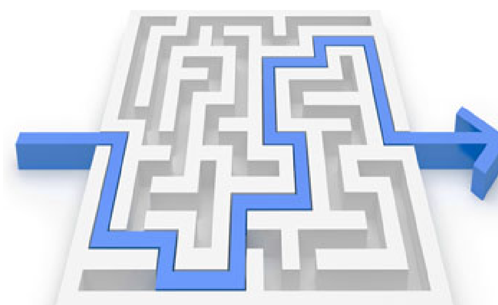
A taxpayer's guide to 2013

The 2013 tax changes you can expect, and what you can do about them.

FIDELITY VIEWPOINTS – 02/27/2013

Taxes IRA Retirement Accounts Roth 401(k) Roth IRA Traditional IRA

After a long period of uncertainty over taxes, the fiscal cliff deal has finally given taxpayers some much-needed clarity—and the opportunity to put in place some tax-smart long-term saving and investment plans.



"Now that many of the expiring tax cuts and temporary tax relief provisions have been made permanent, you have the opportunity to take stock of the situation, create a careful plan, and then put it into practice over the coming years," says John Sweeney, executive vice president at Fidelity.

First the good news:

For most taxpayers with modified adjusted gross income (MAGI) under $200,000—$250,000 for married couples filing jointly—marginal income tax rates won't increase, and most tax relief provisions remain in effect. Among them: marriage penalty relief, the child tax credit, the American Opportunity Tax Credit, and lower capital gains tax rates.

The alternative minimum tax ("AMT") exemption is permanently patched (with inflation adjustments), thereby sparing millions of middle-income Americans from the AMT's snare. In 2013 the AMT exemption is $51,900 for single filers and $80,800 for joint filers, up from $50,600 for single filers and $78,750 for joint filers in 2012.

Qualifying municipal bond interest remains free of federal income taxes.

Qualified dividends continue to be taxed at preferential capital gains rates, rather than as ordinary income.

Now, some not-so-good news:

The employee share of payroll taxes will return to its 2010 level of 6.2% on the Social Security wage base, ending the 2011 and 2012 2% tax holiday.

People with MAGI greater than $200,000—$250,000 for couples—may be impacted by a new Medicare surtax on net investment income. Taxpayers with earned income above $200,000—$250,000 for couples—will also pay a higher Medicare payroll tax.

Anyone with an AGI above $250,000—$300,000 for married couple filing jointly—may have their personal exemptions and itemized deductions reduced.

In addition, taxpayers with taxable income greater than $400,000—$450,000 for couples—should get ready for a new 39.6% top marginal income tax rate and higher qualified dividend and long-term capital gains rates.

The bottom line: If your modified adjusted gross income is below $200,000 (single filer), you'll probably feel the biggest impact from the higher payroll taxes. If you make more than $200,000 (single filer), you may see additional taxes kick in, depending on your exact level of income. If you are impacted by these other tax changes, the combination of higher rates and reduced deductions could take a significant bite out of your income. So, it may be all the more critical for upper income people to focus on strategies to manage their taxes effectively.

Income by any other name

Gross income *includes salaries and other employment income, interest, dividends, capital gains, and other sources of income.*

Adjusted Gross Income (AGI) *is gross income minus tax deductions that are allowable whether or not you itemize deductions on your tax return, such as certain IRA deductions, student loan interest, and unreimbursed business expenses. See the IRS definition.*

Modified Adjusted Gross Income (MAGI) *is calculated by adding back certain items to your Adjusted Gross Income that were deducted including traditional IRA contributions, student loan interest, tuition and fees, and adoption benefits. See the IRS definition.*

Taxable income *is adjusted gross income minus standard or itemized deductions and personal exemptions.*

2013 vs. 2012 tax rates

Federal tax rates that took effect on January 1, 2013.

	2012 rates	2013 rates
Ordinary income and short-term capital gains*		
$17,850 or less ($0–$8,925) Joint (Single)	10%	10%
$17,851–$72,500 ($8,926–$36,250)	15%	15%
$72,501–$146,400 ($36,251–$87,850)	25%	25%
$146,401–$223,050 ($87,851–$183,250)	28%	28%
$223,051–$398,350 ($183,251–$398,350)	33%	33%
$398,351–$450,000 ($398,351–$400,000)	35%	35%
$450,001 and over ($400,001 and over)	35%	39.6%
Long-term capital gains		
Income $72,500 or less ($36,250 or less)	0%	0%
Income $72,501–$450,000 ($36,251–$400,000)	15%	15%
Income $450,001 and over ($400,001 and over)	15%	20%
Dividends		
Ordinary dividends	Ordinary income tax rates	Ordinary income tax rates
Qualified dividends	Long-term capital gains rates	Long-term capital gains rates
Estates and gifts		
	$5,120,000 per person, $10,240,000 per couple, with a 35% top tax rate	$5,250,000 per person, $10,500,000 per couple, with a 40% top tax rate
Unearned income (Medicare contribution)		
	None	3.8% surtax on lesser of net investment income or modified adjusted gross income above $200,000 (individuals) and $250,000 (couples)
Medicare payroll tax		
	2.9%; individual pays 1.45%; employer contributes 1.45%	Additional 0.9% on earned income above $200,000 (individuals) and $250,000 (couples)

* Income ranges are inflation adjusted for 2013.

637981.2.0

Here's how the new law may impact taxpayers in three different income brackets—and steps they might consider as they plan for 2013 and beyond.

MAGI less than $200,000—$250,000 married filing jointly

"For most single taxpayers with modified adjusted gross income under $200,000 a year, or couples with less than $250,000, the fiscal cliff resolution is largely about the dog that didn't bark," says Sweeney. "Income tax rates didn't jump up, dividend taxes didn't move, and a number of other hikes didn't come to pass."

The holiday ends

One exception, though, is the end to the payroll tax holiday. This means a return to the 6.2% withholding rate on wages up to $113,700 in 2013. The rate was 4.2% in 2012. So, for a taxpayer with an annual salary of $30,000, the increase in withholding rate means $50 less in take-home pay per month. For someone earning $60,000, take-home pay goes down by $100 per month—and at $90,000, it's $150 less per month. For earners making $113,700 or more, monthly take-home pay is reduced by $189.50.

What to consider

You should see this tax change in your withholding immediately, though the IRS is giving employers the option of waiting until Feb. 15, 2013, to implement the new withholding (with appropriate adjustments to reflect amounts that should have been withheld from earlier paychecks).[1] To get ready, you may want to look for places to cut costs in your budget so you can absorb the additional tax expense.

Income greater than $200,000—$250,000 married filing jointly

The year 2013 will have several new wrinkles for individuals with incomes above $200,000—for couples, $250,000—higher Medicare payroll taxes, the new Medicare surtax on net investment income, and the phaseouts of itemized deductions and the personal exemption.

Medicare payroll and net investment income taxes

The healthcare law included two new taxes that were scheduled to take effect in 2013. These taxes were not repealed as part of the fiscal cliff deal, and will kick in this year as expected.

The Medicare payroll tax. Here is what's changing. In 2012, the Medicare payroll tax was 2.9%. It applied only to earned income, which includes wages you are paid by an employer, plus tips. Your share, 1.45%, was deducted automatically from your paycheck. Your employer kicked in the other 1.45%.

In 2013, high-wage earners will owe an additional 0.9% on earned income above $200,000 (single filers) or $250,000 (married filing jointly). So, for example, if you are a single filer whose salary will be $225,000 in 2013, you will pay a 1.45% Medicare tax on the first $200,000, then 2.35% (1.45% plus 0.9%) on the next $25,000. Your employer will be required to withhold the extra 0.9% once your wages pass the $200,000 threshold for individuals.

The Medicare surtax on net investment income. A 3.8% surtax will be due on the lesser of your net investment income for the year, or the amount by which your "modified adjusted gross income"—or MAGI—exceeds those income thresholds. Note that a taxpayer could be subject to both the additional 0.9% tax on earned income and this 3.8% tax.

Here is a hypothetical example: Paul and Ann's MAGI is $372,000, of which $330,000 is wages and $42,000 is net investment income. Their MAGI is $122,000 over the $250,000 threshold for married couples filing jointly. They'll incur the 3.8% tax on their $42,000 of net investment income, because it is less than the amount they are over the MAGI threshold ($122,000). They'll also owe 0.9% on the $80,000 that their wages are over the $250,000 earned income threshold for married couples filing jointly. Their total Medicare tax surcharge will be $2,316, which includes $1,596 (3.8% of $42,000) and $720 (0.9% on $80,000).

The personal exemption and itemized deduction phaseouts

Single filers with adjusted gross income (AGI) in excess of $250,000 or couples who are married filing jointly and have AGI in excess of $300,000 will also face phaseouts of their deductions and personal exemptions. The phaseout of the personal exemption (sometimes called "PEP") means for every $2,500 of AGI (or portion thereof) above $250,000 ($300,000 for married couples filing jointly), the $3,900 per-person personal exemption will be reduced by 2%. For married couples, personal exemptions will be fully phased out once their AGI exceeds $422,501, or for single filers if AGI exceeds $372,501.

The phaseout of itemized deductions (often called the "Pease" phaseout, for the legislator who sponsored the rule) could also raise tax bills for higher income earners by reducing the tax benefit of the mortgage interest, state income and sales tax, home office, and certain other itemized deductions. The Pease limitation reduces the value of itemized deductions by 3% of the AGI above $300,000 for couples, and $250,000 for single filers—to a maximum reduction of 80% in value. Itemized deductions for certain medical expenses, investment interest, and for casualty, theft, or gambling losses are exempt from the phaseout.

Let's look at a hypothetical example:

Say a married couple, Jim and Erica, claim $25,000 in itemized deductions for mortgage interest and state taxes and claim a combined $7,800 in personal exemptions. The new phaseout schedule will reduce the tax benefit of those deductions based on their earnings. If their AGI was $250,000, putting them in the 33% bracket, they could claim the full amount of their itemized deductions and personal exemptions, resulting in a combined benefit of $10,824. But what if their AGI was $440,000? That would put them in the 35% tax bracket and their exemptions and itemized deductions would have been worth $11,480. But because of the PEP and Pease phaseouts, their personal exemptions would have been fully phased out and their itemized deductions would have been reduced by $4,200 (3% x $140,000). As a result, the tax benefit of their deductions would be only $7,280.

Taxable income above $400,000—$450,000 for couples

In addition to the higher taxes described above, upper-income Americans may be subject to a new 39.6% marginal rate on taxable income over $400,000 or $450,000 for married couples filing jointly. Likewise, they may be subject to tax on capital gains and qualified dividends at a rate as high as 20%—23.8% if the Medicare surtax on net investment income applies.

New taxes for top earners

Year	2012	2013
Top marginal long-term capital gains and qualified dividend rate	15%	23.8%*
Top marginal ordinary income tax rate	35%	39.6%
Top rate on short-term capital gains and non-qualified dividends	35%	43.4%*
Personal exemption phaseout	None	Completely eliminates value of personal exemption for single earners with an AGI over $372,501 and couples filing jointly with an AGI greater than $422,501.
Pease itemized deduction phaseout	None	All itemized deductions reduced by 3% of MAGI over $300,000 for married couples filing jointly ($250,000 for single filers)—to a maximum reduction of 80% in value.

*includes 3.8% Medicare surtax

Strategies to consider

The higher the tax rates go, the more incentive taxpayers have to focus on tax-efficient strategies. Of course, taxes are just one consideration among many when making investment or income decisions. But the new law made them a bigger part of the equation.

Here are some considerations for upper-income people.

Investment considerations.
Look for ways to invest that may potentially minimize your taxes.

Consider muni bonds. If the AMT is not an issue, you may want to consider tax-exempt municipal bonds instead of taxable bonds. Qualifying municipal bond income is not subject to federal income tax, though interest from certain municipal bonds is a preference item for the alternative minimum tax, and all municipal interest from outside of your state of residence may be subject to state or local taxes.

Use capital losses to offset capital gains. You don't want the tail to wag the dog—so don't let a tax decision dictate an investment decision. But if it makes sense for your plan, selling stocks at a loss can reduce your taxable capital gains and adjusted gross income—potentially limiting your tax burden.

Think about your asset location. Tax-efficient assets, like municipal bonds, equity index ETFs, or growth stocks you hold for the long-term may make sense in a taxable account. On the other hand, tax inefficient assets such as taxable bonds, high-turnover equity mutual funds, or REITs could create more of a tax bill and may be better kept in tax-advantaged accounts like 401(k)s, 403(b)s, 457 plans, IRAs, and tax-deferred annuities. So it makes sense to develop a strategy for where you locate your assets.

Income considerations.
Look for ways to manage your taxable income and consider deferrals that might delay receipt of income until you're in a lower tax bracket.

Max out tax-advantaged savings opportunities. If you are still working, the new tax laws add to the long list of good reasons to maximize contributions to qualified accounts such as 401(k)s, 403(b)s, 457 plans, HSAs, SEPs, and Keoghs. Qualifying contributions to these accounts can reduce your AGI, and, given the PEP and Pease phaseouts, that could be a good thing. There are a few other "above the line" deductions you may be able to take advantage of, if eligible, including contributions to IRAs or SIMPLE plans, and self-employed health insurance deductions.

Gifts of appreciated securities to charity are more valuable for high earners. Donations of appreciated securities held at least one year to certain charities may be deducted at their fair market value—without any capital gains tax. So if you are subject to the new higher tax rate on long-term capital gains or the new Medicare surcharge on net investment income, it increases the incentive to donate stocks instead of cash.

Learn more about donating appreciated securities.

Look at nonqualified deferred compensation plans. If you are a small-business owner or your employer offers you a nonqualified deferred compensation plan, you may want to look into it. An NQDC plan may help with your financial planning, potentially giving you the flexibility to stay in a lower tax bracket now, while receiving the income at a time in the future when you're in a lower tax bracket. While most qualified plans enjoy various protections in case of an employer's bankruptcy, nonqualified plans may expose you to the risk of default by your employer.

Read "Nonqualified deferred compensation plans."

If you are living off income in retirement, manage your withdrawals wisely. If you are approaching a tax threshold, you may want to develop a tax-smart withdrawal strategy that combines taxable withdrawals and tax-free withdrawals to meet your income needs while keeping your taxable income at the desired level.

Read "Smart strategies for retirement income."

Delay Social Security. If you can afford it, putting off Social Security may help to keep your taxable income low and potentially increase your monthly benefit when you eventually receive it.

Read "Should you take Social Security at 62."

Learn more

Attend a Tax Smart Investing seminar at a local Fidelity Investor Center near you.

Explore municipal bond funds.

See how the professional portfolio management of Fidelity® Personalized Portfolios, can help you seek enhanced after-tax returns.*

Before investing, consider the funds' investment objectives, risks, charges, and expenses. Contact Fidelity for a prospectus or, if available, a summary prospectus containing this information. Read it carefully.

*Fidelity® Personalized Portfolios applies tax-sensitive investment management techniques (including tax-loss harvesting) on a limited basis, at its discretion, primarily with respect to determining when assets in a client's account should be bought or sold. Because it is a discretionary investment management service, any assets contributed to an investor's account that Fidelity Personalized Portfolios does not elect to retain may be sold at any time after contribution. An investor may have a gain or loss when assets are sold.

The tax information contained herein is general in nature, is provided for informational purposes only, and should not be construed as legal or tax advice. Fidelity does not provide legal or tax advice. Fidelity cannot guarantee that such information is accurate, complete, or timely. Laws of a particular state or laws that may be applicable to a particular situation may have an impact on the applicability, accuracy, or completeness of such information. Federal and state laws and regulations are complex and are subject to change. Changes in such laws and regulations may have a material impact on pre- and/or after-tax investment results. Fidelity does not assume any obligation to inform you of any subsequent changes in the tax law or other factors that could affect the information contained herein. Fidelity makes no warranties with regard to such information or results obtained by its use. Fidelity disclaims any liability arising out of your use of, or any tax position taken in reliance on, such information. Always consult an attorney or tax professional regarding your specific legal or tax situation.

Investing involves risk, including risk of loss.

The municipal market can be affected by adverse tax, legislative, or political changes and the financial condition of the issuers of municipal securities. Interest rate increases can cause the price of a money market security to decrease. Municipal funds normally seek to earn income and pay dividends that are expected to be exempt from federal income tax. If a fund investor is resident in the state of issuance of the bonds held by the fund, interest dividends may also be exempt from state and local income taxes. Such interest dividends may be subject to federal and/or state alternative minimum taxes. Certain funds normally seek to invest only in municipal securities generating income exempt from both federal income taxes and the federal alternative minimum tax; however, outcomes cannot be guaranteed, and the funds may sometimes generate income subject to these taxes. Fund shareholders may also receive taxable distributions attributable to a fund's sale of municipal bonds.

Generally, tax-exempt municipal securities are not appropriate holdings for tax advantaged accounts such as IRAs and 401(k)s.

ETFs may trade at a premium or discount to their NAV and are subject to the market fluctuations of their underlying investments.

1.
IRS Provides Updated Withholding Guidance for 2013.

Fidelity Brokerage Services LLC, Member NYSE, SIPC, 900 Salem Street, Smithfield, RI 02917.

639344.1.0

Subscribe to Viewpoints

Related Articles

Got gains or losses?
A strong year for stocks and higher taxes on gains make tax-loss harvesting important.

Savvy tax moves
Changes in the tax laws for 2013 could have a significant impact on what you owe.

Keep more gains
How choosing the right account can help you cut taxes and keep more of your investment gains.

Lessons from financial crisis
Five things to try now to help improve your personal economy.

View all Tax Strategies articles

Copyright 1998-2013 FMR LLC. All Rights Reserved.