Tax deal not pain free for most people

By Ron Lieber, New York Times

It is tempting for people who earn less than $400,000 to think that they got off easy this week under the tax deal to end the fiscal impasse, given that only those with incomes above that level will be in a higher income tax bracket in 2013.

But the legislation that both houses of Congress have now approved could increase taxes on people with incomes that are not quite that high as well. That's because the bill includes language that begins to do what both President Obama and Mitt Romney proposed at various points in the past: Limit certain tax breaks available to people who are affluent.

The new rules target two tax breaks: personal exemptions and many popular deductions like those for state and local taxes, mortgage interest and charitable contributions. For both breaks, single people with at least $250,000 in adjusted gross income and married people filing jointly with at least $300,000 in income are vulnerable. A hypothetical Texas couple could end up paying about $2,500 more in taxes, for instance.

The mechanics of how the new limits will work are now clear, though it takes a fair bit of explaining to lay them out in plain English. What we don't know yet is how many people will end up paying more in 2013 than they did in 2012.

The uncertainty is tied to the fact that many of the targets of the legislation often end up ensnared by the alternative minimum tax. The A.M.T., and its high tax bill, may continue to catch most of them.

But let's start with the basics. Most of the discussion here begins with that adjusted gross income figure. That's the number you get when you subtract items from your salary or take-home pay that are often referred to as above-the-line deductions.

For the income range we're talking about, these deductions tend to include things like health savings account contributions and alimony. People who work for themselves also get deductions for health insurance premiums, certain retirement contributions and self-employment taxes that an employer would otherwise pay.

Mark Luscombe, principal analyst with CCH, a tax information provider, points out just how confusing the use of adjustable gross income is, given that the new tax limits, the new tax bracket and the new Medicare tax are all based on different definitions of income.

Under normal circumstances, a personal exemption, for a specific dollar amount, is available for each member of your household. You then add all of the exemptions and subtract the total from your adjusted gross income, which has the effect of lowering your taxable income. CCH predicts that the personal exemption amount for 2013 will be $3,900 per person.

The new law requires taxpayers in the targeted income range to reduce the amount of their exemptions by 2 percent for every $2,500 by which their income exceeds the $250,000 or $300,000 limit. So a married, childless couple with $400,000 in adjusted gross income and $7,800 in potential exemptions could lose $6,240 of that $7,800.

The math for the limit on deductions is different. There, the rules call for you to add up the applicable deductions. Let's say that equals $50,000. Then, you subtract from that 3 percent of the amount by which your adjusted gross income exceeds those $250,000 or $300,000 thresholds.

So if you're a married couple with $400,000 in income, you're $100,000 over the threshold. Three percent of that is $3,000.

So you’d subtract that from $50,000. The rule, which existed for years but had been phased out more recently, is known as the Pease limitation, for Representative Donald J. Pease, the Ohio newspaper editor-turned-legislator who got it passed. As before, you can’t lose more than 80 percent of your deductions, no matter how high your income gets.

If you’re trying to figure out whether and how this may affect you, well, join the club. So much depends on your income, your state and your various deductions. All of that will affect whether the A.M.T. hits you as well.

For people who are already in the A.M.T. but will not end up with the $400,000 (for individuals) or $450,000 (for married couples filing jointly) in income necessary to be in the new 39.6 percent tax bracket in 2013, the new exemption and deduction rules may not hurt you. “I don’t think there’s enough there that you would no longer be in the A.M.T.,” said Jude Coard, a tax partner at Berdon L.L.P., of people with income in the $300,000 to $400,000 range.

Much will depend on your own situation. CCH ran two hypothetical cases for me, which you can see in the accompanying graphic. The first examined a family of four in New York with $400,000 in adjusted gross income and $79,000 in total itemized deductions. The household pays the A.M.T. in both 2012 and under the new tax rules in 2013. They pay just $790 more in 2013, but that includes $1,350 in new Medicare taxes. (The total does not include the Social Security payroll tax that has been restored to its prerecession level.)

A family in Texas, however, might have the same income but lower property taxes and no income tax and thus lower deductions for its federal tax return. Their deductions are just $43,700, but they end up being hurt more by the new rules. They would have no A.M.T. liability in 2013 and would end up paying $3,852 more, or about $2,500 if you don’t count the $1,350 from the new Medicare tax.

This is a lot to digest, so much so that even the experts at the Tax Policy Center have not yet finished updating their online calculator. Once they do, if you have the stomach to gather (or try to predict) all of the data, you can take your shot at projecting what these new rules may cost you.