moving purposes.
- 14 cents per mile for charitable purposes.

The annual exclusion for gifts is now$14,000, up from $13,000 in 2012.

The "kiddie tax" threshold is now $1,000, up from $950 in 2012.

The foreign earned income exclusion rises to $97,600 for 2013; taxpayers who are working abroad would file Form 2555 to claim this exclusion on their foreign earnings.

The IRS continues to pursue the reporting of foreign bank accounts with rigor. Taxpayers who have reporting requirements for foreign bank accounts but do not tell the IRS about these accounts may face brutal penalties and/or prison sentences. Check out this lady who was penalized $21 million dollars for not reporting her Swiss bank accounts for a particular terrifying example of what can happen if the FBAR rules are not followed.

Did you hear about the updated procedures for Individual Tax Identification Numbers (ITINs)? As you know if you work with clients who apply for ITINs, the IRS has made the entire ITIN application much stricter and the number of ITIN applicants who receive an IRS letter requesting more information or denying their application has greatly increased. In general you have to submit original documents (no more notarized copies), the "Acceptance Agent Program" has been modified, and newly-issued ITINs will now expire after five years.

For 2013, the "wage base" for Social Security tax has been increased from $110,100 to $113,700. Beyond $113,700 of earnings, the taxpayer does not have to pay any more Social Security tax on his or her earnings. However, the Medicare tax of 2.9 percent—1.45 percent for the employee plus 1.45 percent for the employer—is applied to all earned income without limitation. When the increase of the Social Security tax wage base is combined with the end of the payroll tax cut, the maximum amount of Social Security Tax payable by an employee rises from $4,624 in 2012 to $7,049 in 2013.

Taxpayers who filed their 2012 tax returns with certain tax forms that were delayed by IRS are eligible for late filing penalty relief. Here is a link to the IRS description of this penalty abatement program, where you can view the forms that entitle a taxpayer to avoid the late filing penalty. Notably, Form 4562 (depreciation) and Form 8863 (education credits) are on the list, so if you have a taxpayer who is filing a 2012 tax return late and the tax return includes one of those forms you may be able to help your client avoid a late filing penalty that they otherwise would have to pay.

Be careful and diligent when claiming the "real estate professional" deduction for your client's rental property, a valuable deduction allows higher income taxpayers to claim larger-than-normal losses on rental property. The IRS has been auditing real estate professionals heavily of late and we expect this to continue. Before "checking the box" for real estate professional, make sure that your client meets the two tests: more than half of taxpayer's working hours and at least 750 hours per year spent in real estate activities. If taxpayer is audited, IRS will demand proof of time spent such as calendars.

Electric golf carts are no longer eligible for the Plug-in Electric Drive Vehicle Credit. Golf enthusiasts have been able over the past few years to score up to $5,500 tax credit (up to 10 percent of cost of the cart). But now to claim this credit the vehicle must be able to go at least 45 miles per hour.

The IRS audit rate for 2013 is expected to decline again due to budget cuts. However, "letter audits" continue to rise, and have proven to be extremely effective collection tools. Earned Income Credit eligibility letter audits, in particular, have grown more prevalent each year.

IRS phone wait times have drastically increased as a result of budget cuts, too.

Identity theft continues to be a big problem in the tax system. The main scam being perpetrated involves criminals obtaining Social Security numbers of taxpayers, and then filing tax returns early in tax season, so as to receive the taxpayer's tax refund before the taxpayer has filed a return. We expect that early tax season will continue to be a painful process in terms of IRS delays of taxpayer refunds—it will be a challenge to handle this reality when dealing with the typical early tax season filer who may be more or less desperate to get their hands on their tax refund as soon as humanly possible if not sooner.

After years of neglect, the IRS may start looking more deeply into the Employee vs. Independent Contractor worker mis-classification issue. It is a well-known fact that many employers have been misclassifying employees as independent contractors so as to avoid having to pay the FICA tax on that employee's earnings; there are millions upon millions of dollars of potential tax liability associated with this issue, so we would not be surprised if the IRS did start "cracking down" at some point soon. Workers who feel that they have been misclassified can file Form SS-8 to request an IRS determination as to their correct classification, and workers may also apply to avoid paying the "employer share" of the FICA tax by using Form 8919.

Starting in 2013, higher income taxpayers will see a new 3.8% Medicare tax on unearned income including rental income, dividends, capital gains, and interest income. For Single filing status taxpayers, this new Medicare tax on unearned income "kicks in" once the taxpayer's Modified Adjusted Gross Income (MAGI) exceeds $200,000. For Married Filing Jointly tax returns, the 3.8% Medicare tax on unearned income starts once MAGI exceeds $250,000.

Also starting in 2013, high income earners (defined as unmarried over $200,000 in wages, Married Filing Jointly over $250,000 in wages) will pay an extra 0.9 percent Medicare "surtax" on all their earnings above those designated amounts. For example, a taxpayer who is an employee would see his or her Medicare tax rate go from 1.45 to 2.35 percent on any income above the designated amounts. High-earning self-employed taxpayers will also be affected by this extra 0.9 Medicare surtax. Note that the 0.9% surtax income amounts shown above apply to gross earnings and not AGI or MAGI.

The maximum deductible contribution to an Individual Retirement Account (IRA) is now $5,500 per taxpayer for 2013, with a $1,000 "catch-up contribution" for any taxpayer age 50 or over.

The contribution limit for 401K, 403b, and other elective deferral qualified retirement plans has been increased from $17,000 to $17,500, with an additional $5,500 catch-up contribution allowed for taxpayers age 50 or over. For taxpayers age 50 or over, then, it is now possible in 2013 to defer up to $23,000 into a 401K plan. Here is a link to the IRS pension plan contributions page for more information on contribution limits and related topics.

The Alternative Minimum Tax exemption has been made permanent and will (finally) be adjusted for inflation each year. After decades of Congress issuing yearly "patches" to the AMT exemption amounts, the automatic adjustment of the AMT exemption amounts comes as welcome news for middle-income afraid of being bitten by the AMT. The automatic adjusting of AMT exemption amounts gives a bit of certainty to a historically uncertain area of tax law.

The AMT exemption amounts for 2013 are:

Filling Status	AMT Exemption amounts
Married Joint & Qualifying Widow(er)	$80,800
Single & Head of Household	$51,900
Married Filing Separately	$40,400

IRS Competency Test and Other Miscellaneous Tax Preparer Information:

- On Friday, January 18, 2013, the United States District Court for the District of Columbia issued an order which prevents the Internal Revenue Service from enforcing the regulatory requirements for registered tax return preparers. As a result of this court decision, tax return preparers covered by this program are not required to complete competency testing or secure continuing education for 2013. Repeat: there is no federal test that tax preparers must pass, and there are no federal continuing education requirements for 2013 that tax preparers must complete.
- On Friday, February 1, 2013, the court modified its order to clarify that the order does not affect the requirement for all paid tax return prepares to obtain a preparer tax identification number (PTIN).
- The IRS filed an appeal with the district court on March 29, 2013, asking for a reversal of the above ruling, but as of now neither the federal testing requirement nor the federal continuing education requirement has been reinstated.
- For California tax preparers, then, the continuing education requirement is back to being what it was before: California tax preparers must complete 20 hours of continuing education from a tax education provider approved by the California Tax Education Council (CTEC). By completing this course, you are meeting that requirement. And you won't have to worry about any federal continuing education requirement this year.
- The IRS user fee for PTIN renewal will remain the same at $63.

ObamaCare and the 2013 Tax Return:

Want to read the "Affordable Care Act," a.k.a. "ObamaCare," in its entirety? You can read the full health care law here and please send us you're "Cliff's Notes" as soon as you can! J Without commenting on whether it's a good law or a bad law in any political or moral sense, there can be no doubt that this massive law has been the cause of a great deal of confusion and misinformation since the passage of the original bill in March of 2010.

In June of 2012, the Supreme Court held that the Affordable Care Act is not unconstitutional, and therefore we must expect that this law will continue to be implemented.

In this section of your tax update, we seek to give you a quick overview of the most important facts about the Affordable Care Act that relate to you as a professional tax preparer, here is a link to the IRS health care law update page if you would like more information:

First it is worth noting that the majority of the new law's provisions will not take effect until January 1, 2014.

One Affordable Care Act (ACA) provision that won't take effect until January 1, 2014 but should definitely be on your radar as a professional tax preparer is: the Health Care Premium Credit that will help to subsidize health insurance costs for individuals making up to 138% of the federal poverty level. The formulas of who will qualify for the Health Insurance Premium Credit are confusing to say the least, as they depend not only upon income level but also the state in which the taxpayer lives, but here is a handy health insurance tax credit calculator from the Kaiser Foundation that you can use to test out different scenarios.

Another ACA provision that was due to take effect in 2014 is the employer mandate to provide health insurance for employees. This mandate only applies to companies with more than 50 full-time employees or "Full Time Equivalent Employees." The employer mandate is enforced through the assessment of a $2,000 fine per uncovered employee payable to the Internal Revenue Service on the company's tax return. Larger employers complained so loudly about the complexity of administering this new mandate that the employer mandate provision has now been pushed back to 2015 instead of 2014 as originally planned—the fact that this major provision of ACA has changed shows you the extent to which this is still a very "fluid" situation so you must stay tuned.

In addition to the employer mandate, there is also an "individual mandate" for people to buy health insurance, and this, too, will be administered through the tax code, and this, too, will not take effect until 2014. A basic tenet of the Affordable Care Act is that almost all individuals not covered by an employer-sponsored health insurance plan, Medicaid, Medicare or other public insurance plan, must purchase and comply with an approved private insurance policy or else pay a penalty. (Exceptions would apply to members of a recognized religious sect exempted by the IRS or in some other credible cases of hardship.)

The penalties for 2014 for an individual who does not have health insurance would be $95 per adult and $47.50 per child (up to $285 for a family), or 1 percent of family income, whichever is greater.

Penalty per adult for not purchasing health insurance would theoretically increase to $695 or 1 percent of family income (whichever is greater) in later years; however, seeing how many changes are taking place to this law, we would count on more changes being implemented in the future.

Any penalties assessed would be paid through the individual's tax return. Form 1040 would have some sort of box that would be checked if the taxpayer has health insurance or not, and if not, the penalty would show up on Form 1040 as an additional tax.

What if a taxpayer claimed a Health Insurance Premium Credit based upon their 2013 income, but then in 2014 the taxpayer's income increased, and as a result of the increased income the taxpayer did not qualify for the credit or qualified for a lower amount of the credit? Good question, because according to the current law the credit would be paid out ahead of time to cover the current year's health insurance expenses. As of now, our understanding is that a taxpayer who qualified for a lesser credit than was already paid would have to "pay back" all or a portion of the credit through an additional assessment of tax on the 2014 tax return.

But again, you will not see any of these changes on 2013 tax returns, and our guess is that things will continue to change from now until it is time to fill out 2014 tax returns.

One provision of the ACA law that you will see on 2013 tax returns is that employers will be required to withhold a 0.9% Medicare surtax on high-income earners, as discussed above.

Another provision that you will see on 2013 tax returns is the 3.8% tax on net investment income on high-income taxpayers, also mentioned above.

Businesses that offer indoor tanning services also must pay a 10 percent tax on their services; this is set up as an "excise tax," meaning that (similar to sales tax) the tax is passed on to the customer by the business, and then the business pays the tax to the IRS.

In addition there is the 2.3% tax on medical device makers.

With this raft of new taxes now in place for 2013, critics of the health care law have complained that the extra taxes start now, whereas the benefits—namely, more affordable and widely-available health insurance—don't begin until later years.

In another interesting development, and further indicative of the extremely "fluid" nature of this law, the government will use individuals' 2013 tax return data as one of its yardsticks in determining how much of a Health Care Premium Credit to give taxpayers who qualify. This credit will be determined by the individuals' income.

On the 2013 tax return, in fact, there is supposed to be some type of additional form which indicates that an individual does or does not have health insurance. Not surprisingly, the IRS has yet to finalize the form or procedure that will be used to dole out the Health Care Premium Credit.

CALIFORNIA STATE TAX UPDATE 2013

California lawmakers have not yet finalized the exemption and standard deduction amounts along with other final amounts for certain deductions and credits. At the risk of stating the obvious, this makes it a bit difficult to give you a comprehensive California tax update at this time! However, you can rest assured that we will update this California tax update section as the year progresses and more 2013 figures are released.

Nevertheless, it is anticipated that the 2013 figures will be very similar to the 2012 figures with a small increase in most allowances due to inflation.

For now, then, allow us to give you the 2012 amounts for your reference:

Filing Status	2012 CA Personal Exemption Credit
Single, Married Filing Separately, and Head of Household	$104*
Married Filing Jointly, Qualifying Widow(er)	$208*

*Blind? Add an extra $104.

*Age 65 or over? Add an extra $104.

Dependent Exemption Credits $321.00.

Phase-out of Exemption Credits: reduced by $6 for each $2,500 ($1,250 for Married Filing separately) in excess of federal AGI amounts of:

Filing Status	Federal AGI
Single; Married, filing separate	$169,730
Head of Household	$254,599
Married, filing joint: Qualifying Widower	$339,464

2012 California Standard Deduction Amounts:

Filing Status	CA Standard Deduction
Married Filing Jointly, Head of Household	$7,682
Single & Married Filing Separately	$3,841
Minimum standard deduction for dependents	$950

Itemized Deductions: Reduced by the lessor 6 percent of the excess of the of the taxpayer's federal AGI over the threshold amount or 80 percent of the amount of itemized deductions otherwise allowed for the taxable year. Threshold amounts are:

Filing Status	Federal AGI
Single, Married Filing Separate	$169,730
Head of Household	$254,599
Married Joint or Qualifying Widow(er)	$399,464