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Advising Individual Tax Clients

FOR 2013 AND BEYOND

Attorney CLE Series – February 12, 2014

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INTRODUCTION

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INTRODUCTION

- **Effects of the ATRA on individual taxpayers and businesses**
  - ***Bush-era tax cuts and new highest income tax bracket***
  - ***Higher rates for dividends and capital gains***
  - ***Pease and PEP limitations, AMT and other provisions***
  - ***Changes also affect pass-through businesses***

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INTRODUCTION

- **Overall Thrust of Marginal Rate Changes**
  - ***13.14% Rate Increase on Ordinary Rates***
  - ***33.0% Rate Increase on Capital Gains***

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INTRODUCTION

- **Combined with provisions of ACA effective in 2013**
  - ***3.8% Medicare contribution tax on unearned income***
  - ***.9% Medicare tax on earned (or self-employment) income***

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INTRODUCTION

- **Chapter I:** ***Bush Era Tax Cuts & ATRA Tax Rate Considerations***
- **Chapter II:** ***Pease Limitation Provisions & Individual Exemption Phaseouts***
- **Chapter III:** ***The Alternative Minimum Tax***
- **Chapter IV** ***Medicare Tax on Unearned Income***
- **Chapter V:** ***Medicare Tax Surcharge on Earned Income***
- **Chapter VI:** ***Effects of the ATRA on Pass Through Businesses***

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UNDERSTANDING THE
INDIVIDUAL TAX RATE CHANGES

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INDIVIDUAL TAX RATE CHANGES

- **Ordinary Income Tax Rates**
  - ***Bush-era tax cuts made permanent, except for those in higher-income tax brackets***
    - Individual marginal rates: 10%, 15%, 25%, 28%, 33%, 35%
    - Reinstated 39.6% fixed marginal income tax rate for highest bracket (carved out of prior top bracket)

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INDIVIDUAL TAX RATE CHANGES

- **Importance of Understanding Marginal Income Tax Rates**
  - ***Key financial-planning consideration***
  - ***Rate on "next" dollar of income should be taken into account when analyzing economic decisions***

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INDIVIDUAL TAX RATE CHANGES

- **Example 1: Understanding Marginal Income Tax Rates**
  - ***Married couple filing jointly***
  - ***Husband has taxable income of $750,000***
  - ***Wife looking for job with salary of $60,000***
  - ***Marginal income tax rate on wife's income will be 39.6%***

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INDIVIDUAL TAX RATE CHANGES

- **Example 2: Understanding Marginal Income Tax Rates**
  - ***Same facts as example 1***
  - ***Wife will work as volunteer and have no additional income***
  - ***Husband receives $100,000 and wants to invest it***
  - ***Marginal income tax rates should be taken into consideration when choosing the investment option***

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INDIVIDUAL TAX RATE CHANGES

- **Example 2: (cont.)**
  - ***Assume couple will pay 39.6% tax***
  - ***Apply this tax rate to the investment options to determine which is best***
  - ***Taxable corporate bond with 6.00% annual yield provides slightly better return than tax-exempt bond***
  - ***Taxable net yield = 3.62%, tax-free = 3.50%***

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INDIVIDUAL TAX RATE CHANGES

- **Importance of Understanding Effective Income Tax Rates**
  - ***Also a key financial-planning consideration***
  - ***Because of graduated tax system, effective income tax rate is not a flat number applied to an income level***
  - ***Different rates are applied to taxable portion of income that falls within a range – top rate is the marginal tax rate***

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INDIVIDUAL TAX RATE CHANGES

- **Example 3: Understanding Effective Income Tax Rates**
  - ***Assume Single taxpayer, annual taxable income = $120,000***
    - 10% on portion of income up to $8,925, plus
    - 15% on portion of income >$8,925 but <$36,250, plus
    - 25% on portion of income >$36,250 but <$87,850, plus
    - 28% on the final portion >$87,850

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INDIVIDUAL TAX RATE CHANGES

- **Example 3: (cont.)**
  - ***Based on these facts, marginal (top) rate is 28%***
  - ***Effective rate is 20.08% (tax paid ÷ total taxable income)***
  - ***Difference between marginal and effective rates due to the graduated tax system and the net tax benefits of personal exemption and standard deduction, which reduce her taxable income to $110,000***

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INDIVIDUAL TAX RATE CHANGES

- **Example 4: Understanding Effective Income Tax Rates**
  - ***Married taxpayer, filing jointly with combined annual taxable income of $750,000***
  - ***Couple's income is subject to a 39.6% marginal tax rate****
  - ***Effective tax rate is 32.6% due to progressive rate schedule***

  * This assumes no deductions; however, most taxpayers at this income level would have some deductions, which would be likely to further reduce effective rate

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INDIVIDUAL TAX RATE CHANGES

- ***Planning Consideration*** **– Marginal vs. Effective Tax Rates**
  - ***Focus on legal, legitimate, income-shifting strategies***
    - Acceleration of deductions ("bunching" expenditures)
    - Deferral of income (strategically plan timing)

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INDIVIDUAL TAX RATE CHANGES

- **Capital Gains Rates**
  - ***ATRA made permanent:***
    - 15% rate on adjusted net long-term capital gains
    - 0% rate on adjusted net long-term capital gains for lower income taxpayers
  - ***ATRA increased rate on net long-term capital gains to 20% for individuals, trusts and estates in highest tax brackets***

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INDIVIDUAL TAX RATE CHANGES

- ***Planning Consideration*** **– Capital Gains**
  - ***Timing of long-term capital gains should be carefully considered in conjunction with timing of taxable income***
    - Accelerate/defer payment to be made in year in which tax bracket is lowest to enable 15% tax rather than 20%

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INDIVIDUAL TAX RATE CHANGES

- **Qualified Dividends**
  - ***Taxation of qualified dividends at preferred long-term capital gains rates was made permanent:***
    - 0% for taxpayers in 10% or 15% income bracket
    - 15% for taxpayers in 25%, 28%, 33% or 35% brackets
    - 20% for taxpayers in the highest (39.6%) income bracket

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INDIVIDUAL TAX RATE CHANGES

- ***Planning Consideration*** **– Qualified Dividends**
  - ***Timing of qualified dividends should be carefully considered in conjunction with timing of taxable income***
    - Accelerate/defer payment to be made in year in which tax bracket is lowest to enable 15% tax rather than 20%
    - Additional 3.8% Medicare tax on net investment income should also be taken into consideration

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PEASE LIMITATION PROVISIONS & INDIVIDUAL EXEMPTION PHASEOUTS

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PEASE & PEP LIMITATION PHASEOUTS

- **Due to the expiration of prior temporary repeals, these two "stealth tax" provisions have been reinstated**
- **As a result, otherwise allowable itemized deductions and personal exemptions will again be reduced or eliminated if the taxpayer's AGI exceeds the specified thresholds**

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IMPORTANT THRESHOLDS

	Single	Head of Household	Married Filing Jointly
Ordinary Tax Rates	$ 400,000	$ 425,000	$ 450,000
Ordinary Dividends	$ 400,000	$ 425,000	$ 450,000
Capital Gains	$ 400,000	$ 425,000	$ 450,000
Itemized Deduction Phaseout	$ 250,000	$ 275,000	$ 300,000
Personal Exemption Phaseout	$ 250,000	$ 275,000	$ 300,000
Medicare Surtax	$ 200,000	$ 200,000	$ 250,000
Medicare Tax on Wages	$ 200,000	$ 200,000	$ 250,000

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PEASE & PEP LIMITATION PHASEOUTS

- **Pease – AGI thresholds for phaseout of itemized deductions**

	2013	2014
Married taxpayers filing joint returns and surviving spouses	$300,000	$305,050
Heads of households	$275,000	$279,650
Other single taxpayers	$250,000	$254,200
Married taxpayers filing separate returns	$150,000	$152,525

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PEASE & PEP LIMITATION PHASEOUTS

- **Application of Pease Limitation**
  - ***The following types of itemized deductions are not included:***
    - Medical expenses,
    - Investment interest expenses,
    - Casualty or theft losses, and
    - Allowable wagering losses.

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PEASE & PEP LIMITATION PHASEOUTS

- **Application of Pease Limitation**
  - ***When computing the amount of the reduction of total itemized deductions, all other limitations applicable to those deductions (including 2% floor for miscellaneous itemized deductions) are applied first***
  - ***The Pease limitation is then applied to the resulting total***

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PEASE & PEP LIMITATION PHASEOUTS

- **PEP – 2013 AGI thresholds for phaseout of personal exemptions**

	Begins	Ends
Married taxpayers filing joint returns and surviving spouses	**$300,000**	**$422,500**
Heads of households	**$275,000**	**$397,500**
Other single taxpayers	**$250,000**	**$372,500**
Married taxpayers filing separate returns	**$150,000**	**$211,250**

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PEASE & PEP LIMITATION PHASEOUTS

- **PEP – 2014 AGI thresholds for phaseout of personal exemptions**

	Begins	**Ends**
Married taxpayers filing joint returns and surviving spouses	**$305,050**	**$427,550**
Heads of households	**$279,650**	**$402,150**
Other single taxpayers	**$254,200**	**$376,700**
Married taxpayers filing separate returns	**$152,525**	**$213,775**

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PEASE & PEP LIMITATION PHASEOUTS

- **Examples: Effects of Reinstatement of Limitations**
  - ***Married, joint filers with two dependent children***
    - Exhibit I: AGI within range subject to partial phaseout of personal exemptions and itemized deductions
    - Exhibit II: AGI exceeds the phaseout range, thus, subject to total phaseout of personal exemptions
    - Exhibit III: Effect of 80% maximum reduction to itemized deductions under the Pease limitation

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PEASE & PEP LIMITATION PHASEOUTS

- **Exhibit I: Partial Phaseout of Exemptions and Deductions**
  - ***AGI = $400,000***
  - ***Taxable income is $15,080 more as result of changes***
    - 80% of personal exemptions disallowed
    - $3,000 in itemized deductions lost
  - ***At 33%* marginal rate, results in $4,977 additional tax due***
    ****assume no AMT for simplicity***

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PEASE & PEP LIMITATION PHASEOUTS

- **Exhibit II: Complete Phaseout of Personal Exemptions**
  - ***AGI = $515,000***
  - ***Taxable income is $21,650 more as result of changes***
    - $100% of personal exemptions disallowed
    - $6,450 in itemized deductions lost
  - ***Due to the increase in taxable income, taxpayer not only owes more income tax, he/she is also pushed into the 39.6% bracket and is subject to numerous other increased taxes***

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PEASE & PEP LIMITATION PHASEOUTS

- **Exhibit III: 80% Limitation on Itemized Deductions**
  - ***AGI = $3,000,000***
  - ***Taxable income is $68,800 more as result of changes***
    - 100% of personal exemptions disallowed
    - $53,600 in itemized deductions lost
  - ***At 39.6% marginal rate, results in $27,245 additional tax***

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PEASE & PEP LIMITATION PHASEOUTS

- **Careful planning is required**
  - ***Timing of income and deductions is critical***
  - ***Consideration of the entire income tax code is important***
  - ***State tax consideration is also needed in some cases***

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ALTERNATIVE MINIMUM TAX (AMT)

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ALTERNATIVE MINIMUM TAX (AMT)

- **Designed to ensure that no taxpayer with substantial income avoids tax liability by using exclusions, deductions and credits**
- **Separate but parallel system of income taxation**
- **Applies to income in excess of AMTI over exemption amount**
  - ***26% applied to first $175,000 of taxable excess***
  - ***28% to taxable excess over $175,000***

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ALTERNATIVE MINIMUM TAX (AMT)

- **Curtails favorable tax treatment with system of adjustments and preferences**
  - ***Cost recovery adjustments and preferences***
  - ***Loss adjustments***
  - ***Timing adjustments***
  - ***Tax-exempt or excluded income preferences***
  - ***Adjustments to itemized deductions***

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ALTERNATIVE MINIMUM TAX (AMT)

- **Adjustments and preferences**
  - ***Depreciation adjustments from pass through entities***
  - ***Gain/loss adjustments from pass through entities***
  - ***Itemized deduction preferences***
  - ***Personal exemptions are excluded***

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ALTERNATIVE MINIMUM TAX (AMT)

- **AMT applies if AMT liability exceeds regular tax liability**
- **Historically, no provision allowed for inflation indexing of AMT exemption amount**
  - ***Increasing number of taxpayers were subject to AMT since income and tax brackets were adjusted for inflation***
  - ***Temporarily fixed several times with "AMT patch"***
- **ATRA provided permanent exemption amount with indexing**

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ALTERNATIVE MINIMUM TAX (AMT)

- **AMT exemption amount phased out at higher AMTI levels**
- **ATRA also provided inflation adjustments for thresholds**

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ALTERNATIVE MINIMUM TAX (AMT)

- **Example 1**: ***Married taxpayer with 2 children***

	Reg. Tax	AMT
Adjusted Gross Income	300,000	300,000
Itemized Deductions	(20,000)	—
Personal Exemptions	(15,600)	—
AMT Exemption	—	44,275
Taxable Income	264,400	255,725
Tax	63,565	68,013
AMT		4,448
Effective Tax Rate	24%	27%

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ALTERNATIVE MINIMUM TAX (AMT)

- **Example 2**: ***Year after a transaction***

	Reg. Tax	AMT
Adjusted Gross Income	300,000	300,000
Itemized Deductions	(120,000)	—
Personal Exemptions	(15,600)	—
AMT Exemption	—	(44,275)
Taxable Income	164,400	255,725
Tax	33,438	68,013
AMT		34,575
Effective Tax Rate	20%	27%

YOU JUST WASTED A $100,000 TAX DEDUCTION

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AMT PLANNING

- **Bunching deductions, shifting preference items**
- **AMT crossover point must be determined**
- **Various strategies can be used to reduce AMT liability**

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AMT PLANNING

- **Strategies to minimize effects of AMT**
  - ***Timing: accelerate income items into AMT year and postpone deductions into non-AMT year***
  - ***Real estate/state income taxes: delay payment if possible***
  - ***Mortgage interest: home equity credit may not be beneficial***
  - ***Incentive stock options: carefully calculate impact of gain before exercising ISO; consider tax credit possibility***

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AMT "DANGER" ZONE

- **Taxable income = $100,000-$600,000**
- **Taxable income = $600,000+ with significant capital gains**
- **High state-taxing jurisdiction**
- **Several dependents**
- **Large state tax bills due to one-time event**

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PEASE/PEP/AMT/CONTRIBUTIONS – TIED TOGETHER

- **Know what is limited and know the thresholds**
  - ***Pease limitations*** ***– can be managed through AGI and properly planning the timing of your payments***
  - ***PEP*** ***– can only be managed through AGI***
  - ***AMT*** ***– can be managed various ways (acceleration/deferral of income, acceleration/deferral of deductions)***
  - ***Contribution limitations*** ***– can be managed through AGI and proper timing of deductions***
- **All items must be considered and coordinated in overall plan**

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UNDERSTANDING THE MEDICARE TAX ON UNEARNED INCOME

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MEDICARE TAX ON UNEARNED INCOME

- **Introduced by the ACA, effective on January 1, 2013**
- **Focus of the new 3.8% Medicare tax is on investment income of taxpayers (individuals, trusts and estates)**

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MEDICARE TAX ON UNEARNED INCOME

- **On November 26, 2013, the IRS released final regulations that clarified many issues and provided numerous detailed examples to assist taxpayers and their advisors**
- **However, some questions and uncertainty still remain**

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MEDICARE TAX ON UNEARNED INCOME

- **Net investment income (NII) tax**

  The NII tax is imposed at a rate of 3.8% on the lesser of:

  (1) NII for the tax year, or

  (2) The excess, if any of

  a. An individual's modified adjusted gross income for the tax year, over
  b. The applicable threshold amount.

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MEDICARE TAX ON UNEARNED INCOME

- **Modified adjusted gross income (MAGI)**

  For purposes of the NII tax, an individual's MAGI is:

  (1) AGI as calculated for federal income tax purposes, plus

  (2) Certain excluded foreign-source income of U.S. citizens and residents living abroad, net of certain deductions and exclusions.

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MEDICARE TAX ON UNEARNED INCOME

- **NII thresholds**
  - ***$250,000 for a married taxpayer filing a joint return or a surviving spouse***
  - ***$125,000 for a married taxpayer filing a separate return***
  - ***$200,000 for single taxpayers***
- **These amounts are not currently indexed for inflation**

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MEDICARE TAX ON UNEARNED INCOME

- **For calculation of the new tax, NII is the excess of the sum of the three specific categories of income or gain, less any otherwise allowable deductions properly allocable to such income or gain.**

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MEDICARE TAX ON UNEARNED INCOME

- **Category (i)**
  – ***Gross income from interest, dividends, annuities, royalties and rents, unless such income is derived in the ordinary course of a trade or business, which is nonpassive with respect to the taxpayer, or is derived from trade or business of trading financial instruments or commodities;***

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MEDICARE TAX ON UNEARNED INCOME

- **Trade or business exclusion from category (i) income**
  1. ***There must be an activity that rises to the level of a trade or business***
  2. ***The income must be derived from that trade or business***
  3. ***The taxpayer must materially participate in that trade or business***

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MEDICARE TAX ON UNEARNED INCOME

- **Passive activities**
  – ***NII rules generally adopt Code Sec. 469 rules for passive activities losses***
    - Does the taxpayer materially participate in the trade or business on a regular, continuous and substantial basis?

  – ***Taxpayers are allowed a one-time regrouping in the first year they are subject to the NII tax***

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MEDICARE TAX ON UNEARNED INCOME

- **Rental activity exception for category (i) income**
  - ***Under passive activity rules, rental activity of real estate or equipment is deemed to be passive***
  - ***Several exceptions apply***
  - ***Additional qualifications and safe harbor for real estate professionals***

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MEDICARE TAX ON UNEARNED INCOME

- **Category (ii) trade or business income treated as NII**
  - ***Income from a trade or business that is a passive activity with respect to the taxpayer, or trade or business of financial trading.***
  - ***Under the final regulations, all trading gains or losses are now assigned to category (iii) – previously was category (ii).***

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MEDICARE TAX ON UNEARNED INCOME

- **Ownership levels: determining trade or business income**
  - ***For individuals, estates or trusts that own or engage in a trade or business directly the determination of whether category (i) gross income is derived in a trade or business is made at the individual, estate or trust level.***

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MEDICARE TAX ON UNEARNED INCOME

- **Ownership levels: determining trade or business income**
  - ***For individuals, estates or trusts that own an interest in a trade or business through one or more pass through entities (such as a partnership or S corporation), the determination of whether category (i) gross income is derived from a trade or business that is a passive activity is made at the owner level.***

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MEDICARE TAX ON UNEARNED INCOME

- **Category (iii)**
  - ***Net gain included in computing taxable income that is attributable to the disposition of property other than property held in an active trade or business.***

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MEDICARE TAX ON UNEARNED INCOME

- **Category (iii) gains from disposition of nonbusiness property**
  - ***Includes gain on dispositions of property that***
    - (a) Is not held in an active trade or business, or
    - (b) Is held in a trade or business that is a commodities or financial instruments trading business.

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MEDICARE TAX ON UNEARNED INCOME

- **Category (iii) gains from disposition of nonbusiness property**
  - ***Types of gain generally included in category (iii) income:***
    - Gains on the sale of stocks, bonds, and mutual funds;
    - Capital gain distributions from mutual funds;
    - Gain from the sale of investment real estate (including the sale of a second home that is not a primary residence); and
    - Gains from the sale of interests in partnerships and S corporations held by a passive owner.

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MEDICARE TAX ON UNEARNED INCOME

- **Category (iii) losses**
  - ***Category (iii) net gain cannot be less than zero.***
  - ***Suspended losses from former passive activities can be taken against NII, to the extent that the suspended losses are used for purposes of computing taxable income, but only to the extent of the nonpassive income from such former passive activity that is included in NII in that year.***

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MEDICARE TAX ON UNEARNED INCOME

- **Property held in a trade or business**
  - ***Except for working capital, category (iii) income does not include gains or losses attributable to property held in a trade or business (unless the business is trading in financial instruments or commodities, or is a passive activity with respect to the taxpayer).***

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MEDICARE TAX ON UNEARNED INCOME

- **Interests in partnerships and S corporations**
  - ***In general, the disposition of a partnership interest or S corporation stock generates category (iii) gain or loss, but there is an exception for dispositions of active interests in a partnership or S corporation.***
  - ***Regulations provide clarification of the net gain component of the computation and a simplified calculation method.***

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MEDICARE TAX ON UNEARNED INCOME

- **NII does not include:**
  - ***Any distribution (including deemed distributions) from qualified employee benefit plans or arrangements;***
  - ***Any item of income or deduction taken into account in determining self-employment income for the tax year on which an individual pays hospital insurance tax;***
  - ***Income from gains on the sale of an active interest in a partnership or S corporation.***

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MEDICARE TAX ON UNEARNED INCOME

- **Properly allocable deductions**
  - ***Rent, royalty expenses, trade or business expenses (to extent not taken into account in determining self-employment income), the penalty on early savings withdrawals and net operating losses can be taken against NII.***
  - ***Certain itemized deductions also qualify.***

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MEDICARE TAX ON UNEARNED INCOME

- **Reporting requirements**
  - ***NII is calculated on Form 8960, which should be included with personal income tax returns***
  - ***IRS instructions for single-page form are 20+ pages***
  - ***Pass through entities have additional reporting requirements on Schedules K-1 that are issued to their owners***

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MEDICARE TAX ON UNEARNED INCOME

- **Planning considerations – to reduce MAGI**
  - ***Sale of unrealized losses to offset gains (also reduces NII)***
  - ***Deductible contributions to tax-favored retirement accounts***
  - ***Education-related expenses (tuition, student loan interest and educator's expenses)***
  - ***Defer income payments to avoid NII threshold***

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MEDICARE TAX ON UNEARNED INCOME

- **Example 1:**
  - *Jack and Jill are married joint filers*
  - *Jack is retired: SS = $15,000, retirement plan = $25,000*
  - *Jill owns business: $75,000 salary + $50,000 pass through*
  - *Additional $40,000 income from investment earnings*
  - *Total MAGI = $205,000 (under $250,000 NII threshold)*

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- **Example 1: (cont.)**
  - *Jill considering selling business and retiring*
  - *She received an offer for $500,000 – can be collected as a lump sum or in equal installments over three years*
  - *Lump sum increases MAGI to $705,000, subject to NII tax (plus additional increases for higher-income taxpayers)*
  - *Installments allow them to avoid NII and other tax impacts*

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MEDICARE TAX ON UNEARNED INCOME

- **Planning considerations – to reduce NII**
  - ***Consider strategies used to reduce MAGI***
  - ***Evaluate tax-exempt investment strategies***
  - ***Defer gain on sale of vacation property (Sec. 1031 exchange)***
  - ***Gift appreciated securities to children or charities***
  - ***Determine allocable deductions that apply***

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- **Planning considerations – to reduce NII**
  - ***Consider changing participation in rental or business activity so that it is not considered passive***
  - ***Income from active participation in trade or business can be excluded from NII***

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- **Example 2:**
  - ***Siblings John and Julie each own 20% of family business; their parents own remaining 60%***
  - ***Julie is actively involved in the business and pays no additional tax on pass through income from the business***
  - ***Because John is passive (assuming MAGI >$250,000), he is subject to the 3.8% tax on pass through business income***

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- **Example 2: (cont.)**
  - ***If the business is an S corporation, and the company makes distributions to cover owner's tax liabilities, an additional 3.8% would need to be paid to Julie and her parents, as well as to John, even though they are not subject to the tax***
  - ***Increased distributions result in additional cash outflow of approximately 4% of the income of the business***

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- **Example 3**:
  - *If the taxpayer can meet active participation requirements, he/she not only avoids the NII tax on annual earnings, but can also minimize tax on the ultimate sale of the entity*
  - *Assume similar facts as Example 2, but parents plan to sell the business to an outside party for $5,000,000*

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- **Example 3: (cont.)**
  - *John and Julie would each realize $1,000,000 in gain upon the sale of the business*
  - *John's tax liability would be approximately $38,000 more than Julie's if he remains passive (gains subject to NII tax)*
  - *If sale is in the near future, implications of NII tax should be considered with steps taken to minimize the impact*

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UNDERSTANDING THE MEDICARE TAX SURCHARGE ON EARNED INCOME

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MEDICARE TAX SURCHARGE ON EARNED INCOME

- **ACA increased the Medicare (HI) tax on combined earned income and self-employment earnings of "higher-income" individuals**
  - ***Effective as of January 1, 2013***
  - ***Applies to "employee" portion of Medicare tax only***
  - ***Self-employed individuals pay surtax only once***

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MEDICARE TAX SURCHARGE ON EARNED INCOME

- **Imposed on wages and earnings in excess of thresholds**
  - ***$200,000 for single filers***
  - ***$250,000 for married filing jointly****
  - ***$125,000 for married filing separately***

***Surcharge is based on couple's combined earnings**

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MEDICARE TAX SURCHARGE ON EARNED INCOME

- **Combined earnings criteria may cause issues for married couples with more than one wage earner**
  - ***If single earner's income is below threshold, additional tax will not be withheld***
  - ***However, combined earnings may exceed the threshold, making the couple subject to the tax***
- **Consider this situation when calculating quarterly tax liability or request employers to withhold the additional surtax**

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MEDICARE TAX SURCHARGE ON EARNED INCOME

- **Special consideration required for taxpayers who have both wages and self-employment income**
- **Threshold for self-employment is generally reduced by the amount of wages taken into account to determine the surtax**
- **3-step process used to calculate applicable Medicare taxes**

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MEDICARE TAX SURCHARGE ON EARNED INCOME

- **Partnership income**
  - ***Income flowing through to a <u>general partner</u> is treated as self-employment income and <u>IS</u> subject to the surcharge***
  - ***Income allocated to a <u>limited partner</u> is not treated as self-employment income and <u>IS NOT</u> subject to the surcharge***

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MEDICARE TAX SURCHARGE ON EARNED INCOME

- **Planning considerations**
  - ***Business owners may want to set up entity as S corporation to avoid the surcharge on earned income***
  - ***Maximize contributions to pre-tax qualified retirement savings plans to reduce amounts subject to surtax***

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UNDERSTANDING THE EFFECTS OF THE ATRA ON PASS-THROUGH BUSINESSES

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EFFECTS OF ATRA ON PASS THROUGH BUSINESSES

- **Pass through entities are affected indirectly by tax increases on individuals**
- **Cash distributed by the entity to its owners often does not match the tax impacts on passed through income items**
- **"Next" dollar of income concept used to determine the effect of ATRA on pass through entities**

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EFFECTS OF ATRA ON PASS THROUGH BUSINESSES

- **Example 1:**
  - ***Mike is 25% partner in ABC Partnership***
  - ***ABC has income of $1,000,000***
  - ***Mike must pay taxes of $99,000 on his share of pass through income ($250,000)***
  - ***ABC will distribute funds to Mike to cover his tax liability***

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- **Example 2:**
  - *Rita is 100% owner of S corporation with $350,000 salary*
  - *She must pay taxes on this "cash" income plus the S corp. income of $325,000*
  - *Her taxable income ($675,000) is now in the highest bracket*
  - *S corp. will need to make additional distributions to cover her tax liability, which reduces company's cash flow*

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EFFECTS OF ATRA ON PASS THROUGH BUSINESSES

- **Issue is further complicated by 3.8% Medicare tax on NII**
  - *Passive activities that generate positive income will now be subject to the new tax, on top of the marginal rate increase*
- **Pass through entities will need to distribute higher amounts to cover equity holder tax liabilities**
  - *In some cases, total distribution could reach nearly 50%*

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EFFECTS OF ATRA ON PASS THROUGH BUSINESSES

- **To determine full impact of pass through entity income on taxpayer's liability, calculation must be done twice**
  - ***"With" and "Without" pass through income***
- **Process will help to establish proper amounts of distributions needed to cover the additional tax liabilities**
- **For S corporations, equal distribution rule may result in a "windfall" for active equity holders not subject NII tax**

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EFFECTS OF ATRA ON PASS THROUGH BUSINESSES

- **Example 3:**
  - ***Siblings Mike, Bill and Sue are shareholders in their family S corporation business***
  - ***Bill and Sue are active in the business; Mike is not***
  - ***Company has $900,000 of income passed through equally***
  - ***Each shareholder receives cash distribution of $144,000***

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EFFECTS OF ATRA ON PASS THROUGH BUSINESSES

- **Example 3: (cont.)**
  - *As a passive shareholder, with earnings of $400,000 (not including income from the family business), Mike is subject to the Medicare tax ($11,400) on the NII from the business*
  - *Bill and Sue do not need to pay this tax, thus, this amount is an excess distribution for them, providing a small windfall*

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EFFECTS OF ATRA ON PASS THROUGH BUSINESSES

- **Planning Considerations:**
  - *Focus should be on reducing pass through income at the business-entity level*
  - *Timing strategies (deferral of income and acceleration of deductions) are more difficult for accrual basis taxpayers*

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EFFECTS OF ATRA ON PASS THROUGH BUSINESSES

- **Planning Considerations:**
  - ***First take advantage of beneficial IRC provisions that do not result in a "shift" of income to the equity owner***
    - Utilize depreciation and expensing for fixed assets
    - Claim all credits (R&D, energy tax, etc.)
    - Revisit accounting methods and potentially change to a more tax-advantageous method
    - Maximize qualified plan deferral opportunities

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EFFECTS OF ATRA ON PASS THROUGH BUSINESSES

- **Planning Considerations:**
  - ***Next, analyze strategies that will result in shifts but could still provide some benefit***
    - Benefits realized by reducing income at entity level will likely be offset by receipt of income at owner level
    - Income shift may result in recharacterization of income, which could subject it to the 3.8% tax on NII

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EFFECTS OF ATRA ON PASS THROUGH BUSINESSES

- **Planning Considerations:**
  - – ***Other non-income-shifting opportunities for tax savings***
    - Enhance tax-free employee benefits
    - Possible deduction of compensatory items (limited)

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CONCLUSION AND PRACTICAL CONSIDERATIONS

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CONCLUSION AND PRACTICAL CONSIDERATIONS

- **Impossible to determine impact of all the new provisions without preparing a detailed income tax projection**
- **Tax planning needs to occur at entity level, as well as individual level, for pass through business owners**
- **Focus on cash flow planning**
- **Complete a "with" and "without" assessment**

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CONCLUSION AND PRACTICAL CONSIDERATIONS

- **Future status of "tax extenders" which expired in 2013**
  - ***Action not expected until Spring (or possibly much later)***
  - ***Not all provisions will be renewed, and those that are, will likely expire again at the end of 2014***
- **Without the renewal of provisions, tax projections will be higher, leading to accelerated payment of estimated taxes**

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CONCLUSION AND PRACTICAL CONSIDERATIONS

- **Critical to plan for and monitor tax liabilities and the cash flows associated with those liabilities**
- **GYF can provide assistance in understanding and planning for these tax changes**

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THANK YOU!