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Money Matters | Supreme Court ruling clears path for tax increases in 2013

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Earlier this summer the Supreme Court upheld President Obama's Affordable Care Act. Although most of its provisions focus on health care reform, some of its overlooked income tax provisions will go into effect on January 1, 2013, no matter what lawmakers do on the Bush tax cuts. Regardless of which income tax bracket you are in, you should know what changes are coming and how to plan for them.

The act includes the following tax changes for 2013:

1. Medicare Tax Increase

This provision has been commonly referred to as the "Medicare Surtax" and targets certain earned and unearned income of high-income taxpayers.

The surtax on earned income is an additional nine-tenths of one percent, or 0.9 percent, on earnings that exceed $200,000 for individual tax filers and on the combined earnings that exceed $250,000 for joint income tax filers. The tax also applies to self-employed individuals who already pay both the employee and employer portions of the FICA tax.

The surtax on unearned income is an additional 3.8 percent on the lesser of (1) net investment income or (2) the excess of Modified Adjusted Gross Income (MAGI) over $200,000 for individuals and $250,000 for married couples. Net Investment Income is income from interest, dividends, royalties, rents, capital gains, annuities, and income from a trade or business in which you do not actively participate (Passive Activity Income) minus expenses allocable to the income. It does NOT include income from an active trade or business and distributions from IRAs or qualified retirement plans. This basically amounts to all of your income on Schedules B, D and E of your tax return, with a few exceptions.

So, what can you do to reduce these surtaxes?

Consider accelerating your earned income into 2012, if possible, to lessen the amount subject to the earned income surtax.

Reduce your Adjusted Gross Income by making contributions to Traditional IRAs and qualified retirement plans.

Consider making appropriate investments in municipal bonds that generate tax-exempt income, which is not subject to the surtax on unearned income.

If you will need cash flow in the near-term from selling appreciated capital assets, consider selling them in 2012, versus waiting until 2013, to avoid the surtax.

Consider converting from a Traditional IRA to a Roth IRA. Distributions from Roth IRAs are tax-free, which will reduce your future Modified Adjusted Gross Income.

2. Itemized Deductions for Medical Expenses

The threshold for the itemized deduction for unreimbursed medical expenses increases from 7.5% of adjusted gross income to 10% of adjusted gross income, except for for individuals age 65 and older for tax years 2013 through 2016. If you are under age 65, then consider bunching your medical expenses into 2012, if possible, to take advantage of the current lower threshold.

3. Flexible Spending Account Limits

Pre-tax contributions to Health Flexible Spending Accounts (FSA) will be capped at $2,500 a year, versus $5,000 now. The Dependent Care Flexible Spending Account contribution remains capped at $5,000.

With the focus of the Affordable Care Act on health care reform, these income tax changes will stealthily make it to the attention of affected taxpayers through higher tax bills. A summary of the changes can be found at http://www.kff.org/healthreform/8061.cfm.

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