The Fiscal Cliff, 2013 Taxes, and You

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Now that the election is over, and TV and radio are not filled with nonstop political ads, and the end of the year fiscal cliff draws near, how is the divided congress going to work with a second term president to reduce the deficit? How will their action or lack of action affect the tax bills of working Americans?

Judging from the last few years, lack of action is a safer bet from a divided Congress than a new cohesive tax plan. So, the most important question may be what will happen if Congress and the President don't agree to make sweeping changes? Special low tax rates we have seen for many years expire without any action. Popular tax credits and deductions will disappear all by themselves at the end of this year, unless Congress acts.

We've all heard the rhetoric and promises that new tax increases needed to tame the deficit will only affect those earning over $250,000 per year. Will that be true of the disappearing rates, credits and deductions? Absolutely, that will not be the case. For example, a single or divorced taxpayer with W-2 wages of $60,000 per year who uses a standard deduction will see his or her net federal income taxes increased by over 10%, paying over $850 more in 2013 than in 2012, as a result of the elimination of the 10% rate at the bottom of the scale, and by the increase in the applicable marginal tax rate for them from 25% to 28%. This will no doubt be blamed on President Bush, since the tax cuts he enacted are expiring.

The same taxpayer will pay an extra $1,200 in Social Security tax in 2013 over 2012, since the Social Security rate increases on January 1 from 4.2% to 6.2%. That means that typical single wage earner will pay at least $2,000 more in Federal Taxes alone, not counting state tax increases which are also anticipated.

This scenario also assumes that nothing is done by Congress and the President to stop the huge cuts to the military budget coming automatically in 2013, despite the current state of unrest in the Middle East, with Syrian civil war, Iranian development of nuclear weapons, Egyptian pledges of support for Hamas despite its launching missiles into Israel, the massing of Israeli troops on the Gaza border, and Israel's promise to bomb Iranian nuclear installations. The odds that one or more of these situations will lead to additional U.S. military spending seem pretty high.

The only good news for this single wage earner if he or she doesn't have qualified health insurance coverage is that it is not yet 2014. Next January, the Obamacare personal mandate also kicks in. When that happens, the minimum penalty/tax for each adult in an uninsured household is $95, jumping to $325 in 2015, and $695 in 2016. But because our single taxpayer earns more than minimum wage, he or she would have to pay a penalty/tax of 1% in 2014, 2% in 2015, or 2.5% in 2016. So, our taxpayer would pay $600 in 2014, $1,200 in 2015, and $1,500 in 2016.

A two wage earner married couple with two children at home, who don't own their own home, won't fare any better in 2013 without congressional action. Assuming a combined income of $175,000, still well below the $250,000 level, their marginal tax rate will go from 28% to 31%and they will lose half of their child tax credit, or $1,000. Their income taxes will go up by over $6,300 over 2012, and they will pay an extra $3,500 to social security. That means a true federal tax increase of almost $10,000 per year.

For business owners and those who earn money investing their capital, the tax picture is even worse. The top tax bracket for ordinary income will jump from 35% to 39.6%. Capital gains taxes for those in the current 10% and 15% tax brackets are 0, and will go to 10%, while capital gains for taxpayers in higher brackets will rise from 15% to 20%. Those investors will also pay an extra 3.8% on capital gains to fund Obamacare, and certain dividends now taxed at 15% will be taxed at their full 39.6% marginal tax rate.

If you hope to inherit money, or to leave money to your heirs, less of inherited wealth will pass to heirs from those who die in 2013. The current 2012 Federal Estate Tax exclusion is $5.12 million dollars. Inheritance above that level is taxed at 35%. The exemption will drop on January 1 to $1 million dollars, and the federal estate tax rate will rise to 55%. That means a $5 million dollar estate which would have paid no federal estate tax if the decedent dies December 31, 2012, would pay $2,200,000 more tax if the decedent lives just one day longer!

The federal tax is in addition to state death taxes. Pennsylvania has a 4.5% inheritance tax on the entire estate inherited by a decedent's children, and in addition to that tax is bringing back a state estate tax starting in 2013. Thus, if I left $2 million dollars to my children in 2013, they could expect to receive not much more than half of that money after taxes, not counting lawyers' fees and probate costs.

None of these tax scenarios is set in stone, however. Some 2012 tax rules, like those for alternative minimum tax, are still unclear as of November,

and will be set retroactively. Taxes for 2013 may be changed by congressional action over the next few weeks, or by action after the newly elected congress is seated in January. All taxpayers should be following these events and planning carefully for whatever tax changes occur automatically or by congressional action. I know I'll be watching closely!
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