PERELSON WEINER LLP

**The Fiscal Cliff Deal and What It Means For You**

With the start of the New Year and sunset of Bush tax cuts, Congress passed compromise legislation avoiding "fiscal cliff" spending cuts and certain tax increases. The President has now signed the bill. The compromise combined with existing legislation, does translate into increased taxes for many. Ironically, it's called the American Taxpayer Relief Act ("Act").

The Act's primary focus and impact is in the area of the personal income taxation. All taxpayers with earned income will see an increase in required withholdings for Social Security and/or FICA. At various income levels taxpayers will be subject to hidden tax rate increases due to phase-outs of otherwise allowable exemptions and/or deductions. At the top tier, taxpayers will be paying at rates that were last imposed more than seven years prior to the Great Recession. Awareness and planning are even more critical in the New Year.
Here's a brief overview:

**I. Personal Income Taxes:**

For individuals with taxable incomes above $400,000 or families with taxable incomes above $450,000 ("top tier") the Bush tax cuts have effectively expired. This means that the top tax rate of 35% is increased to 39.6% for ordinary income. Following is a projected 2013 tax table for joint filers per income bracket shown at marginal rates. Since the brackets are to be adjusted for inflation, these are estimated levels for each bracket:

| **Projected* 2013 Income Tax Rate Brackets:** | **Rate** |
|---|---|
| Not over $17,850 | 10% |
| Over $17,850 but not over $72,500 | 15% |
| Over $72,500 but not over $146,400 | 25% |
| Over $146,400 but not over $223,050 | 28% |
| Over $223,050 but not over $398,350 | 33% |
| Over $398,350 but not over $450,000 | 35% |
| Over $450,000 (top tier) | 39.6% |

*[*Projected - tables have not yet been formally issued by the Service.]*

The above are the projected rates for ordinary income. Tax rates on capital gains and qualified dividends previously taxed at 15%, are increased to 20% for the top tier (400/450) taxpayers. Capital gains and qualified dividends are not taxed for taxable incomes in the lowest two brackets (under $72,500). For taxable incomes below the top tier and above the 15% bracket, capital gains and qualified dividends continue to be taxed at 15%. *[Note that special rates and adjustments apply to transactions such as recapture of real estate depreciation on sale (25%) or collectibles (28%).]*

### Net Investment Income Surtax

In addition, individuals with incomes above $200,000 or families with income above $250,000 (“200/250”), per the Affordable Care Act (“ACA”), are generally subject to an additional 3.8% surtax for investment and passive income. Therefore, the capital gains tax rate for top tier taxpayers is increasing to 23.8% in 2013. In addition, for top tier taxpayers receiving passive income such as passive rents, passive royalties, annuities, and interest taxed at ordinary rates, the ACA surtax increases their tax rate on that income to 43.4%.

For taxpayers with incomes above the 200/250 thresholds, ACA likewise increases tax rates for investment and passive income otherwise taxed at ordinary income tax rates. This means that for joint filers with incomes above $250,000 but below $398,350, the surtax can increase their applicable tax rate on investment and passive ordinary income from 33% to 36.8%. Joint filers with incomes ranging from $398,350 to $450,000 may experience an increase in their top rate from 35% to 38.6% on their passive and investment ordinary income. In addition to individuals, the ACA surtax applies to trusts with taxable incomes above $11,950.

### Payroll Taxes

ACA also impacted payroll taxes increasing them by .9% for wages, salaries and self-employment income (“earned income”) above the 200/250 threshold. Hence, the employee portion of the FICA component of payroll taxes above the threshold will increase from 1.45% to 2.35%. These payroll taxes are not paid by the employer, but solely assessed on employee earned income above the 200/250 threshold amounts.

In 2009, a temporary 2% reduction on the employee’s share of the Social Security component of payroll taxes was effectuated. This reduced the employee portion of the Social Security tax liability from 6.2% to 4.2%. This 2% reduction has not been extended thus increasing by 2% required Social Security withholding for the first $113,700 of earned income in 2013.

### Phase Out of Itemized Deductions

In years 2010 through 2012 taxpayers were allowed to deduct the full amount of their itemized deductions (e.g., state and local taxes, mortgage interest, real estate taxes and charitable contributions) from their taxable incomes. Commencing in 2013, single taxpayers with incomes above a threshold of $250,000 or married taxpayers filing jointly with incomes above $300,000 (“250/300”) will be subject to limitations on their ability to reduce their taxable income for any itemized deductions. This is commonly known as the “Pease limitation.” Specifically, where taxpayers have adjusted gross income above the 250/300 threshold, their itemized deductions will be reduced by the lesser of (a) 3% of the excess of adjusted gross income over the applicable 250/300 amount or (b) 80% of the itemized deductions otherwise allowable.

While not advertised as an actual increase in rates, this curtailment generally results in a .3% surcharge to the marginal rate, translating into a 1.2% increase. Hence, for taxpayers filing jointly who itemize, the Pease limitation has the effect of increasing part of the 33% bracket to a tax rate of 34.2%, all of the 35% bracket to a rate of 36.2% and the 39.6% bracket to a rate of 40.8%. The applicable thresholds (200/250) are to be indexed annually for inflation.

## Personal Exemption Phase Out

The same thresholds that apply to the phase out of itemized deductions, 250/300, also apply to the phase out of the personal exemption, set during 2012 at $3,800 person. Under this provision, the amount of total personal exemptions claimed as a reduction against taxable income are reduced by 2% for every $2,500 (or portion of $2,500) by which adjusted gross income exceeds the applicable 250/300 threshold. As a result, married taxpayers filing jointly cannot claim any personal exemption if their joint taxable income is greater than $425,000. This creates yet another hidden tax increase.

## Marriage Penalty Relief

The Bush tax cuts protected two-earner couples from a "marriage penalty" that had previously effectively increased the tax rate for employed individuals after they married. Specifically, the Bush tax cuts expanded the standard deduction for joint filers to twice the amount for single (previously it was only at about 67%) and expanded the 15% bracket for joint filers to twice the amount for single taxpayers. The Act makes permanent this favorable adjustment for married taxpayers.

## Alternative Minimum Tax Relief

In recent years and in response to complaints as to how many taxpayers were paying alternative minimum tax ("AMT"), Congress enacted legislation increasing the AMT exemption levels from $33,750 for single taxpayers and $45,000 for joint filers to $48,450 for single filers and $74,450 for joint filers. This legislation, known as the "AMT patch," has now been made permanent and is to be indexed for inflation. Exemptions levels for 2013 are set at $50,600 for single filers and $78,750 for joint filers. Certain credits not previously allowed can now also be claimed against the AMT liability.

## Miscellaneous - Charitable

Certain miscellaneous provisions also deserve note. The Act extends retroactively through December 31, 2013 tax-free distributions from individual retirement accounts (IRAs) to public charities by individuals 70.5 years of age or older. Although this provision was not extended at the end of 2011 when it first expired, it is now being extended retroactively a full year after sunset. Due to this fact, the Act apparently allows individuals who took their 2012 required minimum distribution during December of2012 to make a charitable contribution prior to February 1, 2013 and have it apply to 2012. The maximum annual amount is $100,000. The Act also extends through December 31, 2013 provisions allowing contributions of capital gain real property for conservation.

## II. Estate and Gift Taxes

Previously, exemptions for estate & gift as well as generation skipping transfer taxes (GST) were set at $5 million (adjusted for inflation in 2012 to $5,120,000) with a top estate/gift tax rate at 35%. Despite a great deal of concern about the expiration of the extended Bush tax cuts in this area and rates returning to pre-Bush levels of 55% with estate & gift exemptions falling precipitously to one million per taxpayer, Congress has retained the prior $5,000,000 exemption level (also to be indexed for inflation) and has only increased the top tax rate to 40%, making that rate permanent and not subject to sunset.

Any unused estate and gift tax exemptions of a decedent can continue to be claimed by a surviving spouse during his or her life or at death. State estate taxes can continue to be deducted.

## III Business Taxes

Bonus Depreciation and Sec. 179 Small Business Expense Deductions
The Act extends 50% bonus depreciation through 2013. Bonus depreciation for certain transportation and longer-use assets is extended through 2014. Qualified leasehold improvements can continue to be depreciated under the shorter 15-year life. Code Section 179 Small Business Expensing will continue through 2013 with 2012 dollar limits at $500,000 with a $2 million investment limit.

### Subchapter S Corporations

The Act extends the reduced five-year holding period for built-in gains to sales occurring during 2012 and 2013. In addition, through 2014, S corporation shareholders may continue take into account their pro rata share of charitable contributions otherwise disallowed as exceeding stock basis.

### Tax Credits

Several significant tax credits have been further extended. The Research Tax Credit is once again, extended. The Work Opportunity credit that grants tax credits to employers who hire individuals from certain targeted groups, including veterans is also extended. Other credits that have been extended include new markets (a discretionary credit for investments in targeted and approved matters) alternative fuel, cellulosic bio fuel production, biodiesel and renewable diesel; low income housing, energy efficient homes and appliances.

### Miscellaneous Domestic and International Tax Provisions

Provisions regarding the active financing exception for Subpart F income (exemptions exist for certain active financing income of banking, insurance or similar businesses and certain insurance income) and the look-through rule for related controlled foreign corporation payments facilitating certain investment activities between controlled foreign corporations are also extended to the end of 2013. In addition, the Act made permanent the application of withholding tax to gains on the disposition of US real property interests by partnerships, trusts or estates passed through to partners or beneficiaries that are foreign persons. Required withholding is set at 20%.

On the domestic side, businesses are no longer eligible for an enhanced deduction for charitable contributions of book inventory or computers. The treatment of mutual funds as qualified investment entities exempting from tax certain interest-related dividends and short-term capital gains is also extended as well as the exclusion of gain from the sale of qualifying small business stock that is held for more than five years.

For more information, contact: Magda Szabo CPA, LL.M.- mszabo@pwcpa.com or your Perelson Weiner Contact - http://www.pwcpa.com/professionals