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Tax Talk 2013 ©

US Tax Law Developments

One could not avoid tax news in 2012. Between the elections and the Fiscal Cliff, new tax regulations were a necessity. The American Taxpayer Relief Act of 2012 did not actually become ratified into law until January 2013, but its effects have solidified many uncertainties of these past few years and provided a basis for planning into the future, particularly in Estate and Gift taxes. The new act has higher rates of tax than recent tax years, but it is still significantly lower than the statutory rates that would have taken effect if no law were passed. It should be noted that even though this law has generally increased taxes or taxable income, depending on your personal situation and tax credits for amounts paid in France, the new law's effect on your final payment due is not necessarily an increase.

Income Tax Rate

The new law has maintained the progressive tax rates from the past few years (maximum 35%) for US taxpayers who fall below the "applicable threshold." For tax year 2012, the applicable threshold amounts of taxable income is $450,000 for married filing jointly, $425,000 for heads of households, $400,000 for single, and $225,000 for married filing separately. Above these annually inflation adjusted limits, the rate of tax is 39.6%.

Qualified Dividends and Long-Term Capital Gains Tax Rate

As with the income tax rates, long-term capital gains will continue to be taxed at a maximum 15% provided the taxpayer is below the same "applicable threshold" (see above for amounts). If the taxpayer is above the applicable threshold, the maximum tax rate for qualified dividends and long-term capital gains is 20%.

Alternative Minimum Tax (AMT), Itemized Deductions, and Personal Exemptions

For the past decade, the AMT has been temporarily "patched" every two years or so to prevent large numbers of middle-income Americans from either paying or needing to calculate the AMT. With the new law, the AMT exemption amounts have been permanently indexed for inflation, thus high-income taxpayers will still be required to calculate and possibly pay the tax, but Congress will no longer need to "patch" the exemption amounts. The 2012 exemption amounts are $78,750 for married filing jointly, $39,375 for married filing separately, and $50,600 for single or head of household.

For tax years 2010 and 2011, there was no high-income limitation of itemized deductions or personal exemptions as there had been in years prior. The new law has reinstated these inflation adjusted limitations for 2012 with phase-outs starting at $300,000 for married filing jointly, $275,000 for heads of households, $250,000 for singles, and $150,000 for married filing separately.

Estate and Gift Taxes

In the past few years, the big tax question on the US side was Estate and Gift Taxes. The new law has permanently enacted the basics of the 2011 and 2012 inflation adjusted exemption amounts for all years going forward, but has also increased the rate of tax above those limits. Also, the 2012 law has made the portability of the unused exemption of an estate to a decedent's surviving spouse a permanent benefit. The exemption from Estate and Gift Tax is now $5.25 million for 2013 at a tax of 40%. Additionally, the annual exclusion for gifts from each taxpayer has been increased to $14,000. In general, this allows a married couple to gift each year to each person $28,000 tax-free and have an estate of up to $10.5 million before paying any estate or gift taxes to the US. Please contact us before making any large gifts as there could be other (French or state-level) tax consequences.

Foreign Earned Income Exclusion

The Foreign Earned Income Exclusion has been inflation adjusted for the 2012 and 2013 income tax years to allow maximum exclusions of $95,100 and $97,600, respectively, of Earned Income for those who are considered tax residents of a foreign country under either the Bona Fide Residence Test or the Physical Presence Test.

Other General US Tax Information

- **The American Taxpayer Relief Act of 2012** contains many other provisions that either maintain current benefits or are unlikely to impact US taxpayers in France. Included among these are the deductions and credits for higher education, the deduction for general sales tax, exclusion of discharge of indebtedness on the principal residence, adoption credits, and various business and energy credits. Further, the law did not extend the payroll tax reduction of 2% that was available for 2011 and 2012. If you believe you will qualify for some of these benefits or if you would like to know more information about them, please contact us.
- **The Foreign Account Tax Compliance Act (FATCA)** that was put partially into effect last tax season continues to require considerably more information on the US tax returns in regards to non-US investments. We recommend reviewing our 2012 Tax Talk to understand what the IRS requires of you. Additionally, the effective date of this Act's reporting requirements for banks has been extended to January 1, 2014. On that date (unless there is another extension/repeal) most non-US banks will begin reporting directly to the IRS on their US citizen or resident clients. If you have not been reporting your foreign bank accounts to the US you could face significant civil or criminal penalties.
- **The IRS** has seen their budget cut in the past few years. This has resulted in longer examination times, slower processing of paper returns and response letters, longer wait times when calling for account information, and all around more difficulty in dealing with the Service. In addition, the move towards e-filing and direct deposit of refunds was supposed to save time and money, but has actually resulted in an explosion of tax fraud estimated at over $5.2 billion for just 2012.
- **For tax year 2013** (next year) there is currently an additional 0.9% payroll tax on self-employment wages above certain thresholds as well as a 3.8% tax on "investment income" over certain thresholds.

FRENCH TAX NEWS

2013 will certainly not be a year of good luck from a French tax perspective. Most of the coming tax changes aim at reducing the State's deficit by raising taxation on all taxpayers, especially corporate taxpayers and individuals considered as wealthy.

The main measures are as follow:

- **Income Tax rate**

The personal income tax liability of individuals is increased through the introduction of an additional tax bracket of 45%, which will apply to net taxable income exceeding €150,000 after applying the income splitting system of the "quotient familial".

The tax bands and rates for 2013 (for income earned in 2012) are as follows:

- Up to €5,963 : 0%
- €5,964 to €11,896 : 5.5%
- €11,897 to €26,420 : 14%
- €26,421 to €70,830 : 30%
- €70,831 to €150,000 : 41%
- From €151,000: 45%

- **The question of the 75% tax rate**

The Finance Act of 2013 provided for an overall 75% tax rate applicable to "professional" income over €1 million per individual.

This 75% rate would have been achieved by introducing an additional 18% contribution to personal income tax (together with (i) the new 45% tax bracket, (ii) the existing 4% exceptional tax on high income and (iii) the 8% social security contributions, resulting in an overall taxation rate of 75%).

This measure, which was expected to concern income received in 2012 and 2013 has been declared invalid by the Constitutional Court.

The French Governmental signals its commitment to reintroducing the measure with a new bill revised to meet the Constitutional Court's rulings, but 2012 revenue will not be concerned by its passage.

- **Tax Reliefs**

Tax reliefs have been reduced for 2013 income, as follows:

a. A reduction in the maximum allowance under the quotient familial (which reduces your tax liability the larger the household). It has been cut from €2,300 to €2,000 for each dependant.

b. The maximum annual tax allowance (crédits d'impôts/ réductions d'impôts) that can

be granted has been reduced to €10,000 for expenses incurred and investments made as of January 1, 2013 except for oversea investments and investments in the movies industries which remains at €18,000 plus 4% of the taxable income.

c. The general abatement against income tax of 10% for professional costs of business owners and employees has been capped at €12,000 for 2012. Company owners who are majority shareholders will no longer be entitled to a 10% allowance for professional costs against liability to their social security contributions.

- **Investment and savings Income: Repeal of the flat tax rate "Prelèvement Forfaitaire Libératoire" on dividends and interest**

Starting from 2013, the flat-rate tax in full discharge of all tax liability (PFL) is repealed.

Thus, dividends / interest paid, as from January 1st, 2013 will be subject to income tax at progressive income tax rates (with the new marginal rate of 45%). Those whose annual income from such savings, dividends etc., is over €2,000 will no longer be able to opt for the withholding tax. All the income will be assessed according to the relevant marginal rate of income tax, as part of total income. Social charges of 15.5% will continue to be payable.

However, to avoid a lag effect in the collection of revenue, taxpayer will remain subject to a tax withheld at source (21% for dividends – 24% for interest) that is creditable against their personal income tax, i.e. the tax withheld will operate as a kind of "installment for tax".

A waiver of this withholding tax on interest earned could be obtained, provided taxpayer's net income in the previous year was lower than €25,000 (€50,000 for a couple). The same applies to dividends, at the rate of 21%, but at income thresholds of €50,000 and €75,000.

The existing 40% allowance applicable to certain dividends remains in force but the personal abatement of €1,525 - €3,050 for a couple- is repealed.

Moreover, the increased 55% rate for payments made to Non Cooperative Jurisdictions is generally increased to 75 %.

Finally, starting January 1st 2013, company owners who use dividends as a method of remuneration will be, in certain circumstances, subject to social security contributions at the rate of around 45% on these dividends when it was previously 15.5%. The contributions will be levied on the gross dividend, before the normal 40% abatement. This will apply where majority shareholder company owners and members of their family receive dividends exceeding 10% of the share capital of the company. Dividend payments below 10% will continue to be subject to 15.5% social charges.

- **Capital gain taxation**

On the sale of shares, for 2012 capital gains tax will be at the rate of 24% (plus 15.5% social charges) and not 19% as has been the case so far. From 2013 the capital gain will be taxed as part of the income tax system based on the progressive tax scale, leading to a maximum 45% taxation rate (before social taxes).
However, the effective taxation will be reduced through a progressive allowance on the capital gain realized, depending on the holding period of the shares sold (20% for a minimum holding period of 2 years, 30% as from 4 years and 40% as from six years). This allowance:
- is computed as from the acquisition of the shares (derogatory rules will apply for specific operations);
- does not apply for social security contribution purposes.

In parallel, the current flat tax rate of 19% (before social taxes) remain applicable (subject to election) to the capital gain derived from the sale of shares held in an operating company controlled by the seller and his or her relatives (holding requirements to consider), to the extent that the seller has been exercising eligible executive functions (or has been employed) in the company over the preceding five years.

Also, the existing deferral of taxation when the proceeds resulting from a sale are reinvested will be available until December 31, 2017.

On a conditional basis, new business start-ups will continue to be able to opt for 19% capital gains tax on the sale of their shares.

The income tax deductibility of the social charges payable on investment income has been reduced from 5.8% to 5.1%.

The flat withholding tax rate applicable to capital gains on the disposal of substantial shareholdings by foreign tax residents is increased from 19% to 45% (subject to tax treaties).
However, subject to conditions, it will be possible to reduce such taxation if the application of the progressive tax scale to the total French source income results in a lower taxation.

- **Free Shares and Stock Options**

(Applicable to free shares / stock-options granted as of September 28, 2012)

2013 Gains arising from the exercise of stocks options and from the granting of free shares are currently eligible for favorable flat tax rates between 18% and 41% (before social security contributions).

Under the Finance Act for 2013, these favorable flat rates will be repealed and such gains will be taxed based on the progressive income tax scale. The new income and social tax regime applies to awards granted from September 28, 2012.

On the other hand, the social contributions rate which was supposed to be increased to 17.5% or 22.5% will remain at 10%.

- **Wealth tax**

As of January 1st, 2013, individuals whose net assets are of at least €1,300,000 are liable to wealth tax.

If this threshold is exceeded, the wealth tax will be levied from a wealth of €800,000.

The tax rates will now range from 0.5% (net assets worth between €800,000 and €1,300,000) up to 1.5% (net assets worth over €10 million).

The total aggregate amount of wealth tax and income taxes will be capped at 75% of the taxpayer's worldwide net income.

ECONOMIC PREDICTIONS FOR 2013

For two consecutive years our firm has accurately predicted a tightening tax regime based on the limited policy options available to Washington and Paris in the context of a global economic correction. This tightening will continue unabated well beyond 2013, with the added complication of increasing policy uncertainty in the months to come.

Economic fundamentals haven't changed since 2000 when the Internet bubble first metastasized into the gargantuan real estate, equity, and commodity zeppelin that landed in 2008. These fundamentals now converge towards a sustained global recession in real terms.

Creative fiscal plans should have bond markets giving elected officials a particularly icy stare; any whiff of hesitation aught to lower their risk appetites and translate into elevated borrowing costs while undermining confidence in numbers already stretched to breaking point by the political imagination. Handing the issuance of money to sovereign debt buyers may be tantamount to letting the fox into the henhouse, but it's the only bribe they'll accept to keep purchasing worthless Treasuries.

190 countries dotting the face of the earth are collectively held hostage to an American central bank pumping liquidity into the global markets like there is no tomorrow. The resulting financial repression abolishes direct links between monetary policy, the financial markets, and economic performance for all 191 nations. While the reasons for such repression might be compelling; the fall-out will be anything but.

Policy makers dread deflation. The nightmare of decreased earnings bankrupting companies and decimating nations with the triple whammy of evaporating demand, shrinking tax revenue, and mass unemployment, is unpalatable to officials whose careers are in the hands of globalization's growing number of losers. The political solution is to counter deflation with inflation, and the monetary spigots are opened to their momentary max. All eyes are glued to a horizon for the first sign of an up-cycle so the spigots can be screwed back to normal. If no sign is coming and a cycle turns out much broader than initially anticipated, everyone will realize they are knee deep in water. If they then refuse to turn off the tap insisting that they still wait for the sign, many of them will simply drown.

Last year in January, we correctly surmised that China's economy would undergo a crunch in 2012. By September of the year, our view had been vindicated. Continued decline will keep growth in the single digits, while limited economic diversity, the poor investment quality of its assets, abysmal regulation, and superficial consumption will work to further expose the hidden costs of backwards governance in the emerging markets. China is showing strains to a growth model based on export monolatry. We're only beginning to see the tip of the iceberg of its outrageously overvalued real estate market, as well as the size of the bad loans in its shadow banking system. A broad collapse of emerging markets could distract the West from its own malaise before other asset classes take the spill-over and force the Fed to into print overload. The

EU did find the wherewithal to corral its PIGS from the brink of sovereign default, but short of a trans-national political union it will be stiffed when a wave of defaults evaporates what remains of China's interest in European imports.

Money has reached stall speeds last seen in the 1930s, tempting the Federal Reserve into showering the nation with a hurricane of cash and paying creditors to take loans. This feeds a vicious cycle of low rates begetting cheap money in order to beget low rates. The nominal value of all outstanding debt will drop in the country's favor, but the brunt of the burden will be borne by people's savings. The responsiveness of the economy to monetary policy will turn negative. Well intentioned moves will engender their opposites, so that when the Board of Governors finally reverse course on the cost of loans, things will just go "boom!"

The end of emerging and commodity markets will undo the bond market's ability to leverage the carry trade to extract payment from the Fed for accepting sub-inflationary yields on US Treasuries. Rates will have nowhere to go but up. If they begin to efficiently absorb the mountain of superfluous cash accumulated in the banking system since 2000, they will do so at the speed of light. Soaring debt service will expose estimates of future annual deficits as federally sponsored accounting chicanery. Inflation will wipe out capital and send the GDP into spasms.

Money can be printed freely, provided the flood of junk from abroad doesn't push average earnings into a deflationary whirlpool sinking global employment to levels where free goods and services become part of the redundancy benefits. A communist utopia for the idealistic dreamers, until the emaciated hand of poverty knocks on their door.

Manufacturers from the Czech Republic to China can neither cut their costs infinitely nor produce an infinite amount of goods to keep up with the present pace of money creation. Inflation might be their Noah's Ark, but the Deluge will take their customers. Seeping into bank accounts, the dark waters will wipe out savings and transform assets into liabilities virtually overnight. Evaporating income will bludgeon demand. Whether a dollar buys less because something costs more or because it is worth less, the result will be the same.

The good news is that volatility has diminished in mature markets and manufacturing is reappearing in advanced economies. On both sides of the Atlantic, determined government programs have stimulated investment in infrastructure without heed for the underfunded liabilities of expanding social safety nets of unemployment, retirement, medical, and welfare. Come what may, tax payers throughout the world will be facing a more determined tax collector.

How does a government in desperate need of revenue avoid aggravating the situation by destroying revenue creation? How does it increase taxation to meet its commitments to providing public goods, without choking the growth necessary for the taxation?

A tantalizing avenue for increasing taxes without inciting an Arab Spring across America's prairies and coasts is to tinker with Tax Expenditures, i.e. foreign credits, exemptions, and rebates. Gradual across-the-board tax increases will combine with stricter, more complicated, and stingier rules on deductions.

Washington is before a rock and a hard place in more than fiscal policy. The ability to decrease tax expenditure without hurting aggregate demand proscribes foreign central banks from pricing their IOUs competitively. The reciprocal clauses in FATCA mean that any gains from its enforcement will be offset by capital flight from states like Florida and New York, where foreigners hold significant deposits. The premium will remain on well crafted tax policies which improve collection efficiency, and on finely tuned international cooperation which presumes political will and clarity.

Improving collection standards by formulating simpler guidelines and streamlining law, is a challenge Washington is guaranteed to fail. A penchant for scapegoating will energize a crusade against loop-holes, fraud, tax evasion, and incompliance, producing a chaotic tax regime even more expensive to enforce. Populist pressure on an IRS whose own budget recently shrank, will assure that the volume of the agency's supercilious notices will parallel the quantity of superfluous money spewed out by the US Mint. An upsurge in filling mistakes, deliberate evasion, and expatriation, will match any broadened collection mandate dollar for dollar.

Whether the Maya's missed the mark by a few months, or years, wont alleviate the impression that men dressed in feathers staring at stars from jungle observatories, had a more solid handle on reality than America's over-educated elites. The performance of America's top earners, including politicians, investors, economists, bankers, journalists, and lawyers, indicates that investment in their education, and the size of their salaries was hyper-inflationary.