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Client Alert

# THE NEW "FISCAL CLIFF" TAX LAW:
## The End of Bush-Era Tax Cuts For High-Income Individuals

**January 14, 2013** – On January 2, 2013, President Obama signed into law the American Taxpayer Relief Act (the "Act"). For tax years beginning on or after January 1, 2013, the Act marks the end of the Bush-era tax cuts for certain high-income individuals. It also makes a number of changes to the federal estate and gift tax regime.

### I. TAXES ON INCOME AND WAGES

***Higher Income Tax Rates for Higher-Bracket Taxpayers***

Taxpayers whose taxable income exceeds the applicable threshold ($450,000 for joint filers, $400,000 for single filers) are now subject to the following tax rates:

- 39.6% marginal income tax rate (increasing the highest individual rate from 35% to 39.6%).
- 20% tax rate on long-term capital gains and qualified dividends (increased from 15%).

Taking into account the 3.8% "Obamacare" surtax on investment-type income and gains that went into effect on January 1, 2013, high-income taxpayers will be subject to an overall rate of 23.8% on long-term capital gains and qualified dividends.

***Payroll Taxes on Wages***

The Social Security tax for all employees has been increased by two percentage points. Moreover, an additional 0.9% Medicare tax will be imposed on a single taxpayer whose wages exceed $200,000 and on a married couple filing a joint return whose wages exceed $250,000.

***Limitation on Itemized Deductions***

Beginning in 2013, itemized deductions will be limited for adjusted gross income ("AGI") over the threshold amount – $250,000 (for single filers) and $300,000 (for joint filers). Thus, for higher-income taxpayers, the total amount of their itemized deductions is reduced by 3% of the amount by which the taxpayer's AGI exceeds the threshold amount, with the reduction not to exceed 80% of the otherwise allowable itemized deductions. In other words, the total amount of itemized deductions allowed is reduced by $.03 for each dollar of AGI in excess of the threshold amounts.

***Alternative Minimum Tax ("AMT")***

For taxable years beginning after 2011, the Act grants relief from the AMT for qualifying individuals by increasing the exemption amount (i.e., the amount excluded from AMTI – alternative minimum taxable income). Under the Act, the AMT exemption amounts for 2012 (which will be indexed for inflation after 2012) are as follows:

- Married couples filing jointly: $78,750.
- Unmarried individuals: $50,600.

***Personal Exemption Phase-Out***

For 2013, the amount deductible for each personal exemption is $3,900. Personal exemptions will be phased out for AGI over $250,000 for single filers and $300,000 for joint filers.

***Important Note****: The Act does not incorporate any of the several prior Congressional proposals to tax carried interest at ordinary income tax rates. Therefore, carried interest allocated to sponsors of private equity funds and hedge funds will be taxed in 2013 (barring any future tax laws affecting carried interest) at the 20% long-term capital gains rate, based upon the character of the underlying income items (qualified dividends and long-term capital gains) generating the carried interest, and will also be subject to the 3.8% "Obamacare" tax on investment-type income and gains, for a combined 23.8% tax rate.*

If you have questions concerning the income and wage tax aspects of the Act or other tax matters, please feel free to contact either the head of our Tax Department, **Isaac P. Grossman**, at igrossman@morrisoncohen.com, or tax partner **Michael C. Weinstein** at mweinstein@morrisoncohen.com, or senior counsel **Michael J. Kearney** at mkearney@morrisoncohen.com.

## II. ESTATE AND GIFT TAXES

The parts of the Act that deal with estate and gift taxes are summarized as follows:

- **The existing $5 million exemption continues for estate and gift taxes, as well as for generation-skipping transfers.** This $5 million exemption is inflation-indexed, for estate and gift taxes as well as for generation-skipping transfers. The 2012 inflation-indexed exemption was $5.12 million, and the 2013 exemption is anticipated to be set at $5.25 million.
- **40% top marginal tax rate on estates, gifts and generation-skipping transfers.** This new rate is 5% higher than the 2012 rate of 35%, but 15% below the 55% rate that would have gone into effect on January 1, 2013 if the Act had not been signed.
- **Deduction for state inheritance and estate taxes.** The Act provides that state inheritance and estate taxes are deductible for Federal estate tax purposes. The effect of this for New York estates is that the combined (state and federal) effective top estate tax rate is 49.6%. For Connecticut, the combined (state and federal) effective top estate tax rate is 47.2%.
- **"Portability" extended.** For surviving spouses whose deceased spouses had not fully used their gift and estate tax exemptions, the Act continues the surviving spouses' prior ability to utilize those unused exemptions. Portability requires the filing of a federal estate tax return for the estate of the first spouse to die, and certain other formal requirements. The effect of portability is that the gift and estate tax exemptions are actually $10 million, plus the inflation adjustment. There is no parallel portability for the generation-skipping tax exemption.

If you have questions concerning the estate and gift tax aspects of the Act or other trusts and estates matters, please feel free to contact the head of our Individual Client Services Department, **G. William Haas**, at bhaas@morrisoncohen.com.

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