2013 CORPORATE/BUSINESS NEWS LETTER

INTRODUCTION

It's once again time to begin thinking of year-end tax planning strategies to reduce the tax burden of your business. Year-end planning is particularly challenging this year given the rapid pace of recent tax law changes and the extensive list of business tax breaks scheduled to ***expire at the end of 2013.***

We are sending you this letter to help you navigate several *new* tax planning opportunities available to businesses because of recent law changes and other current tax developments, while also reminding you of the *traditional* year-end tax planning strategies for businesses (including regular "C" corporations, "S" corporations, partnerships, LLCs, and self-employed individuals). **Planning Alert!** Since there are significant business tax breaks ***expiring after 2013,*** you may have to act promptly to take advantage of these short-lived provisions! Therefore, we ***highlight prominently*** the ***expiration dates*** for the various provisions discussed in this letter which are scheduled to expire. **Caution!** Although Congress has traditionally extended many of these expiring business tax breaks in the past, there is no guarantee that they will do so in the future.

Planning Alert! Although this letter contains many planning ideas, you cannot properly evaluate a particular planning strategy without calculating the overall tax liability on the business and its owners (including the alternative minimum tax) with and without the strategy. In addition, ***this letter contains ideas for Federal income tax planning only*. *State income tax issues are not addressed.*** You should also consider any state income tax consequences of a particular planning strategy. We recommend that **you call our firm before implementing any tax planning technique** discussed in this letter, or if you need more information.

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TAKE ADVANTAGE OF BUSINESS TAX BREAKS SCHEDULED TO EXPIRE AFTER 2013

A host of current tax breaks for businesses are scheduled to ***expire after 2013,*** unless Congress takes action to extend these provisions. **Caution!** Although Congress has traditionally extended a majority of expiring tax breaks in the past, there is no guarantee that it will do so in the future. **Tax Tip.** Regardless of how Congress ultimately addresses these expiring tax breaks, there are real tax savings available if your business takes advantage of these provisions ***before their scheduled expiration date.*** The following are some of the more popular tax breaks that have been available to businesses over the past several years, but are ***currently scheduled to expire after 2013*****: 1)** 15-Year (Instead of 39-year) Depreciation Period for "Qualified" Leasehold Improvements, Restaurant Property, and Retail Improvement Property; **2)** 7-Year Depreciation Period for Certain Motor Sports Racetrack Property; **3)** Research and Development Credit; **4)** Employer Differential Wage Credit for Payments to Military Personnel; **5)** Favorable S Corporation Charitable Contribution Provisions Involving Capital Gain Property (expires for contributions in tax years beginning after 2013); **6)** a Host of Tax Benefits for Qualified Energy-Efficient Expenditures and for Qualifying Investments in Empowerment Zones; **7)** Election for C Corporations to Exchange Bonus Depreciation for Refundable AMT Credits; **8)** Parity Between Employer-Provided Parking and Employee Transportation Fringe Benefits; and **9)** Enhanced Charitable Contribution Rules for Qualifying Business Entities Contributing Food Inventory. **Planning Alert!** If you would like to take advantage of any of these provisions, but you need more information, please call our office so we can help you take the necessary steps to lock in these deductions before it is too late.

In addition to the expiring provisions listed above, the following are business tax breaks scheduled to expire after 2013 ***that warrant special attention*** as we approach ***the end of 2013:***

The 50% 168(k) Bonus Depreciation Scheduled To Expire After 2013. A significant "targeted" business tax break ***scheduled to expire*** *(for most qualifying property)* ***after 2013*** is the ***50% 168(k) first-year bonus depreciation*** deduction. The amount of this deduction has fluctuated over the last several years. However, for qualifying property placed-in-service after 2011 and before 2014, the deduction is 50% of the cost of the property. The deduction is ***scheduled to expire altogether*** for qualifying property placed-in-service ***after December 31, 2013*** (placed-in-service after December 31, 2014 for certain long-production-period property and qualifying noncommercial aircraft). Therefore, if you are considering acquiring qualifying property for your business in the near future, and you do not want to miss out on this deduction, your business must ***generally "acquire"*** and ***"place in service"*** the qualifying property ***no later than December 31, 2013.*** However, there are special rules for long-production-period property and noncommercial airplanes placed-in-service before 2015. **Planning Alert!** This December 31, 2013 deadline applies whether your business is a ***fiscal-year*** or ***calendar-year*** taxpayer.

- **"Placed-In-Service."** Generally, if you are purchasing "personal property" (equipment, computer, vehicles, etc.) "placed-in-service" means the property is ***ready and available*** for use. To be safe, qualifying property should be ***set up and tested*** on or before the ***last day of 2013.*** If you are dealing with building improvements (e.g., qualified leasehold improvement property, non-structural components of a building), a ***certificate of occupancy*** will generally constitute placing the building improvements in service.

- **Qualifying 50% 168(k) Bonus Depreciation Property.** Generally, property qualifies for the 50% 168(k) bonus depreciation deduction if it is purchased ***new*** and it is either a "qualified leasehold improvement" (discussed below), or it has a depreciable life for tax purposes of *20 years or less* (e.g., machinery and equipment, furniture and fixtures, cars and light general purpose trucks, sidewalks, roads, landscaping, depreciable computer software, farm buildings, and qualified motor fuels facilities). **Tax Tip.** Make sure you properly classify "land improvements" as "15-year property" (and not as part of the building) since land improvements qualify for the 50% bonus depreciation deduction, and buildings (other than "qualified leasehold improvements," farm buildings, and qualified motor fuels facilities) generally do not. **Planning Alert!** These are only examples of qualifying property. If you have a question about property that we did not mention, call us and we will help you determine if it qualifies. **Caution!** "Qualified restaurant property" and "qualified retail improvement property" (described in the section 179 discussion below) do not qualify for the 50% 168(k) deduction unless the property also constitutes a "qualified leasehold improvement."

- **Reconditioning Used Property.** Although the 50% 168(k) bonus depreciation property must generally be "new," the IRS regulations provide that capital expenditures incurred to recondition or rebuild used property may qualify. **For example,** lets assume that your business purchases a *used* machine during 2013 for $50,000. Also during 2013, you incur $20,000 to recondition the machine. The $50,000 cost of the used machine does not qualify for 50% 168(k) bonus depreciation deduction. However, the $20,000 expenditure to "recondition" the machine would qualify for the 50% deduction.

- **"Qualified Leasehold Improvement Property."** Even though improvements to a commercial building *generally* do not qualify for the 50% 168(k) bonus depreciation deduction, "qualified leasehold improvement property" (QLHIP) does qualify. *QLHIP* is generally any capital improvement to an interior portion of a building that is used for nonresidential commercial purposes, provided that **1)** the improvement is made under or pursuant to a lease either by the lessee, sublessee or lessor of that interior building portion; **2)** the interior building portion is to be occupied exclusively by the lessee or sublessee; **and 3)** the improvement is placed-in-service ***more than 3 years*** after the date the building was first placed-in-service. **Planning Alert!** *QLHIP* ***does not include*** any improvement attributable to: the enlargement of the building; any elevator or escalator; any structural component benefitting a common area; or the internal structural framework of the building. **Caution!** Leasehold improvements made to property leased between ***certain*** *related persons* ***will not qualify.***

- **Newly-Constructed Or Renovated Buildings And Cost Segregation Studies.** Depreciable components of buildings that are properly classified as depreciable *personal* property under a ***cost segregation study*** are generally depreciated over 5 to 7 years. Since these non-structural components have a depreciable life of 20 years or less, they should qualify for the 50% 168(k) bonus depreciation if the building is ***placed-in-service in 2013.***

- **Entire Cost Of Property Received In A Trade-In Qualifies For 50% 168(k) Bonus Depreciation.** Let's assume that in 2013, your business trades in a dump truck that has a tax basis of $50,000 in return for a new dump truck plus $30,000 cash. This trade in will generally constitute a tax-deferred "like-kind" exchange for tax purposes. However, the entire $80,000 basis (i.e., the $50,000 basis in the old truck plus the additional $30,000 payment) will qualify for the 50% 168(k) bonus depreciation deduction. **Practice Alert!** A section 179 deduction (discussed below) may not be taken on the $50,000 carryover basis, but may be taken on the $30,000 cash payment.

- **50% 168(k) Bonus Depreciation For Passenger Automobiles, Trucks, And SUVs.** The maximum annual depreciation deduction (including the section 179 deduction) for most *business automobiles* is capped at certain dollar amounts. For a business auto first placed-in-service in ***calendar year 2013,*** the maximum first-year depreciation deduction is generally capped at $3,160 ($3,360 for trucks and vans not weighing over 6,000 lbs). However, Congress has temporarily increased these first-year depreciation caps by $8,000 if a qualifying "new" vehicle is ***placed-in-service before 2014.*** **Planning Alert!** These depreciation caps are reduced if the vehicle is not used 100% for trade or business purposes.

"Expanded" Section 179 Deduction Scheduled For Major Reduction For Tax Years Beginning After 2013. Another extremely popular business tax break, ***scheduled to be scaled back for tax years beginning after 2013,*** is the "expanded" section 179 deduction. For the last several years, Congress has temporarily increased the maximum section 179 up-front deduction for the cost of qualifying "new" or "used" depreciable business property (e.g., business equipment, computers, etc.). For property placed-in-service in ***tax years beginning in 2010 through 2013,*** the overall section 179 cap is ***$500,000,*** and the $500,000 deduction is not reduced until the section 179 property placed-in-service during the year exceeds ***$2,000,000.*** In addition, for ***property placed-in-service in tax years beginning in 2010 through 2013,*** a taxpayer may elect for **up to $250,000** of ***"qualified real property"*** to be section 179 property. **Planning Alert!** For **tax years *beginning after 2013,*** the maximum section 179 deduction is currently scheduled to drop ***to $25,000,*** the phase-out threshold ***drops to $200,000,*** and there will ***no longer be a section 179 deduction*** for ***"qualified real property"*** or ***computer software.***

- **Consider Accelerating 179 Acquisitions!** If your business is searching for purchases between now and the end of the year that will generate substantial tax deductions, you should seriously consider taking

advantage of the expanded section 179 deduction. **Planning Alert!** These expanded section 179 provisions ($500,000 cap, application to "qualified real property," etc.) expire for qualifying property ***placed-in-service in tax years beginning after 2013.*** Therefore, if your business uses a calendar tax year, it must place the qualifying property in service ***no later than December 31, 2013.***

●● **Potential Trap For Fiscal Year Pass-Through Entities.** If you have a pass-through business entity (e.g., S Corporation, LLC, Partnership), you must apply the $500,000/$2,000,000 limitations twice–once at the entity level and again to the owners (i.e., to the S Corporation Shareholders, LLC Members, and Partners). This rule can present a trap for the owners of a fiscal-year entity. For example, let's assume that Bob owns 100% of his S corporation, and the S corporation's tax year ends September 30. The S corporation's last tax year that begins in 2013 would be its fiscal year running from October 1, 2013 through September 30, 2014. Therefore, the S corporation would be entitled to the expanded $500,000/$2,000,000 limitations for qualifying section 179 property purchased and placed-in-service ***as late as September 30, 2014.*** However, the section 179 deduction taken by the S corporation for its fiscal tax year ending September 30, 2014, would flow through and be reported on Bob's individual tax return for 2014 (when the section 179 cap is scheduled to revert to $25,000). In that situation, the IRS says that even though the S corporation could pass through the 179 deduction of $500,000 (for its fiscal year ending September 30, 2014), Bob could only deduct $25,000 of the pass through on his 2014 individual return and the remaining $475,000 could not be carried forward to future years. **Planning Alert!** The good news is that if the S corporation passes through the $500,000 179 deduction and Bob's section 179 limitation actually drops to $25,000 for 2014, the S corporation return could be amended to reduce the amount of section 179 elected by the S corporation to $25,000.

- **Up To $250,000 Of *"Qualified Real Property"* Temporarily Qualifies As Section 179 Property.** Traditionally, the section 179 deduction has been limited to depreciable, tangible, "personal" property, such as equipment, computers, vehicles, etc. However, businesses may **"elect"** to treat qualified "real" property as §179 property, for property **placed-in-service in tax years beginning in 2010 through 2013.** The maximum section 179 deduction that is allowed for *qualified real property* is $250,000. "Qualified Real Property" includes the following: **1) Qualified Leasehold Improvement Property** (generally capital improvements to an interior portion of certain leased buildings that are more than 3 years old and that are used for nonresidential commercial purposes); **2) Qualified Retail Improvement Property** (generally capital improvements made to certain buildings that are more than 3 years old and which are open to the general public for the sale of tangible personal property); **and 3) Qualified Restaurant Property** (generally capital expenditures for the improvement, purchase, or construction of a building, if more than 50% of the building's square footage is devoted to the preparation of, and seating for, the on-premises consumption of prepared meals). **Planning Alert!** To the extent the section 179 deduction is not taken, each of these three properties is depreciated ***over 15 years*** (using the straight-line depreciation method) ***if placed-in-service before 2014.*** If placed-in-*service* ***after 2013,*** each of these properties is depreciated ***over 39 years.***

- **Heavy Vehicles (i.e., > 6,000 lbs.)** Trucks and SUVs with loaded rated vehicle weights over 6,000 lbs are generally exempt from the annual depreciation caps that were discussed previously in this letter. These "heavy vehicles," ***if used more than 50% in business,*** will also qualify for the 50% 168(k) bonus depreciation deduction (if new), and the section179 deduction (whether new or used). However, the section 179 deduction for an *SUV* is limited to $25,000. ***For example,*** let's assume that in 2013 you purchase and place-in-service a new "over-6,000 lb" SUV ***for $50,000*** used entirely for business. If you elect to take the section 179 deduction on the vehicle, for 2013 you could deduct: **1)** up to $25,000 under section 179, **2)** 50% of the remaining balance as 168(k) first-year bonus depreciation, and **3)** 20% of the remaining cost as regular depreciation for the first year. Thus, for a $50,000 new heavy SUV placed-in-service in 2013, you could write off $40,000 in 2013 (assuming 100% business use and the half-year convention applies). **Tax Tip!** Pickup trucks with loaded vehicle weights over 6,000 lbs are exempt from the $25,000 limit under §179 (imposed on SUVs) if the truck bed is at least six feet long. **Planning Alert!** If you take the section179 deduction and/or the 50% 168(k) first-year bonus depreciation on your business vehicle, and your business use percentage later ***drops to 50% or below,*** you will generally be required to bring into income a portion of the deductions taken in previous years.

<u>Work Opportunity Tax Credit Extended.</u> Over the last two decades, many employers have taken advantage of the Work Opportunity Tax Credit (WOTC) by hiring workers from certain disadvantaged groups. For example, hiring a worker who receives certain government benefits, or is a veteran, may qualify your business for this credit. Currently, the WOTC is scheduled to ***expire for any qualified worker who begins work after December 31, 2013.***

- **Expanded WOTC For "Qualified Veterans."** To encourage employers to hire more military veterans, in late 2011, Congress added an expanded ***"qualified veteran"*** category to the types of employees that qualify for the WOTC. Depending on the "tax" classification of the *"qualified veteran,"* the maximum credit runs from $2,400 to $9,600. In addition, unlike the WOTC credits for other individuals, tax-exempt employers (other than government agencies) that hire *"qualified veterans"* may receive a *"refundable"* credit of 65% of the credit allowed for taxable employers. However, the WOTC is scheduled to expire for "qualified veterans" ***who begin work after December 31, 2013.***

- **Planning Alert!** To qualify for the WOTC, all employers (including tax-exempt employers who hire "qualified veterans") must have the new worker complete IRS **Form 8850** ("Pre-Screening Notice and Certification Request for the Work Opportunity Credit"), and submit that form to the state employment security agency ***no later than 28 days*** after the employee begins work. You can locate Form 8850 at www.irs.gov. The instructions to the form provide a detailed explanation of the categories of workers who qualify for the WOTC (including the definition of a *"qualified veteran"*).

<u>100% Exclusion For "Qualified Small Business Stock."</u> If ***"qualified small business stock"*** (QSBS) is acquired ***after September 27, 2010 and before January 1, 2014*** and you ***hold the stock for over 5 years,*** you will be able to exclude the ***entire gain*** from taxable income (the gain will also be exempt from the alternative minimum tax). ***QSBS*** is generally stock of a non-publicly traded domestic "C" corporation engaged in a qualifying business, purchased directly from the corporation, and **held for more than 5 years;** where the issuing corporation meets certain active business requirements and has assets at the time the stock is issued of $50 million or less. Businesses engaged in a professional service, banking, insurance, financing, leasing, investing, hotel, motel, restaurant, mining, or farming activity generally *do not* qualify. **<u>Planning Alert!</u>** If you are considering investing in or starting a new business, we will gladly help you evaluate whether structuring your investment as QSBS will work to your overall tax advantage. However, you must act promptly to take advantage of this narrow window of opportunity to ultimately qualify for the 100% exclusion. Only stock acquired ***from September 28, 2010 through December 31, 2013*** qualifies for the 100% exclusion (after it has been held for more than five years). Also, to qualify for the exclusion, you must purchase the stock directly from the corporation that is issuing the stock or from an underwriter of the stock (stock purchased from other third parties does not qualify). **<u>Caution!</u>** One of the key requirements for QSBS is that it be issued by a regular "C" corporation. Traditionally, a "C" corporation has not been the preferred entity for many new business ventures for various reasons, including the fact that the corporation's operating income is potentially subject to double taxation (once when earned by the corporation, and a second time when it is distributed to a shareholder as a taxable dividend or upon liquidation of the corporation.

<u>S Corp 10-Year Built-In Gain "Waiting" Period Temporarily Shortened To 5 Years.</u> If a regular "C" corporation elects "S" corporation status (a "Converted S corporation"), the election itself generally does not trigger income. However, the Converted S corporation must generally pay a 35% corporate "built-in gains tax" on gain from the sale of any *"built-in gain asset"* (up to the amount of appreciation in that asset on the effective date of the S election), if the asset is sold during the first 10 years following the S election. A ***"built-in gain asset"*** is generally any asset with a market value greater than the asset's basis on the effective date of the S election. Recent legislation *has temporarily* reduced the 10-year waiting period *to* ***5 years*** for sales of ***built-in gain assets during tax years beginning in 2011 through 2013.*** For example, there will be no 35% built-in gains tax on the sale of a ***built-in gain asset*** by a ***Converted S corporation*** for a taxable year of the S corporation ***beginning in 2013,*** provided the sale occurs more than 5 years after the effective date of the "S" election. **<u>Planning Alert!</u>** For sales of "built-in gain assets" that occur in tax years beginning ***after 2013,*** the waiting period to avoid the *built-in gains tax* is scheduled to revert to 10 years. **<u>Caution!</u>** We have just summarized these extremely complicated rules in this letter. If your Converted S corporation plans to sell a *built-in gain asset*, please call us. We will gladly help you determine if the S corporation qualifies under this special 5-year rule.

<u>THE NEW 3.8% "NET INVESTMENT INCOME TAX" – STRATEGIES FOR BUSINESS OWNERS</u>

<u>**Overview.**</u> ***Beginning in 2013*****,** the *Affordable Care Act* imposes a new 3.8% tax on the ***net investment income*** (*3.8% NIIT*) of ***higher-income*** *taxpayers*. With limited exceptions, ***"net investment income"*** generally includes the following types of income (less applicable expenses): interest, dividends, annuities, royalties, rents, "passive" income (as defined under the traditional "passive activity" loss rules), long-term and short-term capital gains, and income from the business of trading in financial securities and commodities. <u>**Planning Alert!**</u> Income, including "passive" income, ***is not*** *"net investment income"* (and is therefore exempt from this new 3.8% NIIT), ***if the income is "self-employment income"*** subject to the 2.9% Medicare tax. The 3.8% NIIT applies to individuals with modified adjusted gross income (MAGI) exceeding the following ***"thresholds": $250,000*** if ***married filing jointly; $200,000*** if ***single;*** and ***$125,000*** if ***married filing separately.*** The 3.8% NIIT is imposed upon ***the <u>lesser of</u>*** an individual's: **1)** modified adjusted gross income (MAGI) in excess of the ***threshold,*** or **2)** net investment income.

- **Example.** For 2013, Mark (a single taxpayer) has MAGI of $210,000 comprised of W-2 compensation of $180,000 and "investment income" (e.g., capital gains, interest, dividends) of $30,000. Mark has $10,000 of deductible expenses allocable to investment income. Therefore, Mark's "net investment income" is $20,000. The 3.8% NIIT would be imposed on the ***lesser of:*** **1)** ***$10,000*** (i.e., Mark's MAGI of $210,000 less the $200,000 threshold for a single individual), or **2)** ***$20,000*** (Mark's net investment income). Therefore, Mark would pay NIIT of $380 (i.e., $10,000 x 3.8%).

<u>**Business Income Of Passive Owners May Trigger The 3.8% NIIT.**</u> For purposes of this 3.8% NIIT, *net investment income* includes *operating* business income that is taxed to a ***"passive"*** owner (unless the operating income constitutes *self-employment* income to the owner that is subject to the 2.9% Medicare tax). For this purpose, an owner is considered *"passive"* in a business activity (excluding activities conducted through a C corporation) if the owner is "passive" under the *passive loss limitation* rules that have been around for years. For example, you are deemed to *materially participate* (i.e., your not "passive") if you spend ***more than 500 hours*** during the year working in the business.

- **Special Rule For "Passive" Operating Income.** As mentioned above, business income reported by a ***"passive"*** owner is ***not subject to the 3.8% NIIT*** if the income constitutes *self-employment income* ***subject to the 2.9% Medicare tax.*** Pass-through business income to a ***"general"*** partner ***is*** classified as *self-employment income* subject to 2.9% Medicare tax, ***regardless of whether*** the partner "materially participates" in the partnership's business activities. Therefore, pass-through business income to a ***general*** partner ***is exempt*** from the 3.8% NIIT. However, pass-through business income to an ***S corporation shareholder*** or a ***"limited"*** partner (other than "guaranteed payments") is ***not classified*** as ***"self-employment income",*** and therefore is not subject to the 2.9% Medicare tax. Consequently, if you are a ***limited partner*** or ***S corporation shareholder,*** your pass-through business income will generally constitute ***net investment income*** (and, thus exposed to the 3.8% NIIT) ***unless*** you ***"materially participate"*** in the operations of the business.

- **"Passive" S Corporation Shareholders And Limited Partners Should Consider "Materially Participating."** If you are an ***S corporation shareholder*** or ***limited partner,*** and you *materially participate* in the business, your pass-through business income will generally be ***exempt*** from the new 3.8% NIIT. <u>**Note!**</u> The pass-through income is also exempt from Social Security and Medicare taxes (including the new .9% Additional Medicare Tax on earned income). Thus, if you are currently a "passive" limited partner or S corporation shareholder and your MAGI exceeds the thresholds for the 3.8% NIIT (e.g., exceeds $250,000 if married filing jointly; $200,000 if single), you should begin now taking steps to establish that you *"materially participate"* in the business. For example, one way to *establish that you materially participate* in the business would be to devote *over 500 hours* during the year working in the business. <u>**Tax Tip.**</u> Depending on your specific facts and circumstances and the type of ownership interest you have in a business (e.g., S corporation shareholder vs. limited partner), there may be other ways you can *establish that you "materially participate"* in the business without working more than 500 hours. <u>**Planning Alert!**</u> If you have other *"passive"* activities generating losses, you may prefer to remain *passive* so that your pass-through business income may be used to offset your *passive* losses from the other

passive activities. **Caution!** These rules are complicated and require a thorough review of your particular situation to develop the most tax-wise strategy.

Rental Income Is Generally Subject To The 3.8% NIIT. Generally, ***rental income*** is classified as ***"investment income"*** for purposes of the ***3.8% net investment income tax.*** Therefore, individuals with MAGI exceeding the NIIT thresholds, will be required to pay the 3.8% NIIT on all or a portion of their net rental income. However, as discussed in the next segment, there are exceptions from the general rule that rental income is net investment income (NII).

Certain Owners Of Rental Real Estate May Be Able To Avoid The 3.8% NIIT. Real estate rental income is generally presumed "passive" income, and is not usually subject to the self-employment tax. Consequently, ***net real estate rental income*** generally constitutes ***net investment income,*** and is subject to the 3.8% NIIT. However, it appears that your real estate rental income would be exempt form the 3.8% NIIT if you ***meet all of the following requirements:*** **1)** you are a ***"qualified real estate professional"*** (defined below), **2)** you ***"materially participate"*** in the real estate rental activity that is generating the net rental income, **AND 3)** the real estate rental activity is considered to be a ***"trade or business"*** for tax purposes. In addition, income from renting real property to a trade or business in which you materially participate may not be subject to the 3.8% NIIT, if the real estate rental activity is considered to be a trade or business. **Planning Alert!** Whether rental real estate activities constitute a *"trade or business"* is a gray area and is determined by applying case law to the facts and circumstances in each situation.

- **Qualified Real Estate Professional.** Generally, a ***"qualified real estate professional"*** is an individual **1)** who performs ***more than 750 hours*** of services during the year in ***"real property"*** trades or businesses (e.g., real estate development, management, construction, rental, leasing, brokerage) in which the individual materially participates, **and 2)** ***more than 50%*** of the personal services performed in trades or businesses by the individual during the year are performed in *"real property"* trades or businesses in which the individual materially participates. **Tax Tip.** There are certain tax elections relating to your rental real estate activities that may enhance your ability to qualify for these special rules.

- **Planning Alert!** As illustrated by this discussion, the rules for determining whether a qualified real estate professional may be exempt from the 3.8% NIIT are tricky and complicated. If you think that this exception to the 3.8% NIIT might apply to you, we will be glad to review your specific situation.

AFFORDABLE CARE ACT EMPLOYER MANDATE DELAYED – BUT NOT GONE

Overview. The Affordable Care Act (*ACA)* generally provides that ***"applicable large employers"*** (using a 50-employee threshold test) must offer an ***"eligible employer health plan"*** to its full-time employees, or face a ***nondeductible excise tax*** (the so-called *play-or-pay* penalty) **if at least one of its full-time employees** obtains insurance on the exchange and **receives a premium assistance credit.** Although *ACA* states that this provision becomes effective in 2014, last summer the ***IRS announced that it will not impose this excise tax on employers until 2015.*** The IRS also says that it will delay, ***from 2014 to 2015,*** the *ACA* requirement that employers must provide certain annual health insurance information to the IRS and to their employees. **Note!** This delay essentially gives employers an additional year to prepare for the health care mandate imposed by *ACA.* **Planning Alert!** The employer ***"excise tax"*** for failure to offer an *"eligible employer health plan"* to employees applies only to *"applicable large employers*." An ***"applicable large employer"*** is generally an employer that employed **on average** 50 or more employees (determined by adding together the number of "full-time employees" and the"full-time equivalent employees") during each month of the entire ***preceding calendar year.*** Under this rule, an employer would be classified as an "*applicable large employer"* for ***2015*** (i.e., the first year the IRS will enforce the employer mandate excise tax) if it employed a **monthly average** of at least 50 employees *("full-time employees"* plus *"full-time equivalent employees"*) during the ***entire 2014 calendar year.*** **Caution!** The IRS has released a set of comprehensive regulations containing rules for determining whether an employer meets the 50-employee threshold. These rules are lengthy and complicated, so please call our firm if you need additional details.

- **Department Of Labor Employee Notice.** As mentioned above, the IRS generally delayed the Affordable Care Act (ACA) IRS information reporting requirements for employer ***until 2015.*** However, the

Department of Labor (DOL) did not delay a requirement for employers to provide a notice to employees regarding certain health care options available under ACA. The DOL has provided two model notices that employers may use to comply with this employee notification requirement. One model notice is for employers who offer health insurance coverage to some or all of its employees, and the other model notice is for employers who do not offer a health plan to its employees. The model notices can be obtained from the DOL website at www.dol.gov/ebsa/healthreform. **Planning Alert!** The DOL announced that employers were required to give this notice to existing employees no later than October 1, 2013, and for employees hired after that date within 14 days of the new employee's hire date. However, on its website, the DOL states: ***"[T]here is no fine or penalty*** *under the law* ***for failing to provide the notice."*** [Emphasis added].

IRS RELEASES MUCH-ANTICIPATED "FINAL" REPAIR VS. CAPITALIZATION REGULATIONS

Summary. One of the most significant "tax" issues confronting business taxpayers is whether they must capitalize or deduct (as a current "expense") expenditures for acquiring, maintaining, or repairing "tangible" business property (e.g., equipment, vehicles, buildings, supplies, etc.). For example, let's assume that a storm damaged the roof of your commercial building costing you $50,000 to bring the roof back to its pre-damaged condition. If you are allowed to treat the expenditure as a *repair*, you could deduct the entire $50,000 immediately. By contrast, if you are required to *capitalize* the expenditure as an "improvement" to the building, you would be required to deduct the $50,000 over the depreciable life provided for a commercial building (i.e., over 39 years). Virtually every business, large and small, eventually confronts this "repair" vs. "capitalization" issue.

In December 2011, the IRS released long-awaited ***"temporary"*** repair vs. capitalization regulations ("repair regulations") applicable to "tangible" business property which were originally scheduled to be effective for tax years beginning after 2011. However, in November 2012, the IRS announced that it planned to issue the ***"final"*** repair regulations during 2013, and that taxpayers ***were not required*** to apply either the "temporary" or the "final" repair regulations ***until tax years beginning after 2013.*** As promised, in September 2013, the IRS released its "final" repair regulations which are generally effective ***for tax years beginning after 2013.***

- **Generally Good News!** As compared to the earlier *"temporary"* regulations, the *"final"* expense regulations include significant taxpayer-friendly changes. For example, the *final* regulations contain: **1)** a new ***"elective"*** *de minimis safe harbor* generally allowing taxpayers that meet certain criteria to deduct individual purchases of tangible business property not exceeding $500 (not exceeding $5,000 for certain businesses that have a qualifying financial statement); **2)** a new ***"elective"*** *de minimis safe harbor* generally allowing a business with average gross receipts of $10 million or less to deduct qualifying expenditures with respect to buildings that cost $1 million or less; **3)** a revised and simplified ***"routine maintenance"*** safe harbor that, if satisfied, allows taxpayers of any size to deduct qualifying expenditures with respect to personal property (e.g., business equipment, vehicles, etc.) and buildings; and **4)** clearer rules for identifying "incidental" materials and supplies that are deductible when paid for and "nonincidental" materials and supplies which are deductible when consumed. In addition, the IRS simultaneously released new *proposed* regulations that make several pro-taxpayer changes to the tax treatment for dispositions of depreciable property (including revised tax treatment for the disposition of a building component).

- **Planning Alert!** These new ***"final" regulations*** are long (approximately 200 pages), comprehensive, and are generally not effective until ***tax years beginning after 2013.*** However, the IRS ***gives us the option*** to apply either the "final" regulations, the "temporary" regulations (released in 2011), or the older pre-2011 regulations ***for tax years beginning in 2012 or 2013.*** Moreover, there are provisions in the final regulations that may make it advantageous for you to: **1)** have written "expensing" policies in place as early as **January 1, 2014; 2)** amend your 2012 return to retroactively "elect" one or more of the *safe harbors* (discussed above) allowed under the final regulations; or **3)** apply for an accounting method change to apply the final regulations to prior years. Consequently, our firm is in the process of examining how these rules apply to various situations. In the meantime, if you need more information, feel free to call us.

TRADITIONAL YEAR-END PLANNING FOR "S" CORPORATIONS AND PARTNERSHIPS

S Corporation Shareholders Should Check Stock And Debt Basis Before Year End. If you own S corporation stock and you think your S corporation will have a tax loss this year, you should contact us as soon as possible. These losses will not be deductible on your personal return unless and until you have adequate "basis" in your S corporation. Any pass-through loss that exceeds your "basis" in the S corporation will carry over to succeeding years. You have basis to the extent of the amounts paid for your stock (adjusted for net pass-through income, losses, and distributions), ***plus*** any amounts you have personally loaned to your S corporation. **Planning Alert!** If an S corporation anticipates financing losses through borrowing from an outside lender, the best way to ensure the shareholder gets ***debt basis*** is to: **1)** have the shareholder personally borrow the funds from the outside lender, and **2)** then have the shareholder formally (with proper and timely documentation) loan the borrowed funds to the S corporation. It also may be possible to *restructure* (with timely and proper documentation) a pre-existing outside loan directly to an S corporation in a way that will give the shareholder debt basis. **Caution!** A shareholder cannot get debt basis by merely guaranteeing a third-party loan to the S corporation. ***Please do not attempt to restructure your loans without contacting us first.***

Making Payments On S Corporation Shareholder Loans May Trigger Income. As discussed above, let's assume that you have previously loaned funds to your S corporation which, in turn, created basis that you have used to deduct pass-through losses from prior years. If all or a portion of the loan is paid back after the loan's basis has been reduced by pass-through losses, you will recognize a gain on the repayment. The amount, character, and timing of the gain is dependent on several factors, including: **1)** when during the tax year the payment is made, **2)** whether the loan is an "open account" advance, or evidenced by a written promissory note, and **3)** the amount of the unpaid balance on an "open account" advance as of the end of the tax year. For example, if the loan is an "open account" (i.e., not evidenced by a written promissory note), any gain triggered by a payment on the loan will generally be taxed at ordinary income tax rates. However, if the loan is evidenced by a written promissory note and has been outstanding for over one year, any gain triggered on the payback may qualify for favorable long-term capital gains treatment. **Tax Tip.** It may save you taxes in the long run if you postpone principal payments on the depleted-basis loan until the loan's basis has been restored by subsequent S corporation pass-through income. ***Please consult with us before your S corporation repays shareholder loans.*** We will help you structure the loans and any loan repayments to your maximum tax advantage.

Salaries For S Corporation Shareholder/Employees. For 2013, an employer must pay FICA taxes of 7.65% of an employee's wages up to $113,700 and FICA taxes of 1.45% on wages in excess of $113,700. In addition, an employer must withhold FICA taxes from an employee's wages of 7.65% on wages up to $113,700 and 1.45% of wages in excess of $113,700. If you are a stockholder/employee of an S corporation, this FICA tax is generally applied only to your W-2 income from your S corporation. Other income that passes through to you or is distributed with respect to your stock is generally not subject to FICA taxes or to self-employment taxes.

- **Salaries Must Be "Reasonable."** If the IRS determines that you have taken an unreasonably "low" salary from your S corporation, the Service will generally argue that other amounts you have received from your S corporation (e.g., distributions) are disguised "compensation" and should be subject to FICA taxes. Determining "reasonable salaries" for S corporation shareholder/employees is a hot audit issue, and the IRS has a winning record in the courts on this issue. Over the years, the IRS has been particularly successful where S corporation owners pay themselves ***no salary*** even though they provided significant services to the corporation. However, more recently, the IRS has won several cases where the S corporation owners paid themselves ***more than a de minimis salary,*** but the court still held that an additional portion of their cash "distributions" should be reclassified as "salary" (subject to payroll taxes). **Caution!** Determining a "reasonable" salary for an S corporation shareholder is a case-by-case determination, and there are no rules of thumb for determining whether the compensation is "reasonable." However, recent court cases make it clear that salaries to S corporation shareholders should be supported by independent data (e.g., comparable industry compensation studies), and should be properly documented and approved by the corporation.

- **Planning Alert!** Keeping salaries low and minimizing your FICA tax could also reduce your Social Security benefits when you retire. Furthermore, if your S corporation has a qualified retirement plan, reducing your salary may reduce the amount of contributions that can be made to the plan on your behalf since contributions to the plan are based upon your "wages."

Deductions For Business Expenses Paid By Partners And Shareholders May Be Limited. Historically, the IRS has ruled that a partner may deduct business expenses ***paid on behalf*** of the partnership ***only if*** there is an agreement (preferably in writing) between the partner and the partnership providing that those expenses are to be paid by the partner, and that the expenses will not be reimbursed by the partnership. **Tax Tip.** If you are a partner paying unreimbursed expenses on behalf of your partnership, to be safe, you should have a written agreement with the partnership providing that those expenses are to be paid by you, and that the expenses will not be reimbursed by the partnership. **Planning Alert!** The courts continue to hold that a corporate shareholder may not deduct expenses the shareholder pays on behalf of the corporation ***unless*** the shareholder is employed by the corporation, the shareholder is required to incur the expenses as a part of his or her duties as an employee, and there is an agreement or understanding that the corporation will not reimburse the expenses. Even if the expenses are deductible by the shareholder-employee, they are classified as *miscellaneous itemized deductions* which are subject to the 2% reduction rule, and are not deductible at all for *alternative minimum tax* purposes. **Planning Alert!** These rules ***apply to both S corporation and C corporation*** shareholders. **Tax Tip.** If business expenses paid by a shareholder for an S corporation or C corporation are reimbursed to the shareholder under a qualified *"accountable plan"*, the corporation can take a full deduction and the shareholder will exclude the reimbursement from taxable income.

Self-Employed Individuals, Partners, And S Corporation Owners Should Take Maximum Advantage Of Deduction For Health Insurance Premiums. Generally, if you are self-employed, a partner in a partnership, or a more-than-2% shareholder of an S corporation, you may qualify for an "above-the-line" deduction (i.e., unrestricted by the limitations on "itemized deductions") for health insurance premiums you pay for yourself, your spouse, your dependents, or your children under 27 at the end of the year (even if the child is not your dependent). The IRS says that if you otherwise qualify for an *above-the-line* deduction for health insurance premiums, you may be able to deduct your Medicare premiums (including ***Part B*** and ***Part D***).

- **Planning Alert!** If you are a partner in a partnership or an S corporation shareholder, and you are paying your 2013 health insurance premiums directly (including Medicare premiums), the IRS says that you should have the partnership or S corporation reimburse you for those premiums ***before the end of 2013*** to qualify for the *above-the-line* deduction. The IRS also says that, if you are an S corporation shareholder, the premium reimbursement must be included in your W-2. For partners, the premium reimbursement must be treated by the partnership as a "guaranteed payment."

OTHER YEAR-END GENERAL BUSINESS PLANNING

Establishing A New Retirement Plan For 2013. Calendar-year taxpayers wishing to establish a qualified retirement plan for 2013 (e.g. profit-sharing, 401(k), or defined benefit plan) *generally* must adopt the plan **no later than December 31, 2013.** However, a SEP may be established by the due date of the tax return (including extensions), and a SIMPLE plan must have been established no later than October 1, 2013.

Planning For C Corporation Estimated Tax Requirements. If your C corporation had less than $1 million of taxable income for ***each*** of the past three tax years, it qualifies for the "small corporation safe harbor" for estimated taxes, which allows it to base its current year quarterly estimated tax payments on 100% of its ***"prior" year*** tax liability. If your corporation does not qualify for this safe harbor (i.e., it had $1 million or more of taxable income in any of the prior three tax years), it must generally base its quarterly estimated tax payment (after the first installment) on 100% of its "current" year tax liability, or 100% of its annualized tax liability. **Planning Alert!** Even if your corporation otherwise qualifies for the *small corporation safe harbor*, but it had no income tax liability in the prior tax year (e.g., it incurred a tax loss for the prior year or was not in existence last year), it must pay 100% of the "current" year tax or 100% of the annualized tax to avoid an estimated tax underpayment penalty. **Tax Tip.** If your corporation currently qualifies for the *"small corporation safe harbor"* and anticipates showing a small tax loss in 2013, you may want to accelerate income (or defer

expenses) in order to generate a **small income tax liability in 2013.** This will preserve the corporation's ability to use the "100% of last year's tax" safe harbor for 2014 estimates. **Caution!** This technique may not be advisable if your corporation anticipates a 2013 net operating loss that can be carried back to previous years that would generate a sizeable refund. **Planning Alert!** If your corporation expects taxable income of more than $1 million for the first time in 2013, consider **deferring income into 2014** or **accelerating deductions into 2013** to ensure the corporation's 2013 taxable income does not exceed $1 million, so that it retains the *small business safe harbor* for 2014.

Self-Employed Business Income. If you are self-employed, it continues to be a good idea to defer income into 2014, if you believe that your marginal tax rate for 2014 (including the new .9% Additional Medicare Tax and the new 3.8% tax on Net Investment Income) will be equal to or less than your 2013 marginal tax rate. If deferring 2013 income to 2014 will save you overall taxes, and you use the cash method of accounting, consider delaying year-end billings until 2014. **Planning Alert!** If you have already received the check in 2013, deferring the deposit does not defer the income. Also, you may not want to defer billing if you believe this will increase your risk of not getting paid.

Year-End Accruals To Employees. Generally, if an accrual-basis business accrues year-end compensation to its rank-in-file employees (nonshareholder employees), the accrual must be paid no later than the 15th day of the third month after year-end to be deductible for the year of the accrual. Otherwise, the accrual is not deductible until paid. **Planning Alert!** These rules also apply to accrued vacation pay, and to accruals for services provided by independent contractors (e.g., accountants, attorneys, etc.).

Accruals To "Related Parties." Year-end accruals to certain cash-basis recipients must satisfy the following rules in order for an accrual-basis business to deduct the accruals. **These rules apply to fiscal year as well as calendar year businesses:**

- **Regular "C" Corporations.** If a C corporation accrues an expense (e.g., compensation, interest, etc.) to a cash basis stockholder owning ***more than 50%*** (directly or indirectly) of the company's stock, the accrual is not deductible by the corporation until the **"day"** it is includable in the stockholder's income. **Tax Tip.** If the corporation's tax rate for 2013 is significantly greater than the more-than-50% stockholder's individual rate for 2013, the accrued amount should be paid by the ***end of 2013.***

- **S Corporations And Personal Service Corporations.** If your S corporation or personal service C corporation accrues an expense to any shareholder (regardless of the amount of stock owned), the accrual is not deductible until the **day** it is includable in the shareholder's income.

- **Partnerships, LLCs, LLPs.** If your business is taxed as a partnership, its accrual of an expense to **any owner** will not be deductible until the day it is includable in the owner's income.

- **Other Related Entities.** Generally, an expense accrued by one related partnership or corporation to another **cash-basis** related partnership or corporation is not deductible until the day it is includable in the cash-basis entity's income.

Personal Use Of Company Cars. If your company provides employees with company-owned cars, the company is required to include the value of the personal use of the car in the employees' W-2 income. However, this is not required if the employee reimburses the company for the personal use. **Planning Alert!** If your company does not report the employee's personal use as W-2 income and the employee does not reimburse the company for the personal use, the IRS says the company's deductions (for depreciation, gas, tires, insurance, etc.) are lost to the extent of the personal use. In addition, the IRS will include any unreimbursed personal use in the employee's income even if the company is not allowed a deduction for the personal use portion. **Tax Tip.** If the employee chooses to reimburse the company for personal use of the car, the obligation for reimbursement should be established ***on or before December 31st*** so the employee will not have income in one year and a deduction in the next. This can be accomplished by establishing a published policy for reimbursement of personal use. Furthermore, your company should obtain signed statements from employees listing their business and personal mileage for the company car.

<u>Charitable Contribution Planning.</u> If your regular "C" corporation uses the accrual method for tax purposes, it can deduct an accrued charitable contribution if the contribution is authorized by the company's Board of Directors by year-end, and the contribution is paid on or before the 15th day of the third month after that year-end (e.g., March 15, 2014 for December 31, 2013 year-ends). Your corporation should have a "Board of Directors Charitable Contribution Resolution" on its year-end tax planning checklist. **<u>Planning Alert!</u>** A regular C corporation's charitable contributions generally cannot exceed 10% of its taxable income (after certain adjustments). Furthermore, contributions in excess of the 10% cap cannot be carried back to previous years, but may be carried forward for up to five years. **<u>Tax Tip.</u>** If you own a closely-held C corporation, it may be more beneficial for you to make charitable contributions individually, rather than allowing your corporation to make contributions in excess of the 10% of taxable income limitation.

FINAL COMMENTS

Please contact us if you are interested in a tax topic that we did not discuss. Tax law is constantly changing due to new legislation, cases, regulations, and IRS rulings. Our firm closely monitors these changes. In addition, please call us before implementing any planning ideas discussed in this letter, or if you need additional information. **<u>Note!</u>** The information contained in this material represents a general overview of tax developments and should not be relied upon without an independent, professional analysis of how any of the items discussed may apply to a specific situation.

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