Patterson Belknap Webb & Tyler LLP

Tax Department Alert January 2013

American Taxpayer Relief Act of 2012: Tax Implications for U.S. Taxpayers Living Abroad

Although the American Taxpayer Relief Act of 2012 ("Fiscal Cliff Legislation") passed last week does not contain any sweeping changes targeted at U.S. taxpayers living abroad, a number of provisions are relevant to such U.S. taxpayers - in particular, the sections dealing with income tax rates, itemized deductions (including the deduction permitted for foreign taxes not claimed as a credit against U.S. tax), personal exemptions, limits on itemized deductions, the alternative minimum tax and payroll taxes. Below is a brief summary of some of the more pertinent sections. We note that additional tax legislation is likely forthcoming in 2013, which may have retroactive effect, and that we also expect the Treasury Department to issue final regulations pursuant to the Foreign Account Tax Compliance Act (FATCA) in the coming months.

Tax Rates on Ordinary Income

For most taxpayers, ordinary income tax rates remain the same as they were under the Bush tax rates - that is, the 10%, 15%, 25%, 28%, 33% and (to a somewhat more limited extent) 35% rates remain in place. The Fiscal Cliff Legislation creates a new high income bracket, however. For taxable income exceeding $450,000 for married individuals filing jointly, taxable income exceeding $425,000 for heads of households, and taxable income exceeding $400,000 for unmarried individuals, the tax rate on ordinary income is 39.6%. Those threshold amounts are indexed for inflation for years 2014 and later. As with current law, there is an exemption for approximately $100,000 of foreign "earned" income.

Tax Rates on Capital Gains and Qualified Dividends

The Fiscal Cliff Legislation extends the 15% rate on capital gains and qualified dividends where total taxable income does not exceed the $400,000, $425,000 and $450,000 thresholds mentioned above. Where taxable income is above those thresholds, a 20% rate applies. Note that where the 20% rate applies (and in some circumstances where a 15% rate applies), it is likely that the new 3.8% tax on net investment income will also apply, bringing the combined rate up to 23.8% (or 18.8%) on such income.

Personal Exemption Limitations

The Fiscal Cliff Legislation reinstates the personal exemption phaseout rules, which generally reduce a taxpayer's personal exemption by an applicable percentage when the taxpayer's adjusted gross income (AGI) exceeds a specified threshold amount. The threshold amounts are adjusted for inflation and are identical to the threshold amounts for the "Pease" limitation (discussed immediately below).

Itemized Deduction Limitations

The Fiscal Cliff Legislation reinstates the so-called "Pease" limitation for tax years beginning after 2012. The limitation generally limits the amount of otherwise available itemized deductions, including the deduction for charitable contributions, payments of non-U.S. taxes, mortgage interest and state and local tax payments. If an individual's adjusted gross income (AGI) exceeds a certain threshold ($300,000 for joint filers, $275,000 for heads of households, $250,000 for single filers and $150,000 for married taxpayers filing separately), the amount of itemized deductions otherwise allowable for the year will be reduced by the lesser of (1) 3% of the excess of AGI over the threshold or (2)

80% of the amount of itemized deductions otherwise allowable for the year. For tax years after 2013 the threshold amounts are adjusted for inflation. For U.S. taxpayers who make payments of non-U.S. taxes, the Pease limitation will affect the choice between claiming, on the one hand, a foreign tax credit (which is not subject to the limitation) and, on the other hand, a foreign tax deduction (which is subject to the limitation). Indeed, the limitation could reduce the potential tax savings of a taxpayer's foreign tax deduction, which thereby could make the foreign tax credit an even better alternative than might previously have been the case.

Alternative Minimum Tax ("AMT")

The Fiscal Cliff Legislation increases the 2012 AMT exemption amounts to $78,750 for joint filers, $50,600 for single filers and $39,375 for married taxpayers filing separately. The legislation also indexes the exemption amounts for inflation and allows a taxpayer to offset his or her entire regular tax and AMT liability by certain non refundable personal credits.

Payroll Taxes

In general, payroll taxes consist of the social security tax and the Medicare tax. For tax years 2011 and 2012, the social security tax rate was reduced from 6.2% to 4.2%. The Fiscal Cliff Legislation does not extend the reduction and, as a result, beginning in tax year 2013 the rate will return to 6.2%. In addition, other recently enacted legislation made changes to the payroll taxes that will take effect in 2013. For example, a 0.9% Medicare tax (in addition to the 1.45% Medicare tax on wages) will be imposed on wages in excess of $250,000 for joint filers, $125,000 for married taxpayers filing separately and $200,000 in all other cases. Wages paid to a U.S. taxpayer employed outside the United States by a non-U.S. employer generally are not subject to the payroll taxes discussed immediately above.

Timing

There is no change in the filing dates of either tax or information returns.

Estimated Taxes

There are no changes in the estimated tax payment dates or in the safe-harbor rules, but note that taxpayers who use the "normal" safe harbors for estimated tax may find themselves underpaid when they finish preparing their returns for 2013, simply because of the higher rates, reduced deductions and exemptions, etc. discussed above.

This alert is for general informational purposes only and should not be construed as specific legal advice. If you would like more information about this alert, please contact one of the following attorneys or call your regular Patterson contact.

Henry P. Bubel	**212-336-2615**	**hpbubel@pbwt.com**
Matthew Kohley	**212-336-2017**	**mkohley@pbwt.com**
Jenny L. Longman	**212-336-2409**	**jlongman@pbwt.com**

IRS Circular 230 disclosure: Any tax advice contained in this communication (including any attachments or enclosures) was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed in this communication. (The foregoing disclaimer has been affixed pursuant to U.S. Treasury regulations governing tax practitioners.)

Patterson Belknap Webb & Tyler LLP

1133 Avenue of the Americas New York, NY 10036-6710 212.336.2000 www.pbwt.com