Action now can minimize your tax burden in 2013

Higher rates and new Medicare levies could mean reduced take-home earnings in the future

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The nation's tax code seems to be in a constant state of flux, and the present era is no exception. Unless Congress and the president agree otherwise, expect the tax cuts enacted in 2001 and 2003 to expire, Social Security and Medicare taxes to increase, and the allowable first-year depreciation on equipment purchases to plummet.

Let's examine what's in store for 2013 and beyond, assuming that the tax changes currently planned actually do take place. We'll also highlight some concrete steps you can take to minimize your tax burden starting in 2013.

If the 2001 and 2003 tax cuts expire on December 31, marginal tax rates will increase to the pre-2001 levels. (See table, "Income tax brackets, 2012 versus 2013," and chart, "Projected tax brackets for 2013.")

You also should expect to pay higher taxes on capital gains and corporate dividends once rates revert to their pre-2003 levels. Ten years ago, the tax rate on long-term capital gains was capped at 20% and the tax rate on dividends was one's marginal tax rate. (See table, "Maximum income tax brackets on capital gains and corporate dividends, 2012 versus 2013.")

POWER POINTS

- With tax rates set to increase on earnings from dividends and income, you can save by making sure your most tax-efficient investments are in taxable accounts.
- If your practice is an S corporation, maximize the amount of pay you take in distributions, because they are not subject to Medicare taxes.

STEPS YOU CAN TAKE

What can you do to counter these higher tax rates? Here are some options:

1. Start by maximizing your retirement plan contributions whenever possible.

Money contributed to these accounts reduces your taxable earnings and grows tax-deferred. The higher the tax rates on earned income and investment income, the more attractive these pre-tax accounts become.

2. If you own a practice, determine whether it's time to revamp your practice's retirement plan to one that allows for higher annual contributions.

Some physicians have begun to explore whether setting up a defined benefit plan, such as a cash balance plan, makes sense for their practices, because these plans generally permit significantly higher annual contributions than do defined contributions plans such as 401(k) and Keough plans.

3. Shift income to children and other family members in a lower tax bracket to reduce your tax burden as well.

You must actually employ these family members and pay them a fair wage for services provided, however.

4. Compensate a spouse not covered under another employer's retirement plan.

CONTINUED ON PAGE 39

CONTINUED FROM **PAGE 35**

Doing so enables the spouse to take maximum advantage of pre-tax salary deferrals allowed through your practice's 401(k) plan.

For 2012, each employee can contribute up to $17,000 as salary deferrals (the limit is $22,500 for those aged at least 50 years). If you're in a high tax bracket, this provision can save you as much as $6,700 in federal income taxes.

OTHER TAX-SAVING OPPORTUNITIES

Now is the time to explore other pre-tax savings opportunities, too:

1. Pair a health savings account with a qualified high-deductible health insurance plan.

Doing so not only reduces your monthly medical insurance premiums but also allows you to make tax-deductible contributions into an account that is available to pay your family's healthcare costs, and then supplement your retirement once you reach age 65.

2. Contribute to a 529 account to pay for a child's education.

Doing so won't lower your tax bill, but your contributions will grow tax-free as long as the 529 money is used for the beneficiary's qualified education expenses. Qualified education expenses include unreimbursed college and graduate school expenses for tuition, fees, books, supplies, required equipment, computers, software, and Internet access while the beneficiary is in college. Room-and-board expenses also qualify if the beneficiary attends school at least half-time.

HIGHER SOCIAL SECURITY, MEDICARE TAXES IN STORE

As part of an effort to stimulate the economy, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 lowered Social Security taxes by 2%. Initially implemented for just 2011, this tax reduction subsequently was extended through 2012.

Starting in 2013, however, every non-government worker will see that his or her Social Security withholding taxes increase from the 2012 rate of 4.2% back to the pre-2011 rate of 6.2%. Physicians earning more than the current Social Security cap of $110,100 will pay an extra $2,202 in Social Security taxes next year.

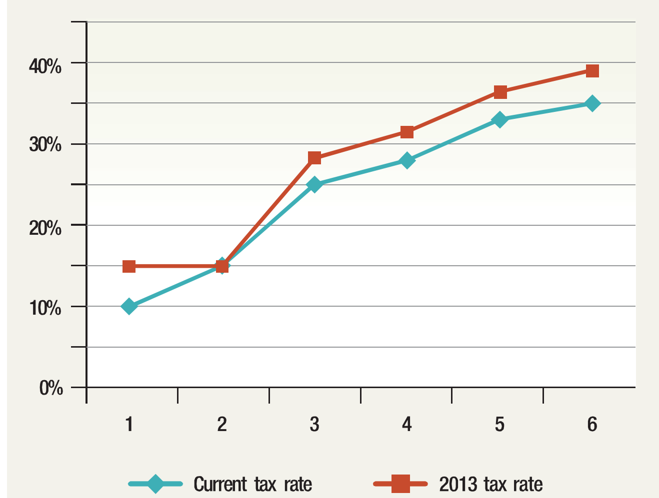
The first Medicare increase is based on salaries, self-employment income, and other forms of earned

Income tax brackets, 2012 versus 2013

Current tax rate	Projected 2013 tax rate	Increase
10%	15%	5%
15%	15%	0%
25%	28%	3%
28%	31%	3%
33%	36%	3%
35%	39.6%	4.6%

SOURCE: INTERNAL REVENUE SERVICE

Projected tax brackets for 2013



SOURCE: INTERNAL REVENUE SERVICE

Maximum income tax rates on capital gains and corporate dividends, 2012 versus 2013

Type of income	Current tax rate	Maximum 2013 tax rate	Increase
Long-term capital gains	15%	20%	5%
Corporate dividends	15%	39.6%	24.6%

SOURCE: INTERNAL REVENUE SERVICE

CONTINUED FROM **PAGE 40**

income. Single individuals earning more than $200,000 and married couples who together earn more than $250,000 will see their Medicare tax increase from the current rate of 1.45% to 2.35%.

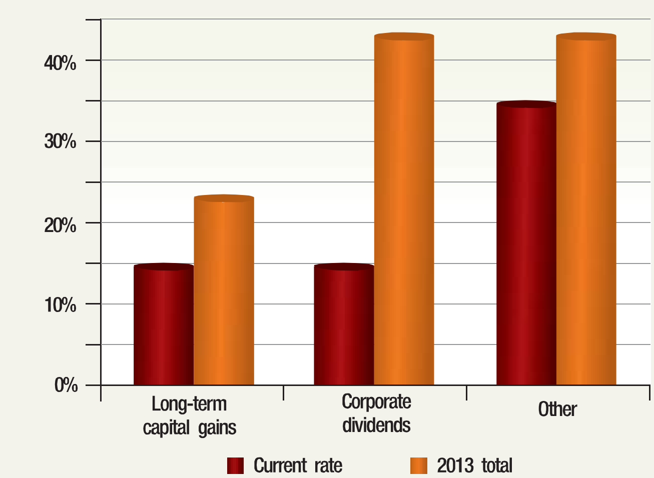
In addition, the Medicare tax will apply to unearned income for the first time since this tax was enacted. Individuals earning more than $200,000 and married couples earning more than $250,000 will pay Medicare taxes at a rate of 3.8% on interest, dividends, capital gains, net rental income, and other unearned income beginning in 2013. (See table, "Maximum tax rates on investment income, 2012 versus 2013" and chart, "Changes in maximum tax rates on investment income, 2012-2013.")

Maximum tax rates on investment income, 2012 versus 2013

Type of unearned income	Current maximum tax rate	2013 maximum tax rate	New Medicare tax rate	Total 2013 tax	Increase
Long-term capital gains	15%	20%	3.8%	23.8%	8.8%
Corporate dividends	15%	39.6%	3.8%	43.4%	28.4%
Other unearned income	35%	39.6%	3.8%	43.4%	8.4%

SOURCE: INTERNAL REVENUE SERVICE

Changes in maximum tax rates on investment income, 2012-2013



SOURCE: INTERNAL REVENUE SERVICE

Here are some specific steps to consider for minimizing the effects of these tax increases:

1. If you operate your practice as an S corporation, as many independent medical practices do, you can try to minimize the amount of compensation you take in the form of wages and maximize what you take as distributions.

That's because any W-2 wages you pay yourself are subject to the 3.8% Medicare tax, but profits taken out of the practice as distributions to yourself are not subject to the tax. (Beware also of paying yourself inflated rents because net rental income also is subject to the 3.8% Medicare tax starting in 2013.)

2. Plan ahead to produce substantial tax savings for any investment earnings, because the top tax rate for this category will jump to 43.4% (a 39.6% tax for those in the top bracket, plus the new 3.8% Medicare tax on unearned income).

Consequently, consider reallocating your investment portfolio before the end of 2012, while tax rates on capital gains are still 15%.

Make sure to hold you most tax-efficient investments, such as exchange-traded funds, index funds, non-dividend paying stocks, and municipal bond funds, in your taxable accounts. Use your individual retirement account, 401(k), and other tax-deferred retirement savings accounts for your taxable bond funds, dividend paying stocks, and actively managed funds that routinely pay out high distributions each year.

EQUIPMENT PURCHASES

Starting in 2013, expect to pay an extra 2.3% on purchases of medical devices, because the Affordable Care Act includes a provision requiring manufacturers to collect an excise tax equal to 2.3% of the sales price of equipment they sell. That tax translates into

Maximum annual depreciation allowed — 2012 versus 2013

	2012	2013 5-year asset	2013 7-year asset
Cost of equipment	**$100,000**	**$102,300**	**$102,300**
Depreciation – Year 1	$100,000	$40,460	$36,046
Depreciation – Year 2	$0	$24,736	$18,931
Depreciation – Year 3	$0	$14,842	$13,520
Depreciation – Year 4	$0	$8,905	$9,655
Depreciation – Year 5	$0	$8,905	$6,903
Depreciation – Year 6	$0	$4,452	$6,895
Depreciation – Year 7	$0	$-0-	$6,903
Depreciation – Year 8	$0	$-0-	$3,448

SOURCE: INTERNAL REVENUE SERVICE

an additional $230 for every $10,000 worth of new equipment purchased—assuming the manufacturer passes along the full amount of the tax to you, the purchaser.

You'll lose another tax break on purchasing equipment next year. When you buy equipment, you can deduct the cost of that equipment from your taxes. And each year, you have the option of making a Section 179 election, which allows you to write off the full cost of any equipment you purchase during the year up to a certain limit.

For 2012, you are allowed to write off up to $139,000 under a Section 179 election. In 2013, however, the Section 179 maximum will be reduced to $25,000, greatly decreasing allowable first-year depreciation to practice owners.

The new 2.3% excise tax, combined with the reduced Section 179 deduction, would seem to mean that medical practice owners should purchase medical devices by December 31. If you believe, however, that tax rates will revert to the higher, pre-2001 rates, (before enactment of the Bush tax cuts), then you might minimize your tax burden by holding off purchasing equipment until after 2012. Remember, you'll ultimately depreciate the full cost of the equipment, including the 2.3% tax, over the useful life of the equipment. (See table, "Maximum annual depreciation allowed—2012 versus 2013.")

So if you're in the 35% tax bracket, the after-tax cost of a $100,000 piece of equipment purchased during 2012, after claiming the full Section 179 deduction, is $65,000—a savings of $35,000.

What happens if you wait until 2013 to purchase the same equipment? The cost increases to $102,300 with the addition of the 2.3% excise tax, and the Section 179 deduction allowance falls to $25,000.

On the other hand, the top tax rate will have reverted to 39.6%, and with the additional 0.9% in Medicare taxes, your effective tax rate will be 40.5%, producing a tax savings of $41,715 over the next 5 to 7 years. The after-tax cost is $60,585, or $4,415 less than the 2012 after-tax cost, assuming the tax rules don't change.

WHAT LIES AHEAD?

The changes in tax rules and tax rates describe here are part of a larger debate over balancing the federal budget and reducing the nation's debt. Consequently, whether the changes take place to the extent described here—or take place at all—will depend on the outcome of negotiations before the end of the year between the president and a lame-duck Congress.

So fasten your seatbelts. It promises to be an interesting ride. ME

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