# Attorney CLE Series


# Planning in a Changing Tax Environment

## Feb/Mar/Apr 2015

*presented by the GYF Tax Services Group*

GROSSMAN YANAK & FORD LLP
Certified Public Accountants and Consultants

# Grossman Yanak & Ford LLP

Headquartered in Pittsburgh, Grossman Yanak & Ford LLP is a regional certified public accounting and consulting firm that provides assurance and advisory, tax planning and compliance, business valuation, ERP solutions and consulting services. Led by five partners, the 24-year-old firm employs approximately 55 personnel who serve corporate and not-for-profit entities.

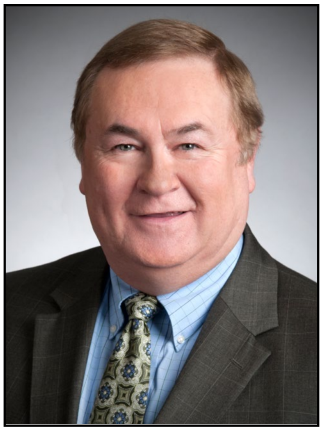
Our firm was founded on the idea that the key to successful, proactive business assistance is a commitment to a high level of service. The partners at Grossman Yanak & Ford LLP believe that quality service is driven by considerable involvement of seasoned professionals on a continuing basis. Today's complex and dynamic business environment requires that each client receive the services of a skilled professional with a broad range of experience and knowledge who can be called upon to provide efficient, effective assistance.

Grossman Yanak & Ford LLP combines a diversity of technical skills with extensive "hands-on" experience to address varied and complex issues for clients on a daily basis. We pride ourselves on bringing value-added resolution to these issues in a progressive and innovative manner. Our ability to produce contemporary, creative solutions is rooted in a very basic and ageless business premise – quality service drives quality results. Our focus on the business basics of quality technical service, responsiveness and reasonable pricing has enabled the firm to develop a portfolio of corporate clients, as well as sophisticated individuals and nonprofit enterprises.

Our professionals understand the importance of quality and commitment. Currently, the majority of the professional staff in our Assurance and Advisory Services and Tax Services Groups hold the Certified Public Accountant designation or have passed the examination and need to complete the time requirements for certification. Each of our peer reviews has resulted in the highest-level report possible, attesting to the very high quality of our firm's quality control function. The collective effort of our professionals has resulted in our firm earning an exemplary reputation in the business community.

**Grossman Yanak & Ford LLP…Quality You Deserve!**

# Robert J. Grossman, CPA/ABV, ASA, CVA, CBA



Bob heads our firm's Tax and Business Valuation Groups. He has over 35 years of experience in tax and valuation matters that affect businesses, both public and private, as well as the stakeholders and owners of these businesses. The breadth of his involvement encompasses the development and implementation of innovative business and financial strategies designed to minimize taxation and maximize owner wealth. As his career has progressed, Bob has risen to a level of national prominence in the business valuation arena.

His expertise in business valuation is well known, and Bob is a frequent speaker, regionally and nationally, on tax and valuation matters. Bob is a course developer and national instructor for both the American Institute of Certified Public Accountants (AICPA) and the National Association of Certified Valuators and Analysts (NACVA) and served as an adjunct professor for Duquesne University's MBA program. He has also written many articles for several area business publications and professional trade journals.

After graduating from Saint Vincent College in 1979 with Highest Honors in Accounting, Bob earned a Masters of Science degree in Taxation with Honors from Robert Morris University. He is a CPA in Pennsylvania and Ohio and is accredited in Business Valuation by the American Institute of Certified Public Accountants. Bob also carries the well-recognized credentials of Accredited Senior Appraiser, Certified Valuation Analyst and Certified Business Appraiser.

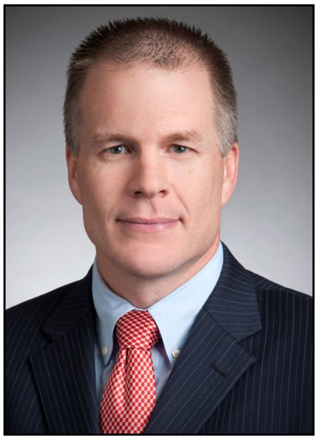
A member of the American and Pennsylvania Institutes of Certified Public Accountants (PICPA), Bob has previously chaired the Pittsburgh Committee on Taxation. He has also served as Chair of the Executive Advisory Board of NACVA, its highest Board; as well as Chair of NACVA's Professional Standards Committee and its Education Board.

Bob received NACVA's "Thomas R. Porter Lifetime Achievement Award" for 2013. One award is presented annually to one of the organization's 6,500 members, who has demonstrated exemplary character, leadership and professional achievements to NACVA and the business valuation profession, over an extended period.

Bob is a member of the Allegheny Tax Society, the Estate Planning Council of Pittsburgh and the American Society of Appraisers. He has held numerous offices in various not-for-profit organizations. Bob received the PICPA Distinguished Public Service Award and a Distinguished Alumnus Award from Saint Vincent College.

Bob and his wife, Susie, live in Westmoreland County. They have two grown children.

# Donald S. Johnston, CPA, MST



Don, a partner in the GYF Tax Services Group, has spent the majority of his 25-year career serving the tax and consulting needs of privately-held organizations and their owners. He has significant experience handling tax planning and compliance-related issues for all types of entities, including corporations, LLCs and partnerships, and a wide base of clientele, ranging from small start-up organizations in the early stages of development to large, billion-dollar entities in need of technical expertise. Don's broad range of experience encompasses numerous industries, including manufacturing, nuclear energy and mining.

Don also has extensive experience working with distribution entities and has devised tax-savings strategies for income, franchise and other business-related taxes for numerous middle market clients. His skills have been utilized for special projects in various areas of expertise, including: acquisition planning and due diligence, Section 338(h)(10) acquisition work; stock vs. asset sale analyses for acquisition and/or disposition scenarios; development of strategies to reduce state tax obligations of multi-state entities; complex valuation-related issues; and other tax concerns for individual clients. His background allows him to assist individuals and businesses to determine advantageous strategies for mergers, acquisitions and divestitures.

After graduating from Slippery Rock University with a B.S./B.A. in accounting and finance in 1989, Don spent four years with a large international accounting firm in Pittsburgh before joining Grossman Yanak & Ford LLP in 1993. He earned his Masters of Science degree in Taxation from Robert Morris University in 1998.

Don, a Certified Public Accountant, is a member of the American and Pennsylvania Institutes of Certified Public Accountants. He is also a member of the Allegheny Tax Society.

A graduate of the Leadership Pittsburgh program, Don is an active participant in community affairs. He is a passionate advocate for organ and tissue donation and supports the work of the Center for Organ Recovery & Education (CORE), a not-for-profit organ procurement organization. Don currently sits on the Board of the Pittsburgh Ballet Theatre and formerly served as Treasurer of EveryChild, Inc., a Pittsburgh based not-for-profit organization that serves the foster care and adoption needs of medically fragile children.

Don resides in Wexford with his wife, Diana, and their children, Sarah, Scotty and Alaina.

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*Understanding ESOPs and Their Use In Exit Planning* ............ October 10, 2013

*Advising Individual Tax Clients for 2013 and Beyond* ............ February 12, 2014

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*Exit Planning: Considerations and Steps for Exiting a Business* ............ October 2, 2014

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# Planning in a Changing Tax Environment

## *Introduction and Background*

A new year always presents challenges. Certainly, 2015 will be no different. *The errors of our recent past can be viewed with disdain and chagrin and largely ignored, or the lessons learned from those often painful experiences can be used to forge a better future.*

While the truth of the preceding paragraph can easily apply to most of us, it is equally relevant to a larger audience and, without exception, the federal government. Balancing political motivations and desires with the care, acumen and wisdom necessary to maintain and grow our national economy and move the country forward has very often been unattainable in the last decade. The loggerhead between political parties and the White House has, for some time, produced an environment that is extremely caustic, if not entirely dysfunctional.

In addition to challenges, a new year also brings with it new hope. In 2015, that new hope is harnessed in a new Congress and a Presidential term that is fast approaching its end. Given the desire to relieve itself of the dysfunction and accomplish something positive, Congress may be ready to move closer to the center and work with President Obama to the benefit of all Americans. Likewise, President Obama is now free to focus on his desired legacy, which includes a number of well-known initiatives. The overriding hope has to be that both sides will see the merit of working together for the greater good, beyond straight partisan politics.

No area is more ripe for improvement in the new year than the U.S. tax system. Often the butt of jokes on competitiveness and complexity, the U.S. now finds its corporate marginal tax rates at a worldwide high of 35%, subjecting corporations to a combined average federal and state income tax rate of 40%. Such high rate levels hamper U.S. businesses and add to the competitive pressures from other countries to lure business offshore.

The problem is no less pronounced for many of the smaller, privately-held businesses within the United States as most of those organizations are taxed as "pass-through" business entities, meaning that the business income of the business is taxed on the equity owner's income tax returns. The 2013 reinstatement of tax provisions limiting the deductibility of personal exemptions and itemized deductions at higher individual income levels; the net investment income tax added by the Affordable Care Act; the alternative minimum tax system; the self-employment tax system; and the Medicare earned income tax mandate – all enacted without differentiating business income – can very often lead to total taxation on business income ranging from 45%-50%.

Additionally, the multiple dimensions of taxation under these rules has led to an ever-increasing level of complexity in the Internal Revenue Code. Last reformed in 1986, the Code was comprised of 26,000 pages at that time. In the intervening 26 years, the Code has nearly tripled in length to over 70,000 pages. In a summary of the Tax Reform Act of 2014, published by the Ways and Means Committee of the U.S. House of Representatives, it is noted that in the last 10 years alone, there have been over 4,400 changes – an average of over one change per day.

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That complexity is compounded by administrative funding cuts at the Internal Revenue Service. In the most recent budget deal, hammered out in July 2014, the Service was subjected to a $346 million cut, while having to satisfy a government-wide pay raise of $250 million next year. In combination, the total of $600 million is a bottom line shortfall for the agency, leading to current hiring freezes and limited overtime. It is well known within professional circles that morale at the IRS is at an all-time low, and that the level of trust between the Republican-led Congress and the current director, Mr. John Koskinen, is non-existent. The training budgets have been slashed materially, and focus is turning away from enforcement and more towards administration.

Adding to the pain is the fact that the combination of budget cuts and hiring freezes comes at a time when the IRS is also being saddled with responsibility to administer both the Affordable Care Act (ACA) and the expanded foreign income reporting rules encompassed in the Foreign Account Tax Compliance Act (FATCA). The budget cuts are sure to negatively affect the Service's 2014/2015 Priority Guidance Plan, which at the outset had 317 projects (now 322) that are part of the ongoing work plan of the IRS in providing guidance to taxpayers and practitioners.

The passage of the Tax Increase Prevention Act (HR 5771) in early 2015 provided, once again, for the extension of a number of tax provisions benefiting individuals and businesses. Interestingly, the bill serves to reinstate, or "extend," the provisions for one year – 2014. Though the bill was signed by the President late in 2014, the same provisions actually expired on December 31st and must be revisited again in the new year. As such, taxpayers find themselves, again, without certainty as to exactly what the tax laws are as they operate through 2015.

Given all of this "noise," there is some expectation by both Congress and the President that something positive can be accomplished. Both sides are well aware of the public's dismay with the interworkings (or lack thereof) in Washington and the voter desire that the dysfunction cease and that our leaders…lead. This overriding public impression and desire as we move towards a Presidential election year, as well as two other recent developments – the Republican House plan for tax reform, introduced in 2014, and the President's budget for 2016 – may provide a foundation for negotiation and movement. While action in Washington can never be guaranteed, there are major areas of similarity between the two sides with overriding themes for tax fairness, middle class initiatives and tax law simplicity. The stars have not been aligned this closely for some years.

On February 26, 2014, House Ways and Means Chairman Dave Camp (R-MI) released a 979-page discussion draft titled "Tax Reform Act of 2014." One of the goals of the proposed legislation is to reduce the size of the federal income tax code by 25%. The bill's summary, as prepared by Congress is 194 pages in length.

This proposal may open the gate to some meaningful discussion in 2015 regarding real tax reform. The content of the proposal is broad and expansive. However, throughout the text of the discussion draft, one thing

 

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is clear. The overriding objective is to lower rates on business income, no matter the form of the business entity (i.e., pass-through businesses), and accomplish the rate reduction through funding offsets resulting from the repeal of hundreds of tax-beneficial provisions. The provisions do not seek specifically to lower rates on higher income individuals, but only on those portions of income that are attributable to business activity.

The President's budget does not contain the same level of detail as the Camp package. Such is expected in budget presentations from any administration. But in the budget, the President seeks to provide tax relief to businesses by lowering the top corporate tax rate and to extend and make permanent certain credits and business incentives used by all taxpayers. The President's budget also addresses a number of middle-class initiatives intended to expand wealth within that segment of the population, a number of which are also noted in the Camp bill.

In the opinion of today's presenters, there is enough common ground between the two proposals to stimulate a conversation by reasonable leaders. Only time will really tell of the outcome of proposed tax reform from either party and whether that reform will happen in the current year. There is a thought process, however, from commentators who observe happenings in Washington, that tax reform is coming, even if the current year fails to see it done.

The problem plaguing taxpayers and business owners is how to navigate through this myriad of challenges and to best position their business and financial affairs in a way that minimizes the overall tax bite that must be paid under the law. Clearly, the most agonizing element of this difficult process is the ongoing unknowns and just how they will affect future earnings and current tax planning.

The uncertainty can be, and often is, crushing. That is why the process of tax and financial planning is an ongoing effort, requiring not only astute attention to the current rules, but also ensuring that care is given to incorporating the maximum level of flexibility possible to be certain that changes in the law can be integrated seamlessly when necessary.

Today's program is centered on a review of the current rules and this type of planning. We have anticipated a varying level of tax knowledge, so many of the examples that been developed assume broad and simple fact patterns to ensure participant understanding and to bring out distinguishing points to emphasize planning initiatives.

The first few chapters will focus on issues and tax matters affecting individuals. Chapter I starts with a review of rules that affect individuals in 2014 (for tax filing purposes), as well as issues individual taxpayers should be thinking about for 2015 and forward. Chapter II will look at the net investment income tax added to the tax regime by the Affordable Care Act of 2010, effective in 2013 and forward. Chapter III addresses general individual tax planning strategies for 2015 in view of possible tax reform in the new year and forward.

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The focus then shifts to business taxes. Chapter IV will look at the important aspects of business filings for 2014 and what might be expected in 2015. Chapter V will address business tax planning strategies for 2015 and forward with and without consideration of possible tax reform. Lastly, Chapter VI will focus on a comparison of the Camp bill and the President's budget, as well as some of the current developments that may affect all participants in tax planning.

Realizing that assumptions regarding proposed legislation are just that – assumptions – only adds to the power of illustration in the discussion and examples. These types of issues, though soft, reflect a necessary effort and attentiveness to ensure that tax strategies are positioned to ensure ease of future compliance with the least amount of resistance and, at the same time, the lowest possible income tax.

Should you have a question that did not get answered or should you wish to discuss any points in particular, the presenters will be available after the program. If you have questions after the session, as always, the presenters can be easily approached or later contacted at the email addresses and numbers indicated below.

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We thank you for your continued attendance at the Grossman Yanak & Ford LLP Continuing Legal Education series. The seminars have proven to be a great success, and we hope that by your continued support, you have found the content to be informative and helpful. Thanks again for taking time from your busy schedules to be with us today!

# Planning in a Changing Tax Environment

## *Chapter I – Tax Rules Affecting Individual Taxpayers*

The foundation of all economic planning for any envisioned investment strategy must, by definition, begin and end with an assessment of shareholder, partner, or equity owner return on investment. The best measure of this return on investment is that amount of free cash flow that can be "pocketed", after all tax implications are considered. As such, careful review and understanding of rules of taxation imposed by any and all applicable tax authorities is absolutely crucial to a proper determination of any transaction's return on investment to its investors. The practical starting point for such a review and understanding of these rules lies with the individual income tax mandates promulgated by Congress and executed by the "then-sitting" President and included in Title 26 of the United States code, i.e., the Internal Revenue Code of 1986, as amended. Note that all references herein to the Internal Revenue Code, the Code, or the IRC refers to this same citation.

The key to fully understanding the individual income tax system within the United States is to appreciate that the system is not singular. Within the parameters of the many tax code provisions that can, and do, often affect individual taxpayers, there are a number of "sub-systems" of taxation that drive a need for analysis on a multi-dimensional basis. From a conceptual standpoint, these sub-systems can be titled as 1) the regular income tax system, 2) the alternative minimum tax system, 3) the self-employment tax system, 4) the net investment income tax system and, finally, 5) the "pass though" tax system for certain qualifying business entities whose items of income, deduction, loss and credit are reflected on equity capital owners' returns. Within the final subsystem, there is yet another subdivision which addresses taxation of items dependent upon owner involvement (what has come to be known as the passive activity rules).

Interestingly, calendar year 2014 did not bring a great deal of additional tax provisions through the introduction of new legislation. It seemed that both parties were reluctant to introduce major new legislation given the mid-term election year and the seemingly endless gridlock in Congress. However, the lack of new income tax provisions did not reduce the compliance impact of Internal Revenue Service guidance issued to answer numerous challenges associated with earlier tax legislation that first became effective in January 2013 and earlier. That guidance continues to keep both taxpayers and practitioners struggling in 2014. A good deal of this new guidance is intended to clarify certain provisions of the "Obamacare legislation." As such, looking to that law serves as an appropriate starting point for today's discussion.

### The Affordable Care Act – Overview

To answer the many questions remaining about the Patient Protection and Affordable Care Act, passed in 2010 and first effective in January 2013, as well as the Health Care and Education Reconciliation Act of 2010

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(both, hereafter, will be referenced as the ACA), the IRS issued a substantial number of Treasury regulations, announcements, notices and other rulings and guidance intended to provide clarification on a number of complex topics affecting both individuals and businesses.

By way of a general reintroduction, the ACA was initially passed with the primary objective of encouraging all uninsured individuals to seek medical care insurance coverage under a plan providing minimum essential coverage. The underlying means of accomplishing this objective was to require the 40% of American citizens not participating in an insurance program with this level of coverage under an employer-based plan to "purchase" such medical care insurance either from a private insurer or through one of the new Insurance Exchanges. From the individual side, those that are uninsured or underinsured and can afford to purchase such insurance are to be penalized if they fail to do so. Those unable to afford the required coverage may qualify for subsidies or [medical care insurance] premium assistance credits.

There are, of course, many other facets of the ACA, including expanding the definition of dependents to include children up to the age of 27 for purposes of participating in parental "employer-provided" medical care insurance plans. In addition, there are expanded Form W-2, Wage and Tax Statement reporting requirements that began in 2012 for large employers requiring reporting of the total cost of employer-provided medical care insurance.

To fund the cost of these new initiatives, the brunt of the revenue-raising side of the ACA fell directly on higher income individual taxpayers, including both employees and self-employed individuals. . In addition, many businesses treated as pass through entities (partnerships and S corporations) were taxed on their earnings in an indirect fashion.

The largest portion of the tax increase is attributable to an additional 3.8% unearned income Medicare tax imposed on net investment income. The law also imposed a .9% Medicare tax on earned income for higher earner taxpayers. Additionally, the threshold limitation for deducting qualifying medical expenses was increased from 7.5% to 10% of adjusted gross income. Only qualifying medical expenses exceeding this threshold are now deductible as itemized deductions. Specific aspects of each of these provisions follows.

*<u>Individual Mandate</u>*

As noted above, a significant, and perhaps the most important, objective of the ACA was to require uninsured or underinsured individuals to obtain medical care insurance providing minimum essential coverage. Beginning in 2014, individuals who do not have minimum essential coverage for themselves and their dependents become liable for a shared responsibility payment civil penalty.

 

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The 2014 penalty will not exceed the greater of $285 ($95 x 3), otherwise known as the “flat dollar amount,” or 1% of the taxpayer’s household income over the filing threshold (the “percentage of income”), with the flat dollar amount increasing to $2,085 and the percentage of income increasing to 2.5% by 2016. After 2016, the flat dollar amount will be increased annually for inflation. Note that household income is defined as modified adjusted gross income increased by foreign earned income and tax exempt interest.

There are certain exempt individuals including prisoners, undocumented aliens, healthcare sharing ministry members, those that object to the law for religious reasons, those below the filing threshold, members of Indian tribes, those with a short term gap in coverage and those living outside the United States.

If an individual is unable to afford the medical care insurance with essential minimum coverage as mandated by the ACA, he or she may be able to benefit from the ACA’s health insurance premium assistance credit, a fully refundable tax credit. To qualify, the individual has to purchase one of four levels of coverage accessed through the new state American Health Benefit Exchanges (AHBE).

Generally, the credit will be available to individuals whose income is up to four times the federal poverty level (approximately $88,000 for a family of four in 2014) and who are NOT receiving Medicare, Medicaid, military or Peace Corps health care coverage. Qualification for the credit first requires that the individual pay between 2% and 9.5% of their annual incomes for medical care insurance premiums.

## Effects on Higher-Income Individuals

The substantial portion of the funding necessary to facilitate the new individual programs mandated by the ACA is levied on the higher income individuals. The primary provisions imposing these new taxes is an additional Medicare tax assessed on earned income above a certain threshold and an additional Medicare tax assessed on unearned income when a taxpayer’s modified adjusted gross income exceeds a certain level.

*Hospital Services Insurance Tax (additional Medicare tax on earned income)*

Beginning in 2013, the ACA increased the combined employer and employee portions of the Medicare payroll tax and the total hospital services insurance tax imposed upon self-employed individuals from 2.9% to 3.8%, for an increase of .9%. Note that the tax is imposed on wages and self-employed earnings in excess of $200,000 ($250,000 for taxpayers filing jointly, and $125,000 for married individuals filing separately). The amounts are NOT adjusted for inflation.

On November 26, 2013, the IRS issued final regulations governing the .9% additional Medicare tax, which provide guidance for employers and individuals relating to the implementation of the additional Medicare tax.

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These regulations include the requirement to withhold additional Medicare tax on certain wages and compensation, the requirement to report additional Medicare tax, and the employer process for adjusting underpayments and overpayments of additional Medicare tax. In addition, the regulations provide guidance on the employer and individual processes for filing a claim for refund for an overpayment of additional Medicare tax.

*Net Investment Income Tax (additional Medicare tax on unearned income)*

The ACA also imposes a 3.8% Medicare contribution tax on unearned income, effective for tax years beginning after December 31, 2012. The tax is imposed on the lesser of an individual's net investment income (NII) for the tax year or modified adjusted gross income in excess of $200,000 ($250,000 for married couples filing a joint return and $125,000 for married couples filing a separate return). Note again that these amounts are NOT indexed for inflation.

Pursuant to the statute, net investment income is the sum of the following items, less any otherwise allowable deductions properly allocable to such income or gain:

- Gross income from interest, dividends, annuities, royalties and rents unless such income is derived in the ordinary course of any trade or business (excluding a passive activity or financial instruments/commodities trading);
- Other gross income from any passive trade or business; and
- Net gain included in computing taxable income that is attributable to the disposition of property other than property held in any trade or business that is not a passive trade or business.

Thus, net investment income includes interest, dividends, capital gains, non-qualified annuities, royalties, certain rents and certain other passive business income, as well as the amount of capital gain on a second home sale that is not the taxpayer's primary residence.

Other potential subject capital gains include:

- Gains from the sale of stocks, bonds, and mutual funds
- Capital gain distributions from mutual funds
- Gain from the sale of investment real estate (including gain from the sale of a second home that is not a primary residence)
- Gains from the sale of interests in partnerships and S corporations (to the extent the partner or shareholder was a passive owner)

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The net investment income tax does not apply to any amount of gain that is excluded from gross income for regular income tax purposes. The pre-existing statutory exclusion in section 121 (relating to the sale of a primary residence) exempts the first $250,000 ($500,000 for a married couple) of gain recognized on the sale of a principal residence from gross income for regular income tax purposes and, thus, from the net investment income tax.

In order to arrive at net investment income, gross investment income (as described above) is reduced by deductions that are properly allocable to items of gross investment income. Examples of deductions, a portion of which may be properly allocable to gross investment income, include investment interest expense, investment advisory and brokerage fees, expenses related to rental and royalty income, tax preparation fees, fiduciary expenses (in the case of an estate or trust) and state and local income taxes.

The IRS has issued final Treasury regulations on key elements of the net investment income tax, effective for the first time on January 1, 2014. These regulations replaced earlier proposed regulations.

Essentially, the final regulations mirror the earlier proposed regulations with changes adopted in response to numerous comments the IRS received during the exposure period. The comments address five main areas, including:

- Calculation of net investment income;
- Treatment of certain types of trusts;
- Interaction between various aspects of the Section 469 passive activity rules with the calculation of net investment income;
- The method of gain calculation regarding a sale of an interest in a partnership or S corporation, and
- Multiple areas where the proposed regulations could be simplified.

It is noteworthy that the final regulations do NOT exempt the net investment income tax from the estimated income tax payment requirements. In addition, though heavily requested from commentators, the final regulations do NOT contain a listing of income and deductions that are excluded from the calculations. A more extensive and detailed discussion of the NIIT rules is included in Chapter II of these materials.

## Medical Benefits and Expenses

### *Medical Benefits for Children under Age 27*

The ACA extended the exclusion from gross income for medical care reimbursements under an employer-provided accident or health plan to any employee's child who has not attained age 27 as of the end of the tax year. The amendment was effective March 30, 2010.

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The IRS has issued guidance to explain that the exclusion applies for reimbursements for health care of individuals who are not age 27 or older at any time during the employee's tax year (generally a calendar year). The IRS has also explained that a "child," for purposes of the extended exclusion, is an individual who is the son, daughter, stepson or stepdaughter of the employee, as well as an adopted individual and an eligible foster child.

*Medical Deduction Threshold*

The ACA increases the threshold to claim an itemized deduction for unreimbursed medical expenses from 7.5% of adjusted gross income (AGI) to 10% of AGI for tax years beginning after December 31, 2012. However, individuals (or their spouses) who are age 65 and older before the close of the tax year are exempt from the increased threshold, and the 7.5 % threshold continues to apply until after 2016.

## The Regular Tax System

The regular tax system, which is defined in the negative in the Internal Revenue Code, by virtue of adding specific provisions applicable to the other four sub-systems, comprises the broadest reach of all individual tax mandates applied collectively to taxpayer facts and circumstances. Fundamentally, this system embraces two basic precepts that serve as the cornerstone for tax planning.

The first of these two basic precepts assumes that any and all sources of economic income and gain are taxable in their entirety unless specifically excluded by a provision within the Internal Revenue Code. The second basic precept assumes that there are no deductions allowed against any of the reported income unless specifically authorized and allowed by a provision within the Internal Revenue Code. The net of the realized and reported income reduced for the authorized and allowable deductions is then subjected to a graduated tax rate structure designed to shift a disproportionate amount of federal tax burden to higher income taxpayers.

The current tax rate structure arose as a result of the American Taxpayer Relief Act (ATRA or the Act), signed into law on January 2, 2013. The Democratic-controlled Senate overwhelmingly approved this legislation, passing it by a vote of 89 to 8, while the House reluctantly approved the package by a 257 to 167 vote. Often referred to as the "fiscal cliff" bill, this legislation addressed many of the individual tax concerns on the income tax side of the fiscal cliff. Most importantly, the Act's passage prevented a major tax increase common to "all" Americans and honed in on higher-income individuals as those most able to absorb the tax rate increase.

While the tax increases in this legislation have been promoted as a tax on the "wealthy," the reality of the situation is (and our experiences and observations have confirmed), that many small businesses have incurred and will continue to incur reduced cash flow as their owners' tax bills increase and these owners demand higher tax distributions. As a result, increased scrutiny and careful tax planning, at both the entity level and the individual level, is even more important than it was in the past. Careful consideration of potential timing differences becomes even more important, since the tax rate differences between multiple years can significantly alter the tax rate on income and, ultimately, the tax that is owed.

## Individual, Estate and Trust Tax Rates

The lower, Bush-era income tax rates on (most) individuals, estates and trusts have generally been made permanent for tax years beginning after December 31, 2012, as a result of the elimination of The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) sunset provision. Many individuals, especially those with ownership interests in pass-through business entities, are now subject to a top tax rate of 39.6% beginning in 2013. If their taxable income exceeds the applicable threshold amount of $450,000 for married individuals filing joint returns and surviving spouses; $425,000 for heads of households; $400,000 for single individuals; and $225,000 for married individuals filing separate returns, the highest marginal rates will apply, at least to part of their income. Estates and trusts are subject to a top tax rate of 39.6% on all taxable income in excess of the 33% tax bracket.

### *Tax Rates for Individuals*

Under the graduated or progressive federal tax system, taxpayers are generally taxed at higher marginal tax rates as their taxable income increases. Beginning in 1993, individuals, estates and trusts were subject to five possible income tax rates: 15%, 28%, 31%, 36% and 39.6%. Under EGTRRA, the income tax rates of 28%, 31%, 36% and 39.6% were reduced to 25%, 28%, 33% and 35%, respectively, and were scheduled to be phased in between 2001 and 2006.

In addition to the rate reductions, EGTRRA also created a new 10% income tax bracket for a portion of taxable income that was previously taxed at 15%. For tax years 2001 through 2007, the 10% rate was scheduled to apply to the first $6,000 of income for single filers and married taxpayers filing separately; the first $12,000 for joint filers; and the first $10,000 for heads of households. For tax years beginning after 2007, these amounts were scheduled to increase by $1,000 for single filers (other than heads of households) and married taxpayers filing separately; and $2,000 for joint filers. In tax years after 2008, all 10% income bracket amounts were to be adjusted for inflation.

An important aspect of the tax rate structure under the Internal Revenue Code is that the income levels to which the rates are applied change each year as they are indexed for inflation. As such, the higher rates generally do not apply to income in 2015 at the same threshold levels as in 2013, when the ATRA became law.

# Planning in a Changing Tax Environment

_2015 Tax Rate Schedules_

The applicable tax rate schedules for 2015 (estimated) for married individuals filing jointly and surviving spouses, heads of household, single individuals, married individuals filing separately and estates and trusts follow.

### MARRIED INDIVIDUALS FILING JOINT RETURNS AND SURVIVING SPOUSES (FOR TAX YEARS BEGINNING IN 2015)

| *If taxable income is:* Over – | but not over – | *The tax is:* | of the amount over – | *Effective rate* top threshold |
|---|---|---|---|---|
| $ 0 | $18,450 | 10% | $0 | 10.0% |
| 18,450 | 74,900 | $1,845.00 + 15% | 18,450 | 13.8% |
| 74,900 | 151,200 | 10,312.50 + 25% | 74,900 | 19.4% |
| 151,200 | 230,450 | 29,387.50 + 28% | 151,200 | 22.4% |
| 230,450 | 411,500 | 51,577.50 + 33% | 230,450 | 27.1% |
| 411,500 | 464,850 | 111,324.00 + 35% | 411,500 | 28.0% |
| 464,850 | | 129,996.50 + 39.6% | 464,850 | |

### HEADS OF HOUSEHOLDS (FOR TAX YEARS BEGINNING IN 2015)

| *If taxable income is:* Over – | but not over – | *The tax is:* | of the amount over – | *Effective rate* top threshold |
|---|---|---|---|---|
| $ 0 | $13,150 | 10% | $0 | 10.0% |
| 13,150 | 50,200 | $1,315.00 + 15% | 13,150 | 13.7% |
| 50,200 | 129,600 | 6,872.50 + 25% | 50,200 | 20.6% |
| 129,600 | 209,850 | 26,722.50 + 28% | 129,600 | 23.4% |
| 209,850 | 411,500 | 49,192.50 + 33% | 209,850 | 28.1% |
| 411,500 | 439,000 | 115,737.00 + 35% | 411,500 | 28.6% |
| 439,000 | | 125,362.00 + 39.6% | 439,000 | |

# Planning in a Changing Tax Environment

### SINGLE TAXPAYERS
### (FOR TAX YEARS BEGINNING IN 2015)

| *If taxable income is:* Over – | but not over – | *The tax is:* | of the amount over – | *Effective rate* top threshold |
|---|---|---|---|---|
| $ 0 | $9,225 | 10% | $0 | 10.0% |
| 9,225 | 37,450 | $922.50 + 15% | 9,225 | 13.8% |
| 37,450 | 90,750 | 5,156.25 + 25% | 37,450 | 20.4% |
| 90,750 | 189,300 | 18,481.25 + 28% | 90,750 | 24.3% |
| 189,300 | 411,500 | 46,075.25 + 33% | 189,300 | 29.0% |
| 411,500 | 413,200 | 119,401.25 + 35% | 411,500 | 29.0% |
| 413,200 | | 119,996.25 + 39.6% | 413,200 | |

### MARRIED TAXPAYERS FILING SEPARATE RETURNS
### (FOR TAX YEARS BEGINNING IN 2015)

| *If taxable income is:* Over – | but not over – | *The tax is:* | of the amount over – | *Effective rate* top threshold |
|---|---|---|---|---|
| $ 0 | $9,225 | 10% | $0 | 10.0% |
| 9,225 | 37,450 | $922.50 + 15% | 9,225 | 13.8% |
| 37,450 | 75,600 | 5,156.25+ 25% | 37,450 | 19.4% |
| 75,600 | 115,225 | 14,693.75 + 28% | 75,600 | 22.4% |
| 115,225 | 205,750 | 25,788.75+ 33% | 115,225 | 27.1% |
| 205,750 | 232,425 | 55,662.00 + 35% | 205,750 | 28.0% |
| 232,425 | | 64,998.25+ 39.6% | 232,425 | |

# Planning in a Changing Tax Environment

**ESTATES AND TRUSTS**
**(FOR TAX YEARS BEGINNING IN 2015)**

| *If taxable income is:* | | *The tax is:* | | *Effective rate* |
|---|---|---|---|---|
| **Over –** | **but not over –** | | **of the amount over –** | **top threshold** |
| $ 0 | $2,500 | 15% | $0 | 15.0% |
| 2,500 | 5,900 | $375.00 + 25% | 2,500 | 20.8% |
| 5,900 | 9,050 | 1,225.00 + 28% | 5,900 | 23.3% |
| 9,050 | 12,300 | 2,107.00 + 33% | 9,050 | 25.8% |
| 12,300 | | 3,179.50 + 39.6% | 12,300 | |

*Capital Gains Tax Rates for Individuals, Estates and Trusts*

The reduced long-term capital gains tax rate of 15% on adjusted net long-term capital gain of noncorporate taxpayers was made permanent for tax years beginning after December 31, 2012. In addition, the 0% capital gains tax rate on adjusted net capital gains of individuals in the 10% or 15% income tax bracket (estates and trusts in the 15% income tax bracket) has also been made permanent. The capital gains tax rate, however, increased to 20% beginning in 2013 for adjusted net long-term capital gains of individuals and estates and trusts in the top marginal tax bracket.

Under the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), a maximum capital gains tax rate of 15% applied to the adjusted net capital gains of individuals, estates and trusts if the gain would otherwise be subject to the 25%, 28%, 33% or 35% ordinary income tax rates. A capital gains tax rate of 5% (down from 10% prior to the JGTRRA) applied to adjusted net capital gains that would otherwise be subject to the 10% or 15% ordinary income tax rates for individuals (15% rate for estates and trusts). The 5% capital gains tax rate was reduced to 0% for tax years 2008 through 2012.

The JGTRRA did not institute an overall reduction in maximum long-term capital gains tax rates. For example, it left unchanged the 28% rate imposed on net long-term gain from collectibles and net gain from small business stock. For noncorporate taxpayers, the maximum tax rates on adjusted net capital gain of 15% and 0% are the same for the alternative minimum tax (AMT) as for the regular income tax.

# Planning in a Changing Tax Environment

*Reduced Rates for Long-Term Capital Gain*

The reduced long-term capital gains tax rates of noncorporate taxpayers have generally been made permanent and modified for tax years beginning after December 31, 2012, as a result of the elimination of the JGTRRA sunset.

- Capital gains tax rate for individuals – beginning in 2013, and currently applicable to 2015, the capital gains tax rates are as follows:
  - A capital gains tax rate of 0% applies to the adjusted net long-term capital gains of individuals if the gain would otherwise be subject to the 10% or 15% ordinary income tax rate.
  - A capital gains tax rate of 15% applies to adjusted net capital gains of individuals if the gain would otherwise be subject to the 25%, 28%, 33% or 35% ordinary income tax rate.
  - A capital gains tax rate of 20% applies to adjusted net capital gains of individuals if the gain would otherwise be subject to the 39.6% ordinary income tax rate beginning after December 31, 2012.
- Capital gains rates for estates and trusts – beginning in 2013, and currently applicable to 2015, the capital gains rates are as follows:
  - A capital gains tax rate of 0% applies to the adjusted net capital gains of estates and trusts if the gain would otherwise be subject to the 15% ordinary income tax rate.
  - A capital gains tax rate of 15% applies to adjusted net capital gains of estates and trusts if the gain would otherwise be subject to the 25%, 28% or 33% ordinary income tax rate.
  - A capital gains tax rate of 20% applies to adjusted net capital gains of estates and trusts if the gain would otherwise be subject to the 39.6% ordinary income tax rate.

*Qualified Dividends Received by Individuals, Estates and Trusts*

The taxation of qualified dividends received by individuals, estates and trusts at capital gains rates has been made permanent. Thus, the 0% capital gains tax rate applies for noncorporate taxpayers whose income falls in the 10% or 15% income tax bracket, and the 15% capital gains tax rate applies for noncorporate taxpayers whose income falls in 25%, 28%, 33% or 35% income tax bracket, effective for tax years beginning after December 31, 2012. Similar to other parts of the Act, there is a carve-out of the lowest rate for those individual taxpayers who fall into the highest ordinary income tax bracket. For those individuals, the ATRA added a 20% rate for qualified dividends beginning in 2013. This rate continues for 2015 tax planning.

The reduced dividend tax rates apply only to qualified dividends, which include dividends received during the tax year from a domestic corporation or a qualified foreign corporation.

# Planning in a Changing Tax Environment

*Phaseout of Itemized Deductions*

The phaseout of itemized deductions for higher-income individuals was reinstated for tax years beginning after December 31, 2012, and continues to apply in 2015. As a result, the amount of otherwise-allowable itemized deductions of a taxpayer for 2015 will be reduced or eliminated if his or her AGI exceeds a threshold amount for the tax year.

EGTRRA repealed the limitation on itemized deductions for higher-income individuals. The repeal was phased in over a five-year period, beginning in 2006, and ended with the total repeal of the limitation in 2010.

Under the limitation, individuals whose AGI exceeded a specified threshold amount were required to reduce the amount of their otherwise-allowable itemized deductions. Specifically, itemized deductions that would otherwise be allowed were reduced by the lesser of (1) 3% of AGI that exceeded a threshold amount, (importantly, adjusted annually for inflation); or (2) 80% of the total amount of otherwise allowable itemized deductions.

The applicable threshold amounts beginning in 2015 are:

- $309,900 in the case of married taxpayers filing a joint return or a surviving spouse,
- $284,050 in the case of a head of household,
- $258,250 in the case of an unmarried individual who is not a surviving spouse or head of household, and
- One-half of the amount for a joint return or surviving spouse, after any adjustment for inflation, in the case of a married individual filing a separate return ($154,950 for 2015)

All threshold amounts are adjusted for inflation for all future tax years beginning in calendar years after 2013.

Again, a taxpayer with AGI over the threshold amount will need to reduce otherwise allowable itemized deductions by the lesser of:

- 3% of the amount of taxpayer's AGI in excess of the applicable threshold, as adjusted for inflation, or
- 80% of the itemized deductions otherwise allowable for the tax year.

*Phaseout of Personal and Dependency Exemptions*

The phaseout of personal and dependency exemptions for higher-income individuals is also reinstated for tax years beginning after December 31, 2012. As a result, the amount of otherwise allowable personal and dependency exemptions of a taxpayer for 2013 will be reduced or eliminated if his or her AGI exceeds a threshold amount for the year based on filing status. The applicable threshold amounts for tax years beginning after December 31, 2012, are the same as for the phaseout of itemized deductions (adjusted annually for inflation) as discussed above.

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Taxpayers with AGI over the threshold amount will need to reduce their otherwise-allowable deductions for personal and dependency exemptions by 2% for each $2,500 (or fraction thereof) by which the AGI exceeds the threshold amount. In the case of a married individual filing separately, the exemption reduction will be reduced by 2% for each $1,250 (or fraction thereof) by which AGI exceeds the threshold amount. In no case will the deduction for exemptions be reduced by more than 100%. The deduction for personal exemptions will be fully eliminated when AGI exceeds the threshold amount by more than $122,600 for married taxpayers filing jointly in 2015 ($61,250 in the case of a married individual filing separately).

### Summary and Closing Thoughts

While 2014 reflects the second year of compliance with these changes, nothing can be presumed to guarantee that these same rules will be in effect for 2015. As noted in the President's State of the Union address in January, the administration is proposing an increase in both the qualified dividend tax rate as well as capital gains to allow revenue for more middle class programs. In addition, Congress, now led by the Republican party, is poised to reintroduce a plan first introduced in the spring of 2014 to revamp and reform the entire Internal Revenue Code.

Whether either party's initiatives evolve into real and meaningful legislation is, at best, anybody's guess. However, it does seem prudent in light of the 2016 Presidential election cycle that a cooperative effort from both sides will be helpful to each of their candidates in the run for the White House.

# Planning in a Changing Tax Environment

## *Chapter II – The Net Investment Income Tax*

The net investment income tax (NIIT) on net investment income (NII), was added to the Internal Revenue Code as an additional Medicare tax by the Patient Protection and Affordable Care Act (ACA) in March 2010. Even though the passage of that legislation is old news, the effective date of the NIIT was January 1, 2013, and, as such, the 2014 tax year represents just the second year of the tax's applicability to net investment income earned by taxpayers. Planning for 2015 and forward is still complex as more recent developments clarifying numerous aspects of the provision have been released by the Internal Revenue Service.

As summarized in the last chapter, the NIIT is levied at a rate of 3.8%. The tax is defined as an "additional Medicare contribution tax" and is applied to the unearned income of certain higher-income taxpayers. The tax is imposed on the lesser of:

- An individual taxpayer's NII for the applicable tax year, or
- An individual's modified adjusted gross income (AGI) in excess of $200,000 ($250,000 in the case of married couples filing jointly, and $125,000 in the case of married couples filing separately).

An unfortunate aspect of this tax provision is that the base amounts of modified AGI are not indexed for inflation, as are many other thresholds within the Internal Revenue Code. As such, many more taxpayers will eventually find themselves subject to the additional levy than was originally anticipated at passage of the enacted legislation.

Modified AGI, one of the two primary thresholds, is defined as adjusted gross income, found on line 37 of Form 1040, U.S. Individual Income Tax Return, adjusted for several machinations resulting from the application of certain international tax provisions found in the Internal Revenue Code. The Internal Revenue Service website notes that for individual taxpayers who have not excluded any foreign earned income, modified AGI is generally the same as their regular AGI.

The regulations provide that the term "individual," for purposes of this tax, is any natural person, except for natural persons who are nonresident aliens. Thus, the 3.8% additional Medicare tax applies to any citizen or resident of the United States, but does not apply to a nonresident alien. In the case of a U.S. citizen or resident who is married to a nonresident alien individual, the spouses are treated as married, filing separately, for purposes of the NIIT.

The examples on the following page illustrate the general application of this tax.

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- ***Example A*** – Maria is single and a U.S. citizen. She has modified AGI of $190,000, which includes $50,000 of NII. Maria is NOT subject to the 3.8% tax because her modified AGI is under the threshold.
- ***Example B*** – Assumes the same facts as Example A, except that Maria's modified AGI is $235,000, which includes NII at the same level of $50,000. Maria now has a NIIT liability of $1,330 (3.8% of $35,000).

## Defining Net Investment Income

Net investment income is the key term in assessing the impact of this provision on any particular tax situation. Final Treasury regulations define NII to include three specific categories of income. These include:

- ***Category I:*** Gross income from interest, dividends, rents, royalties, and nonqualified annuities, other than such income derived in the ordinary course of a trade or business not described in Category II.
- ***Category II:*** Other gross income from businesses that trade financial instruments or commodities, and businesses that are passive activities within the meaning of Sec. 469.
- ***Category III:*** Net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property, other than property held in a trade or business that is not described in Category II. Gains and losses from dispositions of trade or business property used in passive activities are included in calculating the net investment income tax.

To arrive at net investment income, note that investment income from these categories is reduced by investment expenses such as early-withdrawal penalties, interest expense, adviser fees, directly-related rental and royalty expenses, and state and local taxes allocable to items included in investment income.

Additionally, wages, self-employment income, unemployment compensation, business income from nonpassive sources, Social Security benefits, tax-exempt interest and qualified pension, annuity and individual retirement account distributions are excluded when calculating net investment income.

### *Category I*

Category I, as noted, includes interest, dividends, annuities, royalties and rents unless such income is derived in the ordinary course of a trade or business (excluding any activity encompassed in Categories II or III). These types of "portfolio" income are easily identified and allow for normal planning opportunities.

Understanding the difference between interest earned in a trade or business and interest that is not earned in a trade or business can be particularly complex for taxpayers owning equity interests in pass-through business entities. To the extent that interest is earned on routine levels of cash and working capital, it is likely that none would be subject to the NIIT. However, for companies accumulating excess working capital that serves in the

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capacity as a "nonoperating" asset, the interest earned on the excess would likely be characterized as not being earned in a trade or business and, as such, subjected to the NIIT.

It is also critical to note the exclusion of tax-exempt interest from Category I. Most often, this income is comprised of interest on bonds issued by U.S. states and municipalities. While subject to certain state and local taxes, and perhaps, the federal alternative minimum tax, the income is not subject to the regular federal income tax and is excluded from the NII calculation.

The resultant planning opportunity is obvious. For taxpayers holding substantial amounts of wealth in interest-bearing investments, a shift to the more tax-beneficial exempt bond arena may make sense.

In order to arrive at NII, gross investment income is first reduced by deductions that are properly allocable to items of gross investment income. Examples of deductions, a portion of which may be properly allocable to gross investment income, include investment interest expense, investment advisory and brokerage fees, expenses related to rental and royalty income, tax preparation fees, fiduciary expenses (in the case of an estate or trust) and state and local income taxes.

Additional considerations involved in the determination of taxpayer Category I NII is the interplay with various other Internal Revenue Code provisions, including the general deferral or disallowance rules used in determining net investment income. An example of such rules would include the limitation on investment interest, expenses and interest relating to the production of tax-exempt income, the "at-risk" limitation rules, the passive activity rules, the partner loss limitation rules, capital loss carryover rules, and the S corporation shareholder loss limitation rules. Each of these rules come into play in assessing the impact of the NIIT, and appropriate planning must contemplate opportunities available within these tax provisions.

The following two examples illustrate the general application of these related provisions:

- ***Example C*** – In 2014, Maria realized a "pass-through" loss from a partnership in which she holds a 10% passive ownership interest in the amount of $2,600. Due to partner loss limitations in 2014, she was unable to use the loss, and it was suspended and will be carried forward to 2015. In 2015, she is expecting to realize passive activity income from this partnership in the amount of $4,600.

  In computing her NII for 2015, Maria can reduce the amount of passive income from the partnership that would have been recognized ($4,600) for the suspended loss carryover ($2,600), thereby netting to $2,000. This amount of her investment income from this activity will be included in her NII calculation.

- ***Example D*** – In 2014, Maria had incurred investment interest expense in the amount of $10,000. In that year, her investment income was $8,000. As such, her investment interest expense deduction was limited, and the unused $2,000 will be available for 2015, to be offset not only against her regular tax on her investment income for that year, but also for the additional Medicare tax on that income.

 

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*Category II*

Category II, as noted, includes other gross income from businesses that trade financial instruments or commodities, and businesses that are passive activities. Passive activities are generally defined by reference to a taxpayer's level of involvement in the day-to-day operating activities of any particular business.

To escape the characterization of any particular activity being defined as passive, the regulations set out numerous tests intended to measure taxpayer involvement in the activity. The bright line test in the regulations is 500 hours per year, but alternative tests may allow for finding that an activity is not passive, while requiring fewer hours of involvement.

The application of the NIIT to passive activities is seemingly reasonable, given that some taxpayers continue to reap large returns from operating activities with which they have little involvement, other than by way of investment. In these cases, these returns fit squarely into the Congressional intent behind the NIIT.

More troubling, however, is the effect of the tax on privately-held, family-owned companies where certain equity owners are active, while others are not. The case is not unusual in that senior generation business owners often transfer equity ownership to both involved and "noninvolved" junior-generation family members. In such cases, the income allocated under applicable tax rules to the noninvolved family members is certain to be construed and characterized as passive income, requiring inclusion in that family member's income calculation for purposes of the NIIT.

The following two examples illustrate the general application of these related provisions:

- ***Example E*** – Maria is the daughter of the founder of the business, and she holds a 10% equity interest in the company, a pass-through business enterprise. She does not work at the company and she contributes nothing to the operations of the company.

  In 2015, Maria expects that the pass-through of income to her from the company will be $8,500. In computing whether the NIIT will apply, she will be required to increase her NII by that amount.

- ***Example F*** – Maria is the daughter of the founder of the business, and she holds a 10% equity interest in the company, a pass-through business enterprise. She works at the company in a full-time capacity and she contributes daily to the operations of the company.

  In 2015, Maria expects that the pass-through of income to her from the company will be $8,500. In computing whether the NIIT will apply, she will NOT be required to increase her NII by the $8,500.

Very often, there may be an ability to increase equity owner involvement in a business activity to a level sufficient to escape the classification of passive. Care must be taken to ensure that this "increased" activity level is valid, and that the change is not simply a sham. If this change can be made, the reclassification from passive

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to one with "material participation" may aid in reducing the taxpayer's regular income tax, as well as the NIIT, should the activity produce losses.

Another important avenue in escaping the passive activity classification is via activity "grouping" elections allowed under the Internal Revenue Code. In the past, if a taxpayer owned an interest in several profitable business activities, whether those business interests were classified as material participation businesses or passive activities was generally moot. If a passive business activity produced a loss, that loss could be deferred under the passive activity rules. But passive business income, in the past, was not detrimental. However, with the NIIT starting in 2013, business income flowing into a Form 1040 from a passive activity is subject to the 3.8% additional Medicare tax.

The IRS regulations allow a taxpayer a one-time "fresh start" opportunity to regroup multiple business activities on Form 1040, if that election helps to minimize passive business income exposed to this new tax. By grouping multiple business activities as a single "appropriate economic unit," a taxpayer's hours of participation in one entity can extend to another business. This causes the combined income to be considered as active business income, which is not subject to the NIIT. The fresh start grouping election should be made at the equity owner's level and would be made on the affected taxpayer's 2013 or 2014 income tax return. Consideration of this election is critical in 2014 if the election was not made in 2013.

Within Categories I and II, there is a crossover assessment of NII generated from the conduct of a rental activity. Under the passive activity rules in the Internal Revenue Code, all rental real estate activities are considered passive by default. If one were to allow the rental activity to default to this passive status, the net rental income would automatically be subject to the NIIT.

In certain situations, however, a taxpayer can overcome the presumption that a rental activity is passive by qualifying as a "real estate professional," the definition of which is set out in those same rules (and explained further below). If a taxpayer can attain this standard, and provided he or she also materially participates in the rental activity, the resulting income or loss will be classified as nonpassive rather than passive. This important distinction would lead to the net rental income being excluded from the additional Medicare tax.

In order to qualify as a real estate professional, under the passive activity rules, the taxpayer must show:

1. That more than one-half of the personal services performed by him/her in trades or businesses were performed in real property trades or businesses in which he/she materially participates; and
2. That he/she worked more than 750 hours in real property trades or businesses in which he/she materially participates.

The first test generally becomes an issue only if the taxpayer is involved in another occupation in addition to real estate. The second is simply a mechanical test, requiring that the taxpayer meet his or her burden of proof

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upon tax authority challenge. To meet this burden, contemporaneous record keeping is certainly the most useful evidence to a taxpayer.

Once the threshold tests have been met for classification as a real estate professional, the activity will not be deemed to be passive under the Internal revenue Code. As such, the NIIT will not apply to income earned from those activities.

The Internal Revenue Service's final interpretive regulations provide further guidance and clarification on the application of the 3.8% tax to rents, including self-rentals. Importantly, the final regulations reverse a position in the earlier proposed regulations, and now allow rental income from a self-rental arrangement to be excluded from NII in certain circumstances.

A very typical self-rental arrangement is one where a business owner establishes a separate entity, such as an LLC or limited partnership, intended to own property that will then be rented to a related trade or business entity in which they have an active involvement and materially participate. As noted earlier, under the passive activity loss rules imposed by the Tax Reform Act of 1986, rental operations are always defined as passive activities unless a specific exception can be identified and its requirements met.

The thrust of the planning opportunity for having self-rentals escape the passive activity taint, again, goes to grouping or combining activities. If that related business activity is held in a pass-through tax entity (i.e., LLC, partnership or S corporation), its owners are able to make a one-time election to combine the rental activities with the trade or business activities so long as those activities grouped together constitute an appropriate "economic unit." The final regulations permit taxpayers to make another one-time election to adopt a more-advantageous grouping if they should find that they are subject to this new net investment income tax.

For many taxpayers, rental activities have already been properly grouped and, as such, can become part of the taxpayer's trade or business activity. If the taxpayer/business owner spends sufficient time with respect to their involvement in this combined trade or business activity (one "bright line" test is 500 hours or more annually), then that taxpayer/owner is considered active for the entire group (the operating business and the rental activity), and this is treated as a nonpassive activity. So long as the rental activity is found to constitute a "trade or business," the 3.8% net investment income tax will not apply.

The regulations, as finalized, do not provide an absolute bright-line test or safe harbor as to what rents are considered to be received in the ordinary course of a trade or business. This determination is based on all of the facts and circumstances relative to the rental activity. The regulations specifically provide that the fact that this self-rental activity is treated as nonpassive under the passive activity loss regulations is not sufficient to avoid

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this 3.8% tax unless the rental activity itself is considered a trade or a business activity under IRC Section 162, the provision of the Internal Revenue Code that most often addresses the term trade or business.

Those rental activities that are at the highest level of risk of not qualifying as a trade or business are those activities that are established as "triple net leases." These types of leases generally require that the lessee is responsible for maintenance, repairs, insurance and taxes (and, as a result, the lessor is unlikely to perform significant activities related to the property). There are a variety of cases in other areas of the tax law where this same conclusion has been rendered, leading one to the conclusion that successfully defeating such a challenge by the Internal Revenue Service is less than likely. In order to qualify a rental activity as a "trade or business," the rental activity has to be more than a simple investment activity. Triple net lease activities are most easily construed as investment activities.

There are, of course, certain steps that can be undertaken to alleviate some of the risk of IRS challenge. In order to better position the rental operation to meet the trade or business requirement, it should be established as a gross lease. The lessor should pay all of the expenses related to this leased property and increase the rental rate to cover these expenses that are legally the responsibility of the lessor.

In addition, it is helpful if the lessor provides some services related to this leased property. As an example, in any real estate rental, the landlord should consider the provision of general maintenance and janitorial services, trash removal, repairs and painting, lawn maintenance and snow removal, pest control, window cleaning and utilities, even if these services are currently provided by independent contractors. Based on numerous decisions and rulings in other areas of tax law, having these services and expenses paid by the landlord would support the position that the rental activity is a trade or business operation and may help win the day, should the rental activity's trade or business status be challenged.

*Category III*

Category III, as noted above, includes net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property, other than property held in a trade or business that is not described in Category II. Gains and losses from dispositions of trade or business property used in passive activities are included in calculating the NIIT.

The Category III elements of the NII determination for purposes of applying the additional 3.8% Medicare tax has garnered much attention since the law's passage. In determining a taxpayer's NII from this category, it is important to reiterate that any and all deferral provisions of the Internal Revenue Code apply. As such, only gains recognized for regular income tax purposes will be considered in determining NII subject to the tax.

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In addition, capital losses are included in the determination of NII. To the extent that gains are not otherwise offset by capital losses, the following gains are common examples of items taken into account in computing net investment income:

- Gains from the sale of stocks, bonds, and mutual funds.
- Capital gain distributions from mutual funds.
- Gain from the sale of investment real estate (including gain from the sale of a second home that is not a primary residence).
- Gains from the sale of interests in partnerships and S corporations (to the extent the partner or shareholder was a passive owner).

The NIIT does not apply to any amount of gain that is excluded from gross income for regular income tax purposes. The pre-existing statutory exclusion in Section 121 exempts the first $250,000 ($500,000 in the case of a married couple) of gain recognized on the sale of a principal residence from gross income for regular income tax purposes and, thus, from the NIIT.

The following examples, adapted from the IRS website, address this matter:

- ***Example G*** – Mark, a single filer, earns $210,000 in wages. He sells his principal residence that he has owned and resided in for the last 10 years for $420,000. Mark's cost basis in the home is $200,000. As a result, his realized gain on the sale is $220,000. Under section 121, Mark may exclude up to $250,000 of gain on the sale.

  Because this gain is excluded for regular income tax purposes, it is also excluded for purposes of determining net investment income. Thus, the NIIT does not apply to the gain from the sale of Mark's home.

- ***Example H*** – Beth and Chad, a married couple filing jointly, sell their principal residence that they have owned and resided in for the last 10 years for $1.3 million. Beth and Chad's cost basis in the home is $700,000. As a result, their realized gain on the sale is $600,000.

  The recognized gain subject to regular income taxes is $100,000 ($600,000 realized gain, less the $500,000 section 121 exclusion). Beth and Chad have $125,000 of other NII, which brings their total NII to $225,000.

  Beth and Chad's modified AGI is $300,000, which exceeds the threshold amount of $250,000 by $50,000. As such, they are subject to the NIIT on the lesser of $225,000 (Beth and Chad's NII) or $50,000 (the amount Beth and Chad's modified AGI exceeds the $250,000 married filing jointly threshold). Beth and Chad owe NIIT of $1,900 ($50,000 x 3.8%).

# Planning in a Changing Tax Environment

## Gains on the Sale of Pass-through Business Interests

Ownership interests in pass-through business entities, including partnerships and S corporations, present an additional complex consideration in the determination of net investment income. While the gains subject to NII will increase the NIIT, the rules allow for a distinction between a sale or taxable disposition of those pass through business entities that constitute trade or businesses to the equity owner and those that do not, and are therefore deemed passive. This topic will be discussed in depth later in these materials, in conjunction with issues affecting business taxpayers.

## Kiddie Tax Rules

An additional planning consideration surrounds the applicability of the NIIT to investment income that is included in a parent's income tax return because of the "Kiddie Tax" rules. The amounts of NII that are included on a taxpayer's Form 1040 by reason of Form 8814 - *Parents' Election to Report Child's Interest and Dividends* (the Kiddie Tax) are included in calculating net investment income. However, the calculation of NII does not include (a) amounts excluded from Form 1040 due to the threshold amounts on Form 8814 and (b) amounts attributable to Alaska Permanent Fund Dividends.

## Concluding Thoughts

In summary, the reach of the NIIT is exceptionally broad, and as the Affordable Care Act is rolled out, it is not difficult to envision an increase in the 3.8% rate to add additional funds to the financing pool. Given this likelihood, it is critically important to fully understand the mechanics and application of these rules to all taxpayers who may find themselves subject to them.

# Planning in a Changing Tax Environment

## *Chapter III – Tax Planning Strategies for Individuals*

Tax planning, in light of the multi-dimensional tax regimes previously discussed, has never been more complex. However, due to the extraordinarily high rates and the "hidden" tax rate increases attributable to the various phaseouts of personal exemptions and itemized deductions, as well as the broadening application of the net investment income tax and the alternative minimum tax, prospective tax planning is not only a wise endeavor, but one that is absolutely necessary. Regularly taking a close look at current and future tax liabilities is critical to tax minimization and retention of taxpayer wealth.

The problem arises, however, as to how best undertake such an exercise when new tax changes are being proposed on an almost-daily basis. As stated in the introduction to today's program, flexibility is, perhaps, the most critical element to build into any income tax planning strategy, as the likelihood of change in the law is always high. In 2015, more than in many recent years, Congress and the President seem to be lining up to the task of major tax reform. While results speak significantly louder than words, there seems to be a full head of steam building towards this result, either this year or in the not-too-distant future.

An additional challenge facing many taxpayers is state and local income tax rate increases. Many states, as well as various local municipalities within those states, continue to look to higher marginal tax rates as an answer to growing revenue needs. The "cost" of these tax increases is exponential, in that the federal tax savings opportunities traditionally associated with these liabilities are more restrictive than ever, given the alternative minimum tax and the itemized deduction phaseouts. The Commonwealth of Pennsylvania is no exception, with newly-elected Governor Wolf already proposing a substantial tax increase for high earners (those with Pennsylvania taxable incomes over $90,000).

All in, taxpayers in Pennsylvania, could find themselves paying tax at the highest marginal tax rate of 39.6% for Federal income tax; approximately another 3% for the average cost associated with the phaseouts; an additional .9% for the additional Medicare tax on earned income; another 3.8% on net investment income; nearly 4% on state gross income; and 1%-2% local earned income tax on gross income. The impact of all of these taxes results in an overall marginal tax rate of 45% or higher.

It is important to remember that tax planning goals are paramount to establishing strategies that are effective for any particular taxpayer. While facts and circumstances can vary widely from one taxpayer to the next, fundamental tax planning goals can generally be reduced to the following list of priorities:

- Reduce the current year's income tax liability.
- Defer the current year's tax liability to future years.



- Reduce any potential future years' tax liabilities.
- Maximize the tax savings from allowable deductions.
- Minimize the effect of the alternative minimum tax on the taxpayer's tax liability.
- Take advantage of available tax credits.
- Maximize the amount of wealth that stays in your family.
- Minimize capital gains tax.
- Minimize the Medicare Contribution Tax on net investment income.
- Avoid penalties for underpayment of estimated taxes.
- Increase availability of cash for investment, business or personal needs by deferring your tax liability.
- Manage your cash flow by projecting when tax payments will be required.
- Minimize potential future estate taxes to maximize the amount left to your beneficiaries and/or charities.
- Maximize the amount of money available to fund your children's education and your retirement.

## Planning Opportunities

To temper the sharp edge of the tax knife, there are common strategies that are tried and true and can serve, if applicable, to substantially reduce the pain of the onslaught of higher taxes. These items are discussed in some detail in the following sections.

### *Controlling the Timing of Income*

While timing of income is often difficult and may be beyond an individual taxpayer's ability in many cases, timing the receipt of certain types of income can often prove fruitful and advantageous. Of course, the timing is wholly-dependent on facts and circumstances surrounding each specific case. Examples of those items that are, at least sometimes, within the control of a taxpayer, follow.

- **Cash Salaries or Bonuses** – Taxpayers anticipating their 2015 ordinary income tax rate to be lower than their 2016 rate can accelerate salary or bonuses into 2015. There can be limitations on amounts that can be accelerated so care must be exercised in adopting such strategies. Alternatively, if taxpayers anticipate their 2016 income tax rate being lower than their 2015 rate, it may make sense to defer such income until next year, provided the income is not constructively received (made available to you in the current year).

# Planning in a Changing Tax Environment

A key element of consideration in adopting such strategies is the risk associated with ultimately receiving the income. If the taxpayer chooses to defer income, the question must be addressed as to how much risk this strategy adds to the later payment.

Another often-overlooked item is the time value of money. Even if a taxpayer's 2015 rate is higher, the earning power (return on investment) on the deferral of income into 2016 must be considered in making such choices. With the position of current short-term interest rates, such considerations are less meaningful.

- **Consulting or Other Self-Employment Income** – If the taxpayer is a cash-basis business and anticipates the current year's tax rate to be lower than next year's rate, income can be accelerated into the current year. Otherwise, those same businesses would want to defer such income.

- **Retirement Plan Distributions** – If a taxpayer is over age 59½ and has a low tax rate in this year, he/she may consider taking a taxable distribution from his/her retirement plan (even if it is not required), or consider a Roth IRA conversion. The law that allowed individuals age 70½ and over to make tax-free distributions of up to $100,000 from individual retirement accounts (IRAs) to public charities expired on December 31, 2014. The provision allowed an individual to exclude the distribution from income; thereby, reducing the limitations based on a percentage of AGI and also reducing state income taxes by reducing state taxable income. However, this taxpayer-favorable option is no longer available.

## Taxes and Investments

No matter why a taxpayer is investing, finding ways to lower taxes on investment income can help taxpayers keep more of their earnings.

### *Investment Sales*

Taxpayers will want to pay attention to holding periods when they are investing outside of a tax-advantaged account. If securities are held for longer than one year before selling them (long-term), any capital gain realized on the sale will be taxed at a favorable rate. In contrast, capital gains on investments held for one year or less (short-term) are taxed at the taxpayer's higher ordinary tax rate. The chart on the next page compares the capital gains tax rates.

Note that the President's budget for 2016 includes a proposal to increase the 20% capital gains tax rate to 28%. While it is unlikely that such a provision would move forward with a Republican Congress, taxpayers should be careful to monitor developments throughout 2015 to ensure that they time their capital gains transactions to obtain the best rate possible.

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### TAX RATES ON CAPITAL GAINS
### (FOR TAX YEARS BEGINNING IN 2015)

| *Holding Period* | *Taxpayer Tax Bracket* | *Capital Gain Rate* |
|---|---|---|
| More than 1 year* | 10% - 15% | 0% |
| | 25% - 35% | 15% |
| | 39.6% | 20% |
| 1 year or less | 10% - 39.6% | same as ordinary tax rate |

** Long-term capital gain on the sale of collectibles or depreciable real estate is taxed differently. A maximum rate of 28% applies to collectibles gain, and a maximum rate of 25% applies to real estate gain, to the extent of prior allowable depreciation.*

*Qualified Dividend Income*

Another source of income that could provide advantageous tax outcomes is qualified dividend income since that income is taxed at the same favorable rates that apply to long-term capital gains. A key requirement for the lower dividend rates is that the taxpayer must hold the underlying stock for a minimum of 61 days during the 121-day period beginning 60 days before the stock's ex-dividend date. The minimum holding period is longer for certain preferred stock dividends.

Selling appreciated investments and dividend-paying stocks prior to meeting the applicable holding period to qualify for long-term capital gains rates is inordinately expensive and can cost significant tax dollars. Of course, taxes are only one factor to be considered when making decisions about when to sell investments. Seeking guidance from a registered investment advisor is always best when making investment decisions.

## Try to Benefit from the 0% Rate

Taxpayers generally owe no federal income tax on long-term capital gains and qualified dividends if total taxable income, including the gains and dividends, is less than the top of the 15% tax rate bracket for that particular taxpayer's filing status. If senior-generation income is too high to qualify for this 0% tax rate, perhaps a family member can take advantage of it.

This is an excellent tool for saving taxes while moving value. If a taxpayer has a son or daughter to whom they anticipate gifting money, it may be beneficial to gift appreciated capital stock and let the donee sell the

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shares. While the junior generation would be required to recognize a capital gain due to assuming the same cost basis as the donor(s), there may be a significant tax savings if their income tax brackets are lower than the donor(s). Note that this may not be as beneficial if children are under age 18 at the end of the tax year, and the Kiddie tax is invoked.

## Use Capital Losses

Taxpayers may use capital losses to offset capital gains and up to $3,000 of ordinary income ($1,500 if married filing separately). Any additional capital losses are carried forward for deduction in later tax years, subject to the same limits.

## Reduce Exposure to the 3.8% Net Investment Income Tax

As discussed in Chapter II, when modified AGI is more than $200,000 ($250,000 on a joint return or $125,000 if married filing separately), investors can be hit with an additional 3.8% Medicare tax. The tax applies to the lesser of the net investment income or the amount by which modified AGI exceeds the applicable threshold.

Investment income for NIIT purposes includes taxable interest, dividends, annuities, royalties, rents, net capital gain, and income earned from passive trade or business activities. It does not include municipal bond interest or distributions from tax-deferred retirement plans.

Various timing strategies may be effective in controlling exposure to the 3.8% surtax, particularly if the taxpayer's modified AGI is close to the threshold that triggers the tax. Other potential planning steps include:

- Increasing contributions to qualified retirement plans
- Strategically taking capital losses to offset capital gains
- Transforming passive business activities into active business activities by increasing participation in the activities
- Deferring capital gains through the use of installment sales

## Consideration of an Installment Sale

When a taxpayer sells appreciated property and will receive at least one payment after the year of sale, using the installment method allows for the deferral of income taxes by recognizing the profit over time as payments are received. Note that the installment method is not available for sales of publicly-traded securities and certain other sales. The example on the following page illustrates how this strategy can be used by taxpayers.

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- *Example* – Don is selling land that he purchased several years ago for $100,000. The selling price is $300,000, and there are no outstanding mortgages on the property. His sale will create a $200,000 capital gain.

  Don allows the buyer to pay the purchase price in equal installments of $60,000 (plus interest) over five years. That way, the tax on his $200,000 gain will be spread out over five years.

*Real Estate and Other Non-Publicly Traded Property Sales*

If you are selling real estate or other non-publicly traded property at a gain, you would normally structure the terms of the arrangement so that most of the payments would be due next year. You can use the installment sale method to report the income. This would allow you to recognize only a portion of the taxable gain in the current year to the extent of the payments you received, thereby allowing you to defer much of that tax to future years.

## Bonds and U.S. Treasury Bills

*Compare Bond Yields*

Interest received from most municipal bonds is free of federal income tax, including the 3.8% net investment income tax. A comparison of the yields on a municipal bond and a taxable bond can be undertaken by calculating taxable equivalent yield.

Be cautious about investing in private activity municipal bonds if there is a likelihood of being subject to the AMT. Although tax exempt for regular income-tax purposes, the interest on most private activity bonds must be included in income for purposes of calculating the AMT.

*U.S. Treasury Bill Income*

If you have U.S. Treasury Bills maturing early next year, you may want to sell these bills to recognize income in the current year if you expect to be in a lower tax bracket this year than next year.

## Retirement Contributions

Investing through an IRA or an employer-sponsored retirement savings plan, such as a 401(k) plan, can offer substantial tax deferral benefits. Moreover, any earnings in your account compound tax deferred, thereby helping the assets in the account grow faster than it would if taxes were taken out each year.

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**HOW MUCH CAN TAXPAYERS CONTRIBUTE?**
**(FOR TAX YEAR 2015)**

| *Type of Plan* | *Under Age 50* | *Age 50 or Older (with catch-up)* |
|---|---|---|
| 401(k), 403(b), 457 plan | $18,000 | $24,000 |
| IRA (traditional and/or Roth) | $5,500 | $6,500 |

Other plan limits may apply. Not all employer plans allow participants age 50 or older to make catch-up contributions, and certain 403(b) and 457 plans have special catch-up provisions. You must have compensation to contribute to an IRA.

Some 401(k) plans give participants a choice of making either pre-tax contributions or after-tax Roth contributions. Pre-tax contributions lower the taxpayer's current tax bill, but he/she will pay taxes at ordinary rates on both the contributions and account earnings upon distribution from the plan. Roth contributions do not save current taxes. But after a taxpayer has reached age 59½ and satisfied a five-year waiting period, account distributions – including earnings – are tax free.

Contributions to a traditional IRA are deductible if the taxpayer does not actively participate in an employer-sponsored retirement plan. If the taxpayer is a plan participant (or his/her spouse is), deductions for IRA contributions are subject to AGI-based restrictions.

## Making the Most of Deductions

Planning for deductions can be just as important as planning the timing of income. The following discussion provides some additional ideas for making the most of the deduction opportunities available in 2014 and 2015, under current law.

### *Look Above the Line (the Adjusted Gross Income Line)*

Deductions claimed in computing adjusted gross income (also called above-the-line deductions) are particularly valuable because many tax breaks are limited or unavailable when AGI is more than a specified threshold. Personal exemptions are phased out and various itemized deductions are reduced when a taxpayer's AGI surpasses the thresholds shown on the following page.

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## WILL YOUR EXEMPTIONS OR DEDUCTIONS BE REDUCED?

| *Filing Status* | *2015 AGI Threshold* |
|---|---|
| Single | $258,250 |
| Married filing jointly | $309,900 |
| Head of household | $284,050 |
| Married filing separately | $154,950 |

Each personal exemption to which a taxpayer is entitled to deduct in full (for himself, his spouse and their dependents) will reduce taxable income by $4,000 in 2015. However, once AGI goes over the threshold shown in the table above, the exemptions start to be phased out. In this situation, increasing above-the-line deductions could help taxpayer(s) retain the benefits of their exemptions.

A partial list of items that are potentially deductible above-the-line is included below. Various limits apply to these deductions.

- Alimony paid
- Self-employed retirement plan contributions and medical insurance premiums
- Traditional IRA contributions
- Health savings account contributions
- Expenses of a work-related move
- Student loan interest

*Bunch Expenses*

Medical expenses are deductible to the extent they (in aggregate) exceed 10% of AGI. The deduction "floor" is a little lower – 7.5% of AGI – if the taxpayer or the taxpayer's spouse is age 65 or older. A still lower floor – 2% of AGI – applies to miscellaneous itemized deductions.

The income floors make it even more important to know what is deductible and requires that taxpayers track their expenses carefully. Medical expenses can add up quickly when considering health insurance premium payments (including Medicare Part B premiums), co-pays and deductibles. Amounts paid for dental care, eye

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exams, eyeglasses and contact lenses needed for medical reasons also count as medical expenses. Examples of miscellaneous itemized deductions include tax return preparation fees, investment management fees, union and professional dues and other unreimbursed employee business expenses.

When it is possible to do so, bunching medical or miscellaneous expenses in one tax year could help a taxpayer to exceed the applicable floors and gain a deduction for a portion of his/her expenses.

*Deduct Charitable Contributions*

Donations to qualified charities are potentially deductible as an itemized deduction. Noncash donations are generally valued at fair market value for deduction purposes, although certain exceptions apply. For large donations of property, an appraisal may be required. If a taxpayer intends to deduct charitable contributions, it is wise to keep the records needed to support the deduction.

Volunteers may deduct various expenses associated with their volunteer work (such as travel) if the charity does not reimburse them, and other requirements are met. Taxpayers can use the standard mileage rate – 14¢ per mile (plus parking and tolls) for driving while performing services for a charity – or deduct actual expenses.

Donating appreciated securities held longer than one year can be a tax-smart strategy that allows taxpayers to avoid capital gains tax (and, possibly, the 3.8% surtax) on the stock's appreciation.

The charitable deduction is one of the itemized deductions that can be subject to an AGI-based limitation. When the limitation applies, the affected deductions are reduced by 3% of AGI in excess of the amount shown in the table on page 34.

## In Summary

As noted earlier, individual tax planning is a task best tied to the specific facts and circumstances facing each taxpayer. While customization of the above-discussed strategies is always required, taxpayers can count on these opportunities as foundational blocks for the process, yielding a strong starting point for the identification and implementation of more complex and technical strategies.

# Planning in a Changing Tax Environment

## *Chapter IV – Tax Rules Affecting Business Taxpayers*

While the focus of our materials so far has been on individual tax concerns and planning matters, we will now focus on tax-related matters that affect businesses and their owners. Numerous tax-related business changes have been implemented over the last several years that can adversely impact the cash flow of a business with the ultimate trickle-down to the individual owners of these businesses. These changes are important for pass-through entities, as well as for C corporations.

Owners and their businesses need to be attentive to the current legislative process as well as the expectations of a new Congress and the plans set forth by the President (discussed in further detail in Chapter VI). Today's business owners must constantly evaluate tax-related risks resulting from changing laws, changing tax rates, aggressive taxing jurisdictions and, of course, a complex set of laws that are increasingly difficult (if not impossible) to comply with.

With the somewhat recent increase in the top individual tax rates (American Taxpayer Relief Act of 2012), many practitioners have jumped on the bandwagon that leads to a place where conversions of pass-through entities to C corporations is the wave of the future. Our firm does not necessarily see it that way and certainly would not opine that any such conversion is clearly the right answer in every situation. While this option may be a good idea in some cases, it is not something that fits every taxpayer and, in many situations, would be a horrible mistake. This issue will be discussed further in Chapter V.

Chapters IV and V of our materials will discuss business-related tax matters and will set forth some considerations that we feel are important and relevant to many of our clients. This chapter will address many of the issues that we see as being important for 2014 and 2015. Chapter V will focus mainly on business planning strategies for 2015, taking into consideration the possibility of major tax reform in the future. Within Chapter V, we will consider the options and strategies one would consider with regards to entity structuring or, possibly, converting from one form of tax structure to some alternative tax structure.

The sections that follow are important areas that we consistently address with our small/middle-market sized clients. To clarify what the small/middle-market means in this context, we will assume that we are referring to start-up companies who, perhaps, have only  a few million dollars of sales to companies that may have several hundred million dollars of sales. While this range includes a large size difference, it is important to know that the tax consequences and/or problems that we encounter are often very similar for all sizes of businesses. Some of these specific issues that we anticipate for tax years 2014 and 2015 are discussed in the following sections.

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## Effect of the Net Investment Income Tax (NIIT) on Pass-through Businesses

The effects of this tax on individual taxpayers was discussed in detail in Chapter II. As the tax relates to businesses, it is important to understand that there is a direct correlation between pass-through entities and the tax consequences of the individuals who own these entities. Proper tax planning for any pass-through entity will require a detailed understanding of the tax position of all of the owners of the entity. This fact is true whether one is considering tax planning ideas for an S corporation or a partnership that has any individual and non-individual owners. A well-thought-out tax plan must consider the tax consequences for the ultimate taxpayer to really make sense. Because of this fact, proper NIIT tax planning is critical to both the individual who will pay the tax as well as the entity that is producing the investment income.

As discussed in earlier chapters, the NIIT has been around since the beginning of 2013. While the NIIT is generally thought of as a tax on the wealthy, the fact that many small business owners are subject to this tax demonstrates that the NIIT applies to many taxpayers who wouldn't be considered "rich" under normal circumstances. An owner of a pass-through entity may be considered a "higher-income individual" simply as a result of having an ownership interest in a pass-through entity and, thus, being subject to tax on the flow-through income.

Government statistics show that 80%-90% of all businesses are "small" flow-through businesses, with their owners being responsible for the tax liability that results from any taxable income that is generated by the business. As a result of this fact, many of these small businesses were, and continue to be, adversely affected by the increase in the individual income tax rates that began in 2013. The creation of the NIIT is one of the new taxes that resulted from the Affordable Care Act that has affected many small/middle market businesses. Any increase to individual income tax rates will ultimately have a negative impact on flow-through entities. The following chart shows the individual tax rate differences between the old law (pre-2013) and the new laws that are currently in effect:

| | *Before 1/1/13* | *After 1/1/13* |
|---|---:|---:|
| Highest marginal income tax rate | 35% | 39.6% |
| Net investment income tax rate | 0 | 3.8% |
| Effective tax rate resulting from phaseouts | 0 | 2.5% |
| **Total tax rate** | **35%** | **45.9%** |

While this increase in the overall tax rate will not affect all taxpayers, it will have a significant impact on many businesses, and this effect will certainly trickle down and change how these businesses are operated. Generally, a

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flow-through entity will distribute cash to its owners in an amount that will at least allow the owners to pay their tax liabilities on the income that flows through from entity. Before the increase in individual tax rates, this federal distribution percentage did not need to be more than 35% of total net taxable income (before any state tax effect).

As a result of the tax rate changes and additional new taxes, the new federal tax distribution rate can be as high as 46%, which is a 32% increase over prior law. Ultimately, the additional cash flow required to make up this difference will need to come out of operating cash flow of the business. This reduction in operating cash flow will reduce the cash flow available to acquire new machinery and equipment or, possibly, to hire more workers. At the end of the day, while Washington attempted to sell these tax increases as being taxes on the "wealthy," those of us working with small/middle market businesses generally believe that these changes had a significant adverse effect on the small/middle market business community.

One of the main problems with the NIIT and how the tax ties into pass-through entities is that it is inconsistent in its treatment of the owners. There are special rules for determining who is subject to the NIIT when the income is generated by a pass-through entity. These special rules require "passive" investors to pay the NIIT on their pass-through income; whereas, an "active" investor would be exempt from the tax (discussed in more detail in Chapter II). As a result of these special rules, two equal owners in a pass-through entity will very often have different tax consequences on the same level of income that flows through to them. For tax distribution purposes, this inequality in tax will generally require the entity to distribute tax at the higher rate to prevent owners from having to come out-of-pocket to pay tax on the flow-through income.

In most cases, since cash distributions are generally required to be made on a pro-rata basis, this causes additional cash flow to be distributed out of the entity and, often, will provide an active investor with an excess distribution that will not need to be used to pay tax. In effect, two different owners who have the same equity interest in an investment will have different tax consequences and, thus, a different return on investment. This difference is a permanent difference that will not true itself up in the future.

There are some ways to plan around the NIIT problem, but one needs to be careful in the approach that is taken. For example, a partner in a partnership could argue that he/she is actively participating in the partnership so that NIIT can be avoided. However, while this argument may be sustainable, the end result could be problematic because that taxpayer may now be subject to self-employment tax on the same income, ultimately producing a similar amount of tax.

The NIIT issue is somewhat new, and we have only begun to deal with the tax consequences of this tax. Larger, more significant problems will arise in the future as investments are sold and the owners begin to be subject to

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the NIIT on large capital gains upon the disposition of a pass-through investment that is considered a passive investment. Careful and up-front planning for these issues is critical to ensure that the ultimate tax liability can be kept to a minimum.

## Tangible Property Regulations (TPR) Effective for Tax Years Beginning in 2014

After a long and drawn-out process that spanned a period of several years, the revision of the regulations concerning the capitalization and repair of tangible property finally came to a close and were made effective beginning with tax year 2014. These final regulations focus on the rules governing when taxpayers must capitalize and deduct their expenses for acquiring, maintaining, repairing and replacing tangible property. The difference between expensing and capitalizing can be a significant one for many taxpayers. Expensing results in an immediate deduction on the tax return. Capitalization, on the other hand, will result in the same deduction being spread over several years.

Treasury Decision 9636 was issued on September 19, 2013, and Revenue Procedure 2014-16, dealing with the accounting-method changes needed to comply with the regulations, was issued on January 24, 2014. The regulations were effective January 1, 2014. Several changes were made with the final regulations' issuance; however, the final regulations are largely the same as the temporary regulations. The main purpose of the regulations for the IRS is to limit controversies and improve efficiency by eliminating the use of a "facts and circumstances" approach and moving to a more objective set of standards.

According to Code Section 263, taxpayers are required to capitalize amounts paid to acquire, produce or improve tangible property. This is in contrast to Code Section 162, which allows the deduction of ordinary and necessary business expenditures, including those for supplies, repairs and maintenance. The main question being addressed with these regulations is in regard to when a taxpayer should capitalize an expenditure (§263) versus when the taxpayer can deduct an expenditure (§162).

Within the regulations, the IRS has established several classes of business items: materials and supplies (non-incidental and incidental); rotable parts; temporary parts; emergency spare parts; and standby emergency spare parts. The rules relating to each specific class are well beyond the scope of this presentation and these materials. More detailed information can be found on our website at http://gyf.com/repair-regs/.

Along with the consideration of the definitions and rules surrounding the previously-mentioned items, taxpayers must also consider a general de minimis rule, as well as other matters including the potential for taxpayers to be required to file for a change (or several changes) in accounting method beginning with tax year 2014.

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Unfortunately, the implications of these regulations caused significant scrutiny from taxpayers, CPAs and the American Institute of Certified Public Accountants. The primary complications of the new legislation for taxpayers and their advisors were:

- The significant cost of compliance for what results in a timing difference.
- The fact there were (originally) no "bright-line" rules and facts and circumstances tests would eventually create tensions between the IRS and taxpayers and cause situations where there are really no right answers.
- The lack of a small business exemption from these rules.

These new regulations are very complex, and all taxpayers were initially required to comply with them. In effect, the rules required taxpayers to review previously-filed returns, complete a "scrubbing" of depreciation schedules in the current year, and calculate cumulative adjustments to taxable income for prior years under the presumption that these new rules had always been in place. The practical application of the new rules is exceedingly complex and would create a huge problem for smaller business that do not have the resources to do the work.

For months, the practitioner community lobbied to have these rules revoked, or at least made effective on a prospective (as opposed to a retroactive) basis. Finally, on February 13, 2015, some relief was granted when the IRS released a new revenue procedure (modifying Rev. Procedure 2015-14 released earlier in the year), providing a simplified process of applying the final 2013 Tangible Property Regulations (TPRs) for small businesses.

The newly-issued Revenue Procedure 2015-20 outlines a simplified procedure for small businesses to comply with the final TPRs. The simplified procedure is available beginning with the 2014 return that taxpayers are filling out this tax season. In effect, the new rules apply, but only on a "go-forward" basis. This is a very important change and reflects the Internal Revenue Service's good faith effort to modulate its rules to the common good of America's small businesses. The new Revenue Procedure does the following:

- Allows small businesses to change a method of accounting under the final tangible property regulations on a prospective basis for the first taxable year beginning on or after January 1, 2014; and
- Waives the requirement to complete and file Form 3115 – Request for Change in Accounting Methods, as required by the final regulations, for "small" business taxpayers that choose to use this simplified procedure for 2014.

As noted, the new simplified procedure is generally available only to "small" businesses. By definition in the new Revenue Procedure, small businesses include businesses with assets totaling less than $10 million on January 1, 2014, or average annual gross receipts for the past three years totaling $10 million or less.

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Note that this definition imposes an "either-or" requirement to qualifying for the new simplified procedure. As such, even if taxpayers are outside the threshold for either total assets or receipts, they may still qualify under the other threshold.

Many of the important aspects of the final regulations still apply to small businesses, but this announcement and Revenue Procedure should be viewed with great relief by those qualifying for the simplified procedure. For those entities that do not qualify as a small business, the final TPRs will apply for tax years beginning in 2014.

## Tax Extenders Legislative Update

With time running out just before the holidays, Congress passed the annual "extenders" package to maintain certain tax law provisions from the 2013 tax year. The extenders were passed via the Tax Increase Prevention Act (HR 5771) by the Senate on December 16, 2014, 13 days after the House of Representatives passed the bill by a vote of 378-46. Although many tax laws were extended under this bill, they were only extended for one year and apply solely to the 2014 tax year. Thus, each of the issues must be revisited in 2015.

While there are over 50 extenders, (details on our website at http://gyf.com/tax-increase-prevention-act/), the two most relevant business provisions of the bill (for our clients) are noted below.

### *Bonus and §179 Depreciation*

The Tax Increase Prevention Act extended Bonus Depreciation at 50% for property placed in service before January 1, 2015. The Bonus Depreciation rules apply solely to "original use" property (i.e., new property). Therefore, Bonus Depreciation may not be claimed for used property purchased and placed in service by a taxpayer.

Additionally, taxpayers may continue to expense up to $500,000 (for 2014) with an investment limitation of $2 million under §179. The §179 expense may be claimed for amounts paid for either new or used property placed in service; however, the amount of the expense is reduced dollar for dollar-for-total asset expenditures spent in excess of the $2 million investment limitation.

*Planning Comment – These two provisions allow many taxpayers to save significant tax dollars and provide many alternative planning ideas not only with respect to the timing of capital assets, but also with respect to minimizing tax rates for multiple periods. Due care should be taken to properly plan and consider the many alternatives that are available with regard to tax depreciation elections.*

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*Research and Development Tax Credit*

The Research and Development tax credit did not change as a result of the Tax Increase Prevention Act; rather, the bill maintained the credit as it was for the 2013 tax year. The credit allows taxpayers to claim a credit for up to 20% of the costs of qualified research expenditures.

***Planning comment*** ***– The research tax credit is one of the tax code's most often missed benefits. For those taxpayers who qualify for the credit, the cost of detailed research and development tax credit study is well worth the expense and in many cases, ends up being only a fraction of the total tax credits generated.***

## Complying with the Affordable Care Act – More Headaches to Come

*More Delays for the ACA*

In 2014, the Obama administration postponed, for another year (until 2016), the Patient Protection and Affordable Care Act's mandatory employer and insurer reporting requirements for businesses with 50-99 full-time employees. Under the new rules, the imposition of any employer-shared responsibility penalty payments is waived for 2015, allowing medium-sized employers with 50-99 workers to avoid providing health insurance to their employees or facing penalties until 2016. Employers are not allowed to cut their workforces in order to fall within the transition relief.

The White House still finds itself under fire from many employers who complain that the reporting rules are too complex to properly comply with them in time. The mandate was initially set to take effect in January 2014, but the White House announced its first delay in July 2013, initially giving large employers (100 or more FTEs) until January 2015 to comply.

The final employer shared responsibility regulations (otherwise known as the employer mandate) provide significant transition relief for both medium-sized and large employers. The final regulations had applied to periods after December 31, 2014; however, employers may rely on them prior to that.

*Major Transition Relief*

The IRS, which has a lot of experience transitioning the application of complex sets of new rules to employer plan sponsors, stepped forward with serious transition relief for employers. Under the original rules, employers with 50 or more full-time employees were required to offer minimum essential coverage to at least 95% of their

# Planning in a Changing Tax Environment

full-time employees by 2015 to avoid being assessed a shared responsibility payment (i.e., a penalty). Under the transition relief, the shared responsibility rules will generally apply to larger firms with 100 or more full-time employees starting in 2015, and employers with 50-99 full-time employees starting in 2016. To avoid a payment for failing to offer health insurance coverage, applicable employers need to offer coverage to 70% of their full-time employees in 2015, and 95% in 2016 and beyond.

*2015 Relief*

The final regulations import the original transition rules that were in place when the start date was set for 2014. A major feature of this transition relief is that employers will not have to include dependent coverage until 2016. In addition, to help employers subject to shared responsibility rules for the first time, employers can determine whether they had at least 100 full-time or full-time equivalent (FTE) employees in the previous year by reference to a period of at least six consecutive months, instead of a full year. Employers with plan years that do not start on January 1 will be able to begin compliance with employer responsibility at the start of their plan years in 2015, rather than on January 1, 2015.

*Full-Time Employees*

The final regulations clarify the rules regarding which employees count as full-time. Volunteer hours worked for a government or tax-exempt entity (such as volunteer firefighters) will not cause them to be considered full-time employees. Teachers will not be treated as part-time for the year simply because their schools are closed during the summer. Employees whose positions customarily last for six months or less generally are not to be considered full-time employees. Service performed by students under federal- or state-sponsored work-study programs is not counted in determining whether the students are full-time employees. Colleges seeking a bright-line rule may credit adjunct faculty with 2¼ hours of service per week for each hour of teaching or classroom time.

***Affordability***

The final rules adopt the safe harbors found in the proposed regulations for determining whether coverage offered by employers is affordable to employees. The safe harbors allow employers to use the wages they pay, their employees' hourly rates, or the federal poverty level in determining whether employer coverage is affordable.

***Look-Back Period***

The final rules adopt the approach found in the proposed regulations, allowing employers to use an optional look-back measurement method to make it easier to determine whether employees with varying hours and seasonal employees are full-time. The final regulations clarify the application of this method and the alternative monthly method of determining full-time status.

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*Final Thoughts on ACA*

Complying with the ACA will not be easy, as the law is very complex. There are many special rules, changing effective dates and different requirements that must be followed depending upon the size of the business. The key to compliance with the mandate is to be sure that your team of advisors completely understands your specific situation, the size of your workforce, the type of benefit plans you currently offer and your overall plan for providing health care in the future. In addition, it is critical that your advisors understand all the areas of the mandate so that they can help you make the right decisions to remain in compliance with these ever-changing rules.

## Report of Foreign Bank and Financial Accounts (FBAR)

In 1970, Congress passed the Currency and Foreign Transactions Reporting Act of 1970, which is commonly referred to as the "Bank Secrecy Act." This legislation requires U.S. financial institutions to assist U.S. governmental agencies in detecting and preventing money laundering. The regulations which govern the Bank Secrecy Act are issued by the Treasury Department's Financial Crimes Enforcement Network (FinCEN). These regulations require all financial institutions to submit five types of reports to the U.S. Government: Currency Transaction Report, Report of International Transportation of Currency or Monetary Instruments, Suspicious Activity Report, Designation of Exempt Person FinCEN Form 110 and Report of Foreign Bank and Financial Accounts (FBAR).

Of these reports, the FBAR has garnered the most attention over the course of the past number of filing seasons. Not only do U.S. financial institutions have a requirement to file an FBAR, each "U.S. person" having a financial interest in, or signature authority over, a bank account, securities or other financial account in a foreign country must report such relationships to the Commissioner of Internal Revenue for each year in which a relationship exists [and the aggregate value of the accounts exceeds $10,000] and must provide such information as shall be specified in a reporting form prescribed under 31 U.S.C. 5314. The current reporting form is otherwise known as FinCEN 114 and is due June 30 of the calendar year following the calendar year being reported.

*U.S. Person*

U.S. persons, as defined in 31 CFR §1010.350(b), are required to file FinCEN 114 provided they meet the qualifications prescribed above. The regulations define a "U.S. person" as: (1) [a] citizen of the United States, (2) [a] resident of the United States, or (3) [an] entity including, but not limited to, a corporation, partnership, trust, or limited liability company created, organized or formed under the laws of the United States, any State, the District of Columbia, the Territories and Insular Possessions of the United States, or Indian Tribes.

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*Reportable Accounts*

Also under 31 CFR §1010.350(c), "reportable accounts" are defined as bank accounts, securities accounts and "other" financial accounts. Bank accounts are defined under the regulations as savings deposit, demand deposit, checking or any other account maintained with a person engaged in the business of banking. Securities accounts encompass those accounts with a person engaged in the business of buying, selling, holding or trading stock or other securities. Please refer to 31 CFR §1010.350(c)(3) for a list of "other accounts."

With respect to whether an account is a reportable account, the reporting requirements do not apply to, among other examples, accounts of international financial institutions of which the U.S. government is a member.

One other element to consider when determining if a financial account is a reportable account is to analyze its location to determine whether it is located in a foreign country. A "foreign country," as defined by 31 CFR §1010.350(d), includes all geographical areas located outside the United States as defined in 31 CFR §1010.350(hhh). By way of example, if a U.S. person maintains a foreign financial account with a branch of a U.S. Bank whose physical location is outside of the United States, that account is a reportable account. Alternatively, if a U.S. person maintains a foreign financial account with a branch of a foreign bank which is located in the United States, that account is not a reportable account.

*Financial Interest or Signature Authority*

One of the most confusing elements of the reporting requirements is for a U.S. person to determine whether he or she has a **financial interest in or signature authority over** a foreign financial account. At a minimum, a U.S. person has a financial interest in a foreign financial account if he or she is the owner of record or the holder of legal title. Additionally, a financial interest can be created by way of a person's status as a constructive owner of a foreign financial account. Generally, a constructive owner is a person acting on behalf of a U.S. person with respect to the account. A U.S. person can also be a deemed owner of a foreign financial account. Please see 31 CFR § 1010.350(e)(2)(ii) for further elaboration on which persons may be a deemed owner of a foreign financial account.

A U.S. person has **signature or other authority over** an account if that person controls the disposition of money, funds or other assets held in a financial account by direct communication with the person with whom the financial account is maintained. There are many exceptions to this requirement which apply to officers and employees of financial institutions that have federal functional regulators. Please refer to 31 CFR §1010.350(2) for a list of the exceptions.

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*Reporting Threshold ($10,000)*

If U.S. persons meet all of the requirements described above, these individuals are required to file FinCEN Form 114 if, at any point during the calendar year, the aggregate value of their accounts exceeds $10,000. When aggregating accounts, the maximum value of each account is added together. If a foreign financial account is reported in a foreign currency, it must be translated into U.S. currency by using the Treasury's Financial Management Service Rate from the last day of the calendar year.

## Foreign Account Tax Compliance Act (FATCA)

On March 18, 2010, Congress passed the Foreign Account Tax Compliance Act (FATCA) which was part of the Hiring Incentives to Restore Employment Act. FATCA requires specified persons to file an information return, Form 8938, with their annual federal tax returns for any year in which their interests in foreign financial assets exceeds the applicable reporting threshold.

Per the instructions to Form 8938, specified persons have an interest in a specified foreign financial asset if any income, gains, losses, deductions, credits, gross proceeds or distributions from holding or disposing of the asset are or would be required to be reported, included, or otherwise reflected on their income tax return.

*Specified Individuals and Specified Domestic Entities*

There are two types of specified persons: "specified individuals" and "specified domestic entities." Specified individuals are any one of the following:

- A U.S. citizen
- A resident alien
- A nonresident alien who makes an election to be treated as a resident alien for purposes of filing a joint income tax return
- A nonresident alien who is a bona fide resident of Puerto Rico or a U.S. possession.

A specified domestic entity is a domestic corporation, a domestic partnership or a trust described in §7701(a)(30)(E), if such corporation, partnership, or trust is formed or availed of for purposes of holding, directly or indirectly, specified foreign financial assets. Whether a domestic corporation, a domestic partnership, or a trust described in §7701(a)(30)(E) is a specified domestic entity is determined annually.

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*Financial Accounts and Foreign Financial Institutions*

"Financial account" and "foreign financial institution" are given their meanings consistent with those described in IRC §1471 relating to withholding requirements on payments to foreign financial institutions. Generally, stock or security issued by a person other than a U.S. person or any other interest in a foreign entity is a foreign asset if it is held for investment. One important distinction with the investment rules is to determine whether the asset is held for investment or held for use in the conduct of a trade or business of a specified person. Any assets held for use in the conduct of a trade or business of a specified person will not qualify as a foreign financial asset and, thus, will not subject the specified person to a filing requirement.

Specified persons must determine their filing requirements based on the threshold amounts described below.

| *Taxpayer Type* | *Total Value of Specified Foreign Financial Assets Exceeds* |
|---|---|
| Unmarried taxpayers living in U.S. | \$50,000 on last day of tax year; or<br>\$75,000 at any time during tax year |
| Married taxpayers, living in U.S.,<br>filing joint returns | \$100,000 on last day of tax year; or<br>\$150,000 at any time during tax year |
| Married taxpayers, living in U.S.,<br>filing separate returns | \$50,000 on last day of tax year; or<br>\$75,000 at any time during tax year |
| Taxpayers, living abroad,<br>filing other than joint return | \$200,000 on the last day of the tax year; or<br>\$300,000 at any time during the tax year |
| Taxpayers, living abroad,<br>filing a joint return | \$400,000 on the last day of the tax year; or<br>\$600,000 at any time during the tax year |

All values must be determined and reported in U.S. dollars on Form 8938. For accounts which are reported in foreign currency, the value is converted into U.S. dollars at year end using the U.S. Treasury Department's Financial Management Service's foreign exchange rate.

These rules have been around for a number of years, and it is critical for taxpayers to comply with them. All taxpayers (individuals and businesses) need to consider whether they have a reporting/filing requirement.

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## *Chapter V – Business Tax Planning Strategies for 2015 and Beyond*

Will 2015 finally be the year for business tax reform? Will any of the "extender" business provisions be made permanent, or will we once again be waiting for an extenders package to be passed at the end of the year? There is a chance that some business changes will occur in 2015, and some of these changes may be beneficial for many businesses. Corporate tax reform is a hot topic in Washington, and there are indications that progress is being made. However, there are still significant differences between what the Republican-controlled Congress wants and what the President will sign.

While there is sizable disparity between the parties involved, there are some issues on which both parties appear to agree. One of these issues is related to an eventual corporate tax rate reduction. While the size of the tax rate reduction has not yet been hammered out, the fact that both parties are in general agreement that such a reduction is necessary seems to indicate that a tax rate decrease may actually happen.

The current corporate tax rate of 35% is the highest in the world and places the United States in a decisive disadvantage when compared to other countries. We have all heard of entities moving their headquarters out of the United States (corporate inversions) for tax reasons. There is no doubt that having the world's highest corporate tax rate has harmed the business community and has had a negative impact on overall tax collections. Current corporate tax rates are listed below.

| *Corporate Income* | *Taxed at:* |
|---|---|
| Up to $50,000 | 15% |
| $50,001 – $75,000 | 25% |
| $75,001 – $100,000 | 34% |
| $100,001 – $335,000 | 39% |
| $335,001 – $10 million | 34% |
| Over $10 million – $15 million | 35% |
| Over $15 million – $18,333,333 | 38% |
| Over $18,333,333 | 35% |

Whether it will be this year or at some time in the near future, the facts certainly indicate that some type of corporate rate reduction is imminent.

# Planning in a Changing Tax Environment

## Entity Conversions and Entity Selection Alternatives

How will corporate tax reform affect U.S.-based corporate taxpayers? Will a reduction in the corporate tax rate cause tax professionals to advise their clients to make a switch from a pass-through entity to a C corporation to enjoy the benefits of a lower tax rate?

This topic is not new, and for the last few years, tax professionals have been discussing this issue with great passion and consternation. With the recent increase in the individual tax rates (effective for tax year 2013 and beyond), the highest individual tax rate is 4.6 percentage points, or more than 12.5%, higher than the current highest corporate tax rate. Additionally, with other new taxes (i.e., the NIIT) assessed on individual taxpayers, the tax rate difference can be even higher.

The tax differences discussed above do not consider additional taxes, like the 3.8% Medicare tax on investment income, nor do they consider other additional taxes that are incurred as a result of both the phase-out of itemized deductions and the loss of personal exemptions. When an individual taxpayer is an owner of a pass-through entity, it is much more likely that these additional tax consequences will occur since the flow-through entity passes its income through to its owners, thus causing higher taxable income and a whole host of additional tax problems resulting in a larger tax liability. When one considers these additional taxes (which are permanent differences), the effective tax rate difference tends to be much higher than the 12.5% noted above.

So, does this mean that newly-formed entities should be structured as C corporations? Should current flow-through entities (S corporations and partnerships) be converted to C corporations? Is this answer more obvious if there is a tax law change that would reduce the maximum tax rate on C corporations from the current 35% rate to a more reasonable 25% or 28% rate? These are very important questions, and the answer is never a simple "yes" or "no." The decision is certainly dependent upon many other factors, which will be different for each taxpayer. Businesses and their owners need to evaluate all of their options and alternative solutions, some of which are discussed below.

Over the next several pages, we will discuss a few of the many issues that should be considered as one decides whether a conversion of a pass-through entity to a C corporation is something that should be done.

*Can the conversion be accomplished tax-free?*

In most cases, there are ways to accomplish such a conversion in a tax-free manner. For example, a conversion from an S corporation to a C corporation can be done immediately, and the actual conversion would not produce immediate tax consequences. Generally, this is not the most significant issue to be considered when a conversion is contemplated, since there are options to avoid a taxable transaction.

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*What are the true tax savings that one would realize from such a conversion?*

It is simple to look at the tax rate differences (between a C corporation and an individual) and conclude that the owners will be better off as a C corporation because the top corporate marginal federal tax rate is lower than the top marginal individual tax rate. However, there are many other issues to consider, which are further discussed below.

*What are the investors' long-term plans? Are they planning an exit in the next three years, 10 years or perhaps, never?*

An ownership group that is working on a short-term exit strategy will most likely want to avoid a C corporation structure, primarily due to the double level of tax that would result if the C Corporation disposes of its assets in any transaction. The threat of a double level of tax on an asset sale will often limit the sellers to a stock sale (which would avoid the double level of tax). Limiting the options with regards to a stock sale rather than an asset sale will often reduce the number of potential buyers since most buyers desire an asset sale.

*What are the short- and long-term growth plans of the entity?*

A company that is mature and is not expected to have a significant value increase over the next several years will have different metrics to be considered when compared to an entity that is expected to double or triple in value over the next several years.

*What are the plans for excess cash flow and the likelihood that excess cash on hand will be distributed annually to shareholders?*

If the entity expects substantial cash flow, and this cash flow will be distributed or issued as dividends to the owners, then it is likely that the entity should be a pass-through entity instead of a C corporation. In this case, the excess cash that comes out of the pass-through entity would be taxed only once, as opposed to a double layer of tax if the entity were a C corporation.

*Are the investors active or passive participants in the entity?*

As a result of the NIIT, there could be substantial tax differences associated with being a passive rather than an active investor in a pass-through entity.

- A passive investor in a pass-through entity (who meets the income thresholds) will incur an additional 3.8% of net investment income tax on all income that passes through the entity. In addition, this additional 3.8% tax will also be due upon a liquidation event. A conversion to a C corporation would eliminate the NIIT on the flow-through income that the individual shareholder is paying. For a long-term investor, this additional tax could be significant and could be the primary reason that such a conversion makes sense.

 

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- An active investor in a pass-through entity would be exempt from the 3.8% net investment income tax with regards to the pass-through income. Additionally, this same investor would not incur income tax upon a liquidating event. However, if a pass-through entity were converted to a C corporation, the shareholders would then (depending upon income levels) be subject to the additional 3.8% tax upon the liquidation event. In this case, a short-term exit strategy would certainly lead one to conclude that a conversion to a C corporation would not be a good idea.

*Are there appreciated assets inside the entity?*

Generally, you do not want to have appreciated assets inside a C corporation due to the significant tax consequences caused by the sale of these assets. If these assets are sold and the shareholders desire to take the net proceeds out of the company, there is generally no way to avoid the double level of tax that would result.

*What are the state tax consequences of a conversion to a corporation? Will it cause the effective state tax rate to increase?*

Increased state tax rates are certainly a concern in Pennsylvania since the corporate tax rate is 9.99%, whereas the individual tax rate is only 3.07%. In this situation, if the entity only has nexus in Pennsylvania, a conversion to a C corporation would raise the company's state tax rate by approximately seven percentage points. This increase could eliminate a large portion of the federal tax savings that resulted from the conversion.

## The Impact of Recent Tax Legislation on Choice of Entity

The selection of the appropriate entity structure at the inception of a business enterprise is, perhaps, the most important aspect of initial business planning. While the ability to modify the structure at some future point is generally possible, the conversion or modification can often prove costly – in terms of tax costs as well as administrative expenses. Many times, these barriers to later modification can prove exceedingly costly to the equity owners of the enterprise.

Careful consideration of any entity selection requires an assessment of the entire lifecycle of the business so the decision can incorporate, to the extent possible, the exit planning strategies of the parties acquiring equity positions in the new business.

While the difficulties in establishing a credible exit plan at the inception of the entity's life are challenging, it should be remembered that in many cases, a substantial portion – if not all of the equity owner's return on investment – occurs at the exit event. Allowing for a tax-inefficient entity structure at the front of the lifecycle of the business, when such can be prevented, will end up costing the equity owners money.

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Personal asset protection and liability considerations are always relevant. With the number of entity structures available that provide for limited liability, it seems unnecessary to run any business in a fashion that leads to exposure beyond the investment in the business. Additionally, financing objectives and self-employment taxes are two other issues that should be considered when selecting an entity.

Over the last two decades, entity selection has come down to two primary choices for most taxpayers – an LLC (generally taxed as a partnership) or an S corporation. Both of these entities are pass-through entities (i.e., all taxes are paid by the owners, not the entity). It has been very rare, over the last two decades to find a situation in which a small/medium-sized business would elect to be a C corporation. However, with the potential for a reduced corporate tax rate in the near future, more taxpayers are now considering a C corporation structure.

As was the case in the prior section, there are many factors to consider when this decision is being contemplated. Each of criteria discussed above should also be considered for a newly-formed entity. There are no hard-and-fast rules that will fit every situation – each and every alternative consideration should be analyzed.

## Illustrative Example

We have prepared an illustrative example (pages 54-56) so that we can review and discuss the alternative considerations relating to whether the tax consequences are more favorable for a corporation or a pass-through entity.

In this example, we compare the tax consequences of an S corporation to the tax consequences of a C corporation using the same income and growth assumptions under each alternative. A few comments about our assumptions and our findings:

- We have used a C corporation federal tax rate of 28%, which is lower than the 35% rate under the current law, assuming that a rate reduction will occur in the near future.
- For the example provided, the net cash flow difference between the two alternatives is immaterial, meaning that under the assumptions provided, the net shareholder cash flows under either option (S corporation vs. C corporation) are virtually identical.
- If the current C corporation tax rate of 35% was used in our example, the cash flow generated by the S corporation option would have been more favorable at the end of the 10-year period.
- It is important to understand that in the example provided, we have assumed that there is a liquidating event in which the shareholders dispose of their entire investment at the end of 10 years. The results would be different if we had used either a shorter or longer time horizon for the eventual liquidation of

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the investment. If there is no plan to sell the company in the future, the results would show that being a C corporation is likely a better option, from purely a cash-flow point of view.

- In the example provided, we assumed that the S corporation shareholder is an active participant in the entity. As a result, there is no net investment income tax on the pass-through income. Note, that if the shareholder is a passive investor, the results would change dramatically, and the overall tax consequences of a C corporation would be much more favorable.
- For our example, we assumed that the stock of the company would be sold after 10 years. Note that the results would be very different if we had considered an asset sale instead of a stock sale after this 10-year period. For example, under an asset sale scenario, a buyer would generally be willing to pay more cash for the company since they would be able step-up the basis of the acquired assets to their fair market value. This step-up would produce favorable tax consequences to the buyer, which would allow for a higher purchase price. The tax benefits to an owner of a pass-through entity (as opposed to a C corporation) can be significant when a transaction occurs. The principal benefits are derived from being able to sell assets, allowing the step-up in basis to the buyer, while still enjoying capital gains treatment on most of the proceeds. The shareholders of the entity avoid double tax on the transaction, and the buyer enjoys stepped-up basis in the assets acquired.
- In our example, we assumed that 100% of the after-tax cash flow was reinvested in the company (i.e., no distributions or dividends were issued). The results would have been very different if all of the after-tax cash flow been paid to the shareholders. One of the primary advantages of a pass-through entity is the ability to distribute excess cash flow to owners with no tax consequences.

Our detailed example shows that the consideration of alternative entity structures is a very complex problem, and careful analyses need to be performed before one can make an informed decision. There is not a single answer that works for everyone. We are hopeful that tax reform will reduce tax rates on all business income. A reduced effective business tax rate would encourage additional investment and would likely produce more business activity, assist with job creation and, ultimately, increase the tax base and help with the national debt.

We hope that you find our example useful, and that it provides you with a general understanding of the many issues and concerns that will need to be analyzed when selecting an entity structure upon formation or considering a restructuring of an established entity. The alternatives vary widely, and selecting the wrong structure can be costly.

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## S Corporation vs. C Corporation After-Tax Cash Flow

### *Calculation for an S Corporation*

| Year | Taxable Income | Marginal Tax Rate (A) | Tax Liability | Present Value (B) | Build-Up in Basis (C) |
|---|---|---|---|---|---|
| 1 | $ 600,000 | 45.0% | 270,000 | 254,717 | 330,000 |
| 2 | $ 618,000 | 45.0% | 278,100 | 247,508 | 339,900 |
| 3 | $ 636,540 | 45.0% | 286,443 | 240,503 | 350,097 |
| 4 | $ 655,636 | 45.0% | 295,036 | 233,696 | 360,600 |
| 5 | $ 675,305 | 45.0% | 303,887 | 227,082 | 371,418 |
| 6 | $ 695,564 | 45.0% | 313,004 | 220,655 | 382,560 |
| 7 | $ 716,431 | 45.0% | 322,394 | 214,411 | 394,037 |
| 8 | $ 737,924 | 45.0% | 332,066 | 208,342 | 405,858 |
| 9 | $ 760,062 | 45.0% | 342,028 | 202,446 | 418,034 |
| 10 | $ 782,864 | 45.0% | 352,289 | 196,716 | 430,575 |
| | | | | 2,246,077 | 3,783,080 |

Liquidation Event (D):

| | | |
|---|---|---|
| Sale Price: | | 5,000,000 |
| Original Basis | 100,000 | |
| Build-Up | 3,783,080 | |
| Total Basis | | 3,883,080 |
| Gain | | 1,116,920 |
| | | |
| Tax Liability on Gain (E) | | 256,892 |
| Present Value of Tax Liability (B) | | 143,447 |

Footnotes:
- (A) Federal Tax Rate = 39.6%, Phase Outs = 2.5%, PA Tax = 2.9%
- (B) Assumed Present Value Discount Rate of 6%
- (C) Net Taxable Income over Distributions for Tax Liability
- (D) Assumed at the end of of Year 10
- (E) Assumed Capital Gain Rate of 23%

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## S Corporation vs. C Corporation After-Tax Cash Flow

### *Calculation for a C Corporation*

| Year | | Taxable Income | Marginal Tax Rate (A) | Tax Liability | Present Value (B) | Build-Up in Basis (C) |
|---|---|---|---|---|---|---|
| 1 | $ | 600,000 | 35.2% | 211,200 | 199,245 | - |
| 2 | $ | 618,000 | 35.2% | 217,536 | 193,606 | - |
| 3 | $ | 636,540 | 35.2% | 224,062 | 188,127 | - |
| 4 | $ | 655,636 | 35.2% | 230,784 | 182,802 | - |
| 5 | $ | 675,305 | 35.2% | 237,707 | 177,629 | - |
| 6 | $ | 695,564 | 35.2% | 244,839 | 172,602 | - |
| 7 | $ | 716,431 | 35.2% | 252,184 | 167,717 | - |
| 8 | $ | 737,924 | 35.2% | 259,749 | 162,970 | - |
| 9 | $ | 760,062 | 35.2% | 267,542 | 158,358 | - |
| 10 | $ | 782,864 | 35.2% | 275,568 | 153,876 | - |
| | | | | | 1,756,931 | - |

| Liquidation Event (D): | | |
|---|---|---|
| Sale Price: | | 5,000,000 |
| Original Basis | 100,000 | |
| Build-Up | - | |
| Total Basis | | 100,000 |
| Gain | | 4,900,000 |
| | | |
| Tax Liability on Gain (E) | | 1,127,000 |
| Present Value of Tax Liability (B) | | 629,311 |

Footnotes:
- (A) Federal Tax Rate = 28.0%,PA Tax = 7.2%
- (B) Assumed Present Value Discount Rate of 6%
- (C) No build-up in basis as a C Corporation
- (D) Assumed at the end of of Year 10
- (E) Assumed Capital Gain Rate of 23%

# Planning in a Changing Tax Environment

## S Corporation vs. C Corporation After-Tax Cash Flow

*Comparison between S Corporation and C Corporation*

| Year | S Corporation Present Value of Tax Liability | C Corporation Present Value of Tax Liability | Difference |
|---|---|---|---|
| 1 | $ 254,717 | $ 199,245 | $ 55,472 |
| 2 | $ 247,508 | $ 193,606 | $ 53,902 |
| 3 | $ 240,503 | $ 188,127 | $ 52,376 |
| 4 | $ 233,696 | $ 182,802 | $ 50,894 |
| 5 | $ 227,082 | $ 177,629 | $ 49,453 |
| 6 | $ 220,655 | $ 172,602 | $ 48,054 |
| 7 | $ 214,411 | $ 167,717 | $ 46,694 |
| 8 | $ 208,342 | $ 162,970 | $ 45,372 |
| 9 | $ 202,446 | $ 158,358 | $ 44,088 |
| 10 | $ 196,716 | $ 153,876 | $ 42,840 |
| Capital Gain | $ 143,447 | $ 629,311 | $ (485,864) |
| **Difference in Tax Liability @ Year 0** | | | **$ 3,282** |

# Planning in a Changing Tax Environment

## *Chapter VI – Understanding Recent Proposals*

The essence of planning in light of potential legislative changes is to first understand expected legislation and proposed modifications to the tax rules as they exist at the date of planning. Unfortunately, beyond obtaining that understanding, trying to predict with any degree of accuracy exactly which of those proposals will find its way into the law is pretty much the proverbial crapshoot. Politics has, and will, always have an influence on deals as bills come up for debate and reconciliation. Additionally, nothing is likely to move forward in the near term without finding a way for Congress and the Administration to find sufficient common ground to start the process of negotiation. Both sides must remain flexible to allow for tradeoffs for the better good.

Currently, there are some similarities between the positions of both parties. The common ground appears to be a desire by both sides to attempt to reform the Internal Revenue Code into a simpler, and more fair, means of revenue generation. The last time that a major overhaul occurred in the development of tax law was when the Code was substantially modified by the Tax Reform Act of 1986. In those debates, and throughout that legislative process, substantive changes to the Code were challenged, argued and finally approved. That same outcome seems more likely (or at least more possible) today than at any time since 1986 and, certainly, since the turn of the century.

A good starting point for developing an understanding of where current tax law might be heading may be to look at two specific proposals of significance. The first is the President's Budget for Fiscal Year 2016 (found at http://www.whitehouse.gov/omb/budget) and the second is a piece of proposed legislation, titled The Tax Reform Act of 2014, crafted by the House Ways and Means Committee in 2014 under the leadership of Paul Ryan. The bill, of course, did not move out of the House in 2014, but is useful in that it can shed light on the current thinking of Republican representatives in both chambers of Congress. The entire package can be found at http://waysandmeans.house.gov/uploadedfiles/tax_reform_executive_summary.pdf.

The common thread permeating both proposals is the focus on protecting and enhancing the economic viability of the middle class and on providing a set of tax rules that can be easily understood by taxpayers. While the President's budget does not provide a great deal of detail (as would be expected in such a document) the House proposal contains a substantial number of detailed provisions that could serve as a starting point for reaching a conciliatory package this year.

The substantive benefits to the middle class, as argued in the House bill, include the following:

- $3.4 trillion in additional economic growth
- 1.8 trillion new jobs
- $1,300 per year more in the pockets of middle-class American families

# Planning in a Changing Tax Environment

In the President's package, the focus is largely on provisions intended to help the middle class, as he had noted in his State of the Union Address for 2015. President Obama's primary vision and goal seems to be what he terms "middle class economics." He defines this vision as restoration of "the link between hard work and opportunity and ensuring that every American has the chance to share in the benefits of economic growth."

With the commonality of purpose among Congress and the Administration, there does seem to be a platform for getting something done in a positive manner. Even though the President's budget does not provide the detail of the House bill, it does provide a number of general provisions which are helpful in today's assessment and conceptual changes designed to accomplish his intended goals.

## House Bill Provisions

In line with the House bill's goal of simplifying, and making the Internal Revenue Code more fair, its summary provides that the bill intends to do so by:

- Providing a significantly more generous standard deduction so that 95% of taxpayers will no longer be forced to itemize their individual deductions
- Reducing the size of the federal income tax code by 25%
- Tackling fraud, abuse and mismanagement at the IRS to protect hard-earned taxpayer dollars

*Provisions Affecting Individuals*

In addressing the specifics of the proposal, the starting point of the House bill is rate simplification and reduction. Currently, the Internal Revenue Code includes seven different rate levels, with the top marginal rate at 39.6%. While this rate is applicable to individual taxation, an innumerable number of businesses find themselves paying this rate or higher, principally due to the phaseouts of tax preferences and the additional taxes created to fund the healthcare legislation. The House bill estimates this "effective" rate to be as high as 44.6%. While that rate might, at first, seem excessively high, it is relatively close to reality.

To resolve these issues, the House bill compresses the current tax rate structure into just two brackets (for virtually all taxpayers) – the rates would be 10% and 25%. It is noteworthy that the House bill splits higher income between production income (taxable at 25%) and other income (taxable at 35%).

The standard deduction, slated at $6,300 for single individuals ($12,600 for married couples filing jointly) in 2015, would be increased to $11,000 and $22,000 in future years. This change, as discussed in the House bill, would greatly reduce taxpayers' needs for itemizing deductions. As such, we would certainly see a substantial

# Planning in a Changing Tax Environment

simplification. The collection of data and record keeping required to support itemized deductions is substantial and cuts across many differing tax statutes.

In another attempt at simplification, the House bill collapses six different family benefits (basic standard deduction, additional standard deduction, personal exemptions for taxpayer and spouse, personal exemptions for dependents, child tax credits and head of household filing status) into three simple family tax benefits. These new benefits are: a larger standard deduction (as discussed above), an additional deduction for single parents, and an expanded child and dependent tax credit of $1,500 per child and $500 per dependent.

In addition to these new tax benefits, the House plan makes specific changes for low-income working families who claim the Earned Income Tax Credit (EITC). The current EITC, which requires most beneficiaries to hire a tax return preparer just to claim the credit, would be simplified by converting it into an exemption of a certain amount of payroll taxes (both the employee's and employer's shares), which are reported directly on a worker's Form W-2, Wage and Tax Statement. Depending on household circumstances, families could be shielded from as much as $4,000 in payroll tax liability. This simplification would make it easier for the roughly 25% of eligible families who fail to claim the EITC due to its current complexity to get the tax relief afforded by this provision.

On the education front, the House bill intends to pare down the 15 different tax breaks for higher education and replace them with five, which include:

- American Opportunity Tax Credit (AOTC)*
- Deduction for work-related education expenses
- Exclusion from taxation for scholarships and grants
- Gift tax exclusion for tuition payments
- Tax-free section 529 plans

*The House bill plans to replace the Hope credit, lifetime learning credit, tuition deduction, and temporary AOTC with a reformed AOTC and to make it permanent.

With respect to retirement savings incentives, the House plan does not purport to change how current retirement savings are treated under the tax law. The plan intends to maintain, in the year of passage, current contribution limits for Individual Retirement Accounts and defined contribution plans, like section 401(k) plans.

Under current tax law, when saving for retirement, taxpayers have a choice as to whether they should put the money away for retirement after taxes and save tax-free (Roth accounts), or put the money away and then pay taxes when they withdraw the funds during retirement (traditional accounts).

# Planning in a Changing Tax Environment

An interesting proposed change would apply to future retirement savings under the House plan. Under the plan, a taxpayer will be allowed to contribute the first $8,750 (half of the 2014 contribution limit) to either a traditional IRA or a Roth account. Any contributions in excess of the $8,750 will be dedicated to a Roth-style account, meaning that there will be no current-year tax deduction, and the distributions will not be taxable in future years when the funds are withdrawn.

The House bill makes no changes to the mortgage-interest rules for any current mortgage. Nor does the plan affect future refinancing of current mortgages. It does, however, include a plan for a gradual reduction in the current $1M mortgage cap to $500,000 (in the plan, for mortgages taken out in 2018 and later).

Charitable giving is also addressed in the House plan. As noted above, because the plan is expanding the standard deduction, 95% of Americans will no longer have to itemize their taxes. As such, these taxpayers will no longer need to keep all of the receipts and fill out all the forms necessary to claim itemized deductions like the charitable deduction – meaning they will have all the benefits of lower taxes, without the attendant complexity.

For those remaining 5% of taxpayers who choose to continue to itemize, the plan preserves the charitable deduction for contributions exceeding 2% of income. So, if a taxpayer who itemizes earns $100,000 and makes total contributions of $10,000, that taxpayer would still be allowed to deduct $8,000. Thus, the House plan imposes an additional limitation on the use of charitable deductions in tax planning; however, the proposed provision does not include a cap on charitable deductions.

One really interesting aspect of the House bill is that it allows charitable contributions to be made through April 15th of the year following the tax year, instead of December 31st of that tax year. The change is intended to help facilitate planning and enhance charitable giving.

With respect to capital gains, the House plan eliminates all preferential rates. However, as an accommodation, the plan proposes to allow a reduction from gross income of 40% of the amount of the adjusted net capital gain earned by the taxpayer(s). An example clearly illustrates the economic effect of such a change:

- ***Example*** - Sherry, who is single, earns $500,000 per year from her job. She sells a capital stock investment in 201X. Her net proceeds, after brokerage fees, are $12,000. The shares were purchased approximately two years prior to the date of sale, at a cost of $4,000. As such, Sherry realized a taxable capital gain of $8,000.

  Under current law, the tax on the gain would be $1,600 (20% of $8,000).

  Under the House bill proposal, Sherry would first exclude 40% of the gain from her taxable income, or $3,200 (40% x $8,000). The balance of the gain, or $4,800, would be taxable at a rate of 25%, for a total tax of $1,200.

 

# Planning in a Changing Tax Environment

The house plan also repeals the Alternative Minimum Tax for all taxpayers but as an offset, repeals the deduction for state and local income, property and sales taxes. Note that this provision is extremely significant, as most taxpayers itemizing deductions realize a significant reduction in their regular tax calculation from the payment of taxes For those not affected by the alternative minimum tax (AMT), which limits this benefit, the trade-off of AMT elimination against the benefit of the itemized tax deductions may not constitute a positive exchange.

Finally, the House bill also eliminates the tax break associated with alimony payments.

Changes such as these should be reasonable, so long as the top tax rates for current taxation are held at 25% and 35%. However, affected taxpayers should realize, that while rates will be lower if the bill were to be enacted in full, it is more than likely that rates will rise again in the future, and the attendant tax deductions will likely never be reinstated.

*Provisions Affecting Small Businesses*

The House bill sets out a number of provisions affecting smaller businesses, which serve as the cornerstone of the U.S. economy. One of the most important concerns of the House bill focuses on the need for the Federal government to assist small businesses in terms of lower tax rates and expanded economic initiatives.

According to the Small Business Administration, small businesses have generated nearly two-thirds of net new jobs over recent years. Nearly half of the private sector workforce is employed by small businesses – a total of nearly 60 million Americans.

The House bill's proposed provisions would aid small businesses by lowering rates, increasing certainty for business planning and reducing complexity. Specifically, the plan:

- Lowers tax rates across the board for small business owners who report their business income on their personal taxes and pay at individual rates, ensuring that virtually every small business pays no more than a top rate of 25%.
- Reduces the double taxation of investment income to historic lows.
- Repeals the Alternative Minimum Tax (AMT).
- Simplifies compliance through various reforms of business deductions and credits.
- Makes permanent section 179 expensing on as much as $250,000 in capital investments each year, including real property.
- Expands the use of "cash accounting" for businesses with gross receipts of up to $10 million, while permitting farms of all sizes to use cash accounting.

# Planning in a Changing Tax Environment

- Creates a simple, consolidated deduction for small businesses' start-up and organizational expenses.
- Simplifies the rules governing S corporations.
- Maintains current law on the estate tax, ensuring that family businesses can continue to be passed on to future generations.

The plan notes that the "relief provided by reducing tax rates will provide greater incentives for investment and hiring and better wages."

Other changes proposed in the House plan include:

- Improving the Research and Development credit and making the credit permanent
- Repealing the corporate AMT
- Modernizing the international tax rules (intended to bring back nearly $2T in "trapped cash" to invest in the United States)
  - Lowering tax rates for U.S. companies to enhance competitiveness
  - Closing loopholes some companies use to ship jobs offshore
  - Eliminating the double tax that applies to overseas earnings of U.S. companies **IF** those companies reinvest in the United States
- Repealing all business credits except the Research and Development credit, the Low-Income Housing credit and the credit to help businesses with the improvements required by the American with Disabilities Act
- Removing the current capital gain benefits associated with "carried interests"
- Simplifying the depreciation rules
  - Eliminating special provisions
  - Continuing section 179 up to $250,000 and makes permanent the expensing of improvements to real property and computer software
  - Changing lives to match more closely with useful economic life of an asset
  - Indexes depreciation for 2017 and beyond
- Repealing the Last in, First Out (LIFO) inventory method
- Reducing tax benefits associated with excessive compensation

# Planning in a Changing Tax Environment

## President's Budget Provisions

As noted above, the President's Budget does not include the same degree of detail as a preliminary bill. However, while there are provisions within the budget that do not mirror the provisions in the House bill, the Budget does tend to illustrate the Administration's thinking on items of import to provide assistance and economic help for the middle class.

*Provisions Affecting Individuals*

- Enhancing and expand the child care credit (triple the current amount)
- Repealing (or allowing to expire) the duplicative and less-effective education tax benefits, including:
  - Lifetime Learning Credit
  - The tuition and fees deduction
  - Student loan interest deduction (for new loans)
  - Coverdell accounts
  - Roll back of the section 529 plan subsidy
- Making permanent certain education incentives including:
  - The American Opportunity Tax Credit (AOTC)
  - Eliminate tax on debt forgiven under "Pay As You Earn" repayment plans
- Creating more work-related savings programs (for retirement)
- Providing a second-earner credit
- Eliminating the "stepped-up" basis rules for estates
- Increasing capital gains tax rates to 28 percent (inclusive of the NIIT)
- Imposing new fees on highly-leveraged U.S. financial firms

*Provisions Affecting Businesses*

- Lowering the corporate tax rate to 28% (25% for domestic manufacturing)
- Making permanent the Research and Development tax credit
- Making permanent the Production tax credit and the Investment tax credit

# Planning in a Changing Tax Environment

- Expanding cash basis accounting for businesses with receipts of less than $25M
- Permanently extending section 179, allowing small businesses to expense up to $1M
- Fundamentally reforming the international tax system
- Assessing a one-time 14% tax on offshore, non-repatriated earnings

## Concluding Thoughts

It is easy to discern the common areas addressed by each proposal's specific provisions. More importantly, it appears as though both proposals are similarly "themed" – focusing on fundamental enhancement and assistance to the middle class and overall simplification of the Internal Revenue Code. While there is much to debate between the two packages, hopefully, there is sufficient common ground to make 2015 the year that moved the tax system forward for the benefit of all of us.

# Planning in a Changing Tax Environment

## *Conclusion and Practical Considerations*

It is true that the tax law, as it is currently structured, can sometimes be extremely difficult to navigate. However, the overriding principles contained therein are generally founded in the goals and motivations of a legislative and administrative process that attempts, through tax legislation, to manipulate taxpayer behaviors through tax policy. To some degree, this process has been effective in the past.

For example, if one looks back to the late 1970s when the Carter administration was in office, there were numerous critical problems within the economy that resulted in economic slowdown and stagnating inflation. In the first year of the Reagan administration, the Congress passed, and the President signed into law the Economic Responsibility Tax Act of 1981, which included a provision focusing on accelerated depreciation and investment tax credit benefits.

The purpose of the provision was, of course, to spur business investment in tangible property and, thereby, not only create more demand for tangible property manufacturers and builders, but also operators of that same equipment once it was placed in service. The long-term effects of that policy and the specific provision can be debated, but there is no question that the 1981 law accomplished its mission to generate significant investment in the country, ultimately returning the economy to a substantially more-normalized and growing position.

Unfortunately, both private and political motivations have too often become involved in the process of drafting and passing tax legislation. One such example is the special shorter tax depreciation life allowed for owners of race tracks (better known as the NASCAR rule) for two additional years as passed in December 2014 with the extenders package. The cost to taxpayers was $71M for the two-year deal brokered by K street lobbyists. Bipartisan support exists for a permanent extension of this preferential tax treatment.

Partisan politics can certainly be a problem in consideration of any long-term remedy to the current Internal Revenue Code. However, even more problematic is the general view by all involved that each district and state represented must get its own piece of the pie. Voters and constituents expect that their representatives in Washington will get them their fair share. And, reelection is often conferred upon those who were able to bring back more benefits than a fair share of the Federal budget to their electorate. Thus, the problem is not only in Washington, but begins with each of us and our desire to change the tax laws only where the sting is not directed towards our personal situations.

Therein lies the rub. As Congress and the President prepare to undertake a major reformation of current tax law, it becomes incumbent upon each of us to realize that there is likely going to be some pain we must endure individually to achieve the greater good. Such is the nature of any major Congressional change.

# Planning in a Changing Tax Environment

Two issues of critical importance influence the public acceptance of massive tax law changes. The first is that the deal is rarely finalized as drafted and passed. Further change is simply at the whim of the next President or the next Congress. For example, in 1986, numerous deductions and allowable reductions in taxable income were repealed and eliminated from the tax law. In return for this concession, taxpayers were awarded with a more simple tax Code with a top income tax rate of 28%. However, as is well known, the rate began to creep up in just a few years, and President Clinton's administration raised the top bracket to 39.6% in 1993. Thus, in just six years, the top marginal tax rate climbed by 11.6 percentage points, or 41%. Meanwhile, all of the deductions and allowable reductions in taxable income were never reinstated, increasing the amounts of income that is subject to income tax.

The second issue related to public acceptance is the need for all citizenry to contribute some tax into the system. There is no question that a graduated tax system is a reasonable means to facilitate the necessary revenue required to fund the appropriate programs and operating expenditures of the Country as determined by those in our Federal government. However, there must be some limitation on how much of any one taxpayer's income can be taken as taxes, when so many citizens pay nothing. Certainly, nobody would suggest that any citizen be harmed with cash expenditures beyond his/her means, but most would agree that all but the most needy should be required to pay in at least some small portion of their income.

The answer of course, is to embrace those programs and operational expenditures most important to our Country, with due consideration given to spending. Then, all steps should be taken to develop new tax laws in a very business-like and nonpartisan fashion. Following this protocol, Congress and the President could pass legislation that is effective, efficient and free of any influence except propriety. Of course, this is easier said than done.

Spending is yet another problem, especially with respect to those entitlement programs, including Social Security and Medicare, which have become a core part of the psyche of the United States. In addition, interest on the national debt will consume a disproportionate amount of the Federal revenues as years go on if the spending is not reigned in to a responsible level.

So what to do in planning for 2015 as the 2014 income tax filing season winds down? It is likely that any major legislation throughout this year is almost certain to address tax rates. The most ardent members of Congress, as well as the President, clearly see the higher tax rates assessed on businesses as a significant competitive issue and one that needs addressed. Moreover, tax simplification, if the issue gets a toehold as summer approaches, will need to be carefully monitored to ensure that the transition between old and new law is smooth and that the changeover does not work to unnecessarily increase tax liabilities.

# Planning in a Changing Tax Environment

The tax professionals at Grossman Yanak & Ford LLP will closely watch developments as they come to light in the coming months. You can count on us to keep our clients and contacts informed at all appropriate points throughout the process. Should you have questions or observations at any time, or as a result of today's program, please do not hesitate to call Bob Grossman at 412.338.9304 or Don Johnston at 412.338.9309.

We hope this program has been informative and helpful as you return to your practices. We appreciate your attendance today, and we thank you for taking time from your busy schedules to spend a little time with us. As always, we appreciate the support from our friends in the legal community. Should you have an opportunity to refer a client to us, please know that we will always do our very best to ensure that we not only meet their expectations, but that we exceed them, and that we will do everything within our power to see that your referral reflects positively on you!

Thanks again for attending. Have a great day!

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