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INFLATION ADJUSTMENT

The Social Security Administration (SSA) has announced the annual cost of living adjustment for social security and unfortunately for most of us, the concurrent increase in our "payroll tax." The amount of the adjustment is 1.7 percent.

Under existing law, the Federal Insurance Contributions Act (FICA), employers pay a tax based on the amount of wages paid to an employee during the year. The tax imposed is composed of two parts: the old age, survivors, and disability insurance ((OASDI) and sometimes referred to as the "Social Security tax") tax equal to 6.2 percent of covered wages up to the taxable wage base ($110,100 for 2012); and the Medicare hospital insurance (HI) tax amount equal to 1.45 percent of covered wages.

In addition to the tax on employers, each employee is subject to FICA taxes equal to the amount of tax imposed on the employer (the "employee portion"). The employee portion of FICA taxes is withheld and remitted to the Federal government by the employer. The same wage base rules apply.

The increase means the taxable base for the 6.2 percent will increase from $110,100 to $113,700 for 2013.

The Self-Employment Contributions Act (SECA) tax applies to the self-employment income of self-employed individuals. The rate of the OASDI portion of SECA taxes is 12.4 percent, which is equal to the combined employee and employer OASDI FICA tax rates, and applies to self-employment income up to the FICA taxable wage base (thus $110,000 in 2012 and $113,700 in 2013). Similarly, the rate of the HI portion of SECA tax is 2.9 percent, the same as the combined employer and employee HI rates under the FICA tax, and there is no cap on the amount of self-employment income to which the rate applies.

PAYROLL TAX RELIEF

You may be thinking to yourself, "Hey aren't we withholding only 4.2 percent on OASDI wages?"

The answer is "yep"- at least for a couple of more months.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 gave us the first temporary reduction (for 2011) in the OASDI rate for the employee portion of the FICA tax. It was reduced by two percentage points to 4.2 percent. Similarly, for taxable years beginning in 2011, the OASDI rate for a self-employed individual was reduced by two percentage points to 10.4 percent.

The Temporary Payroll Tax Cut Continuation Act of 2011 extended that two-percentage point reduction through the end of February 2012.

Earlier this year, Congress passed H.R. 3630, the Middle Class Tax Relief and Job Creation Act of 2012 (MCTRJCA). It extended the temporary two-percentage point payroll tax "holiday" for employees (and to the same extent, to the self-employed) through the end of 2012.

Now here's the weird thing. One would think that another extension of the two percent break would be something both candidates would be embracing. Talk about in the "wheelhouse" of middle class tax relief. Yet the common Washington hallway talk is that the payroll tax cut is among the lowest on the priority list and the common assumption on both sides of the aisle is that it will expire without a whimper. (*This monologue is rhetorical-there is no way in the middle of a presidential campaign that Governor Romney was ever going to endorse what was* *originally President Obama's idea. It is more surprising the Administration has seemed to abandon it.*) We have other priorities but regardless of whether you think it is a good idea or bad idea, be ready, because when the first paychecks are issued in January, some employees are not going to remember it was temporary and that you have nothing to do with that suddenly smaller take home check.

MORE TAX INCREASES

While I am at it, I guess this is as good a time as any to remind you of two new tax increases coming our way on January 1st. These come to us courtesy of health care reform.

Hospital Insurance Trust Tax

As a revenue offset, the health care reform law increases the Medicare Hospital Insurance (HI) trust portion) of the payroll tax to 2.35 percent from 1.45 percent (i.e. a 0.9 increase) on wages or self-employment income over $200,000 for an individual return and $250,000 for a joint return. There is no limit on the amount of wages or self-employment income that is subject to the tax (unlike the social security portion of the FICA tax, which has a wage cap). This is an increase in the employee's share only. The employer will continue to pay to its 1.45 percent rate share on the employee's wages. In the case of the self-employed, they will pay "only" the additional 0.9 percent on the income above the $200,000/$250,000 threshold. *The increase takes effect in 2013.*

(*Yes, just another reason why doing payroll on your own is increasingly becoming a thing of the past for small businesses*.)

Unearned Income Medicare Contribution Tax

Since the HI applies only to earned income, the law establishes a new "Unearned Income Medicare Contribution" (UIMC) tax. This is calculated separately from the HI tax and would apply to "net investment income" which is interest, dividends, royalties, rents, gross income from a trade or business involving passive activities, and net gain from disposition of property (other than property held in a trade or business). The rate is 3.8 percent. The UIMC tax on net investment income would not apply if modified adjusted gross income is less than $250,000 in the case of a joint return, or $200,000 in the case of a single return. ***The UIMC tax takes effect in 2013.***

This latter provision is going to create lot of "holy cow, where did that come from" heartburn. If you read the words carefully there are lots of limitations like the words "involving passive activities" that in addition to the income thresholds, are going to limit the ultimate impact but until a tax advisor sorts through them, "more-often-than-not inaccurate" Internet chatter is sure to sow plenty of anxiety attacks when the switch is flipped at the beginning of the year.

Did I say two increases? Well, technically there are a couple of other smaller ones that have their roots in health care reform.

The threshold for claiming the itemized deduction for medical expenses is increasing from 7.5 percent to 10 percent, beginning in 2013.

Contributions to Flexible Spending Accounts (FSAs) are capped at $2,500 (indexed) annually, beginning in 2013.

COLA-RELATED PENSION AND TAX ITEMS

As it does each year, the Internal Revenue Service (IRS) followed up the SSA release with a list of pension and tax items that are adjusted by that same COLA percentage.

Among the highlights (all effective January 1, 2013):

- The elective deferral (contribution) limit for employees who participate in 401(k), 403(b), most 457 plans, and the federal government's Thrift Savings Plan is increased from $17,000 to $17,500.
- The limitation on the annual benefit under a defined benefit plan under is increased from $200,000 to $205,000.
- The limitation for defined contribution plans is increased in 2013 from $50,000 to $51,000.
- The annual compensation limit for various sections that determine maximum contributions is increased from $250,000 to $255,000.
- The annual exclusion for gifts rises to $14,000 for 2013, up from $13,000 for 2012.