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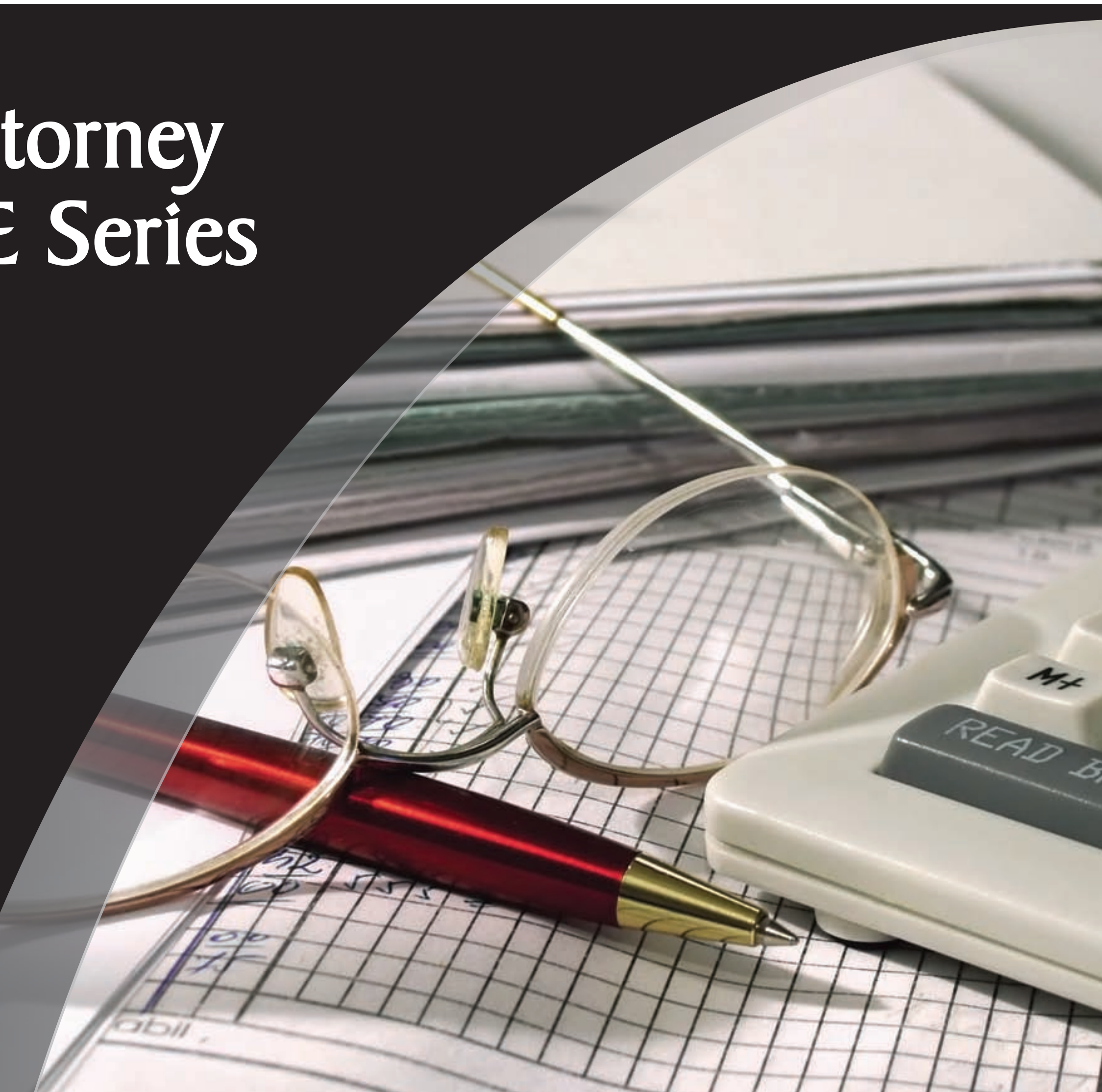


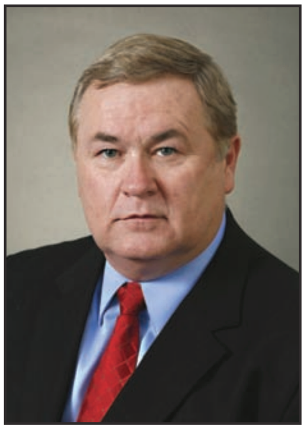
Advising Individual Tax Clients for 2013 and Beyond

February 12, 2014

presented by the GYF Tax Services Group

GROSSMAN YANAK & FORD LLP
Certified Public Accountants and Consultants

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



Bob brings extensive experience in tax and valuation issues that affect privately held businesses and their owners. The breadth of his involvement encompasses the development and implementation of innovative business and financial strategies designed to minimize taxation and maximize owner wealth.

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

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

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

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

Bob is a member of the Allegheny Tax Society, the Estate Planning Council of Pittsburgh and the American Society of Appraisers. He has held many offices and directorships in various not-for-profit organizations. He received PICPA's 2003 Distinguished Public Service Award and the 2004 Distinguished Alumnus Award from Saint Vincent College.

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

Donald S. Johnston, CPA, MST

Don has spent the majority of his 23-year career serving the tax and consulting needs of privately-held organizations and their owners. He has significant experience handling tax planning and compliance-related issues for all types of entities, including corporations, LLCs and partnerships, and a wide base of clientele, ranging from small start-up organizations in the early stages of development to large, billion-dollar entities in need of technical expertise. Don's broad range of experience encompasses numerous industries, including manufacturing, nuclear energy and mining.

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

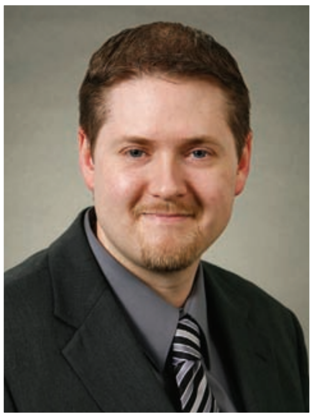
After graduating from Slippery Rock University with a B.S./B.A. in accounting and finance in 1989, Don spent four years with a large international accounting firm in Pittsburgh before joining Grossman Yanak & Ford LLP in 1993. He earned his Masters of Science degree in Taxation from Robert Morris University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

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

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

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

Shawn M. Firster, CPA



Shawn has more than 14 years of experience in public accounting. He currently focuses on providing tax compliance and planning services to corporations, S corporations, partnerships and high-net-worth individuals. Additionally, Shawn has extensive experience in multi-state consolidated and unitary tax filings.

He has experience providing tax planning and compliance services for a variety of industries, including alternative energy production, professional services and manufacturing. Shawn has performed special project work for clients in a variety of areas, including merger and acquisition analysis, multi-state tax planning, financial forecasting, research and development, and cost segregation analysis.

A graduate of Pennsylvania State University, Shawn earned his B.S. degree in accounting in 1997, and is a member of Omicron Delta Kappa, the national leadership honor society.

Before joining Grossman Yanak & Ford LLP in 2000, Shawn worked at another regional public accounting firm. During his tenure with that firm, his responsibilities included tax compliance and research for individual, corporate and partnership clients. Additionally, Shawn performed compilation, review and audit services for various businesses and not-for-profit entities.

Shawn has enhanced his professional training by participating in the various levels of the AICPA National Tax Education Program. He also regularly participates in various other continuing education programs focusing on Pennsylvania and multi-state tax compliance.

A CPA in Pennsylvania, Shawn is a member of the American and Pennsylvania Institutes of Certified Public Accountants. He also serves as President of the Allegheny Tax Society.

Shawn is active in the community and has volunteered his time for various service projects and youth baseball and basketball programs.

He resides in Cranberry Township with his wife, Meghan, and their son, Colton.

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Advising Individual Tax Clients for 2013 and Beyond

Introduction

In early 2013, Grossman Yanak & Ford LLP presented to our friends in the legal community a program explaining the many tax changes that were to become effective for 2013 and beyond. The impact of the changes was predicated upon two completely unrelated and disparate pieces of legislation that were passed and signed into law, in fact, in two different tax years.

The most recent legislation affecting tax law for calendar 2013 taxpayers is, of course, the American Taxpayer Relief Act of 2012 (ATRA). This legislation is better known as the "Fiscal Cliff" legislation, wherein the so-called "Bush-era tax cuts" were made permanent for all but the highest income taxpayers. The tax bill was listed as 2012 legislation, but in fact, was not passed until January 1, 2013, by both chambers of Congress. President Obama signed the bill into law on January 2, 2013.

Generally, the ATRA allows the Bush-era tax rates to "sunset" for tax years beginning after 2012, for individual taxpayers with incomes over $400,000 and families with incomes over $450,000. The legislation effectively moved the highest tax rate for these individuals from 35% to 39.6%. It also led to reinstatement of the Pease limitations for higher income taxpayers. These provisions limit, for those taxpayers affected, the amount of itemized deductions that can be used to reduce tax liabilities in 2012. It also re-established the concept of personal exemption phaseouts for higher-income taxpayers. As will be explained later in these materials, the limitations serve to disguise yet even higher rates.

The ATRA also served to increase the rate of tax on qualifying dividends and capital gains to 20%, as well as increase the maximum tax rate on estates and trusts to 40%, from the pre-legislation rate of 35%.

On the positive side, the ATRA did permanently "patch" the alternative minimum tax and revived, for 2013, many of the tax beneficial provisions known as the "business tax extenders" for one year (though most have expired again at the end of 2013).

The impact of these varying provisions will depend upon the facts and circumstances of each individual's and business' tax situation. However, when viewed simply and directly, it is important to note that an increase in the highest marginal individual tax rate from 35% to 39.6% represents a tax rate "increase" of 4.6% percent. This increase is dramatic, in that if reflects an overall tax increase of more than 13.14% over prior-year rates. The increase on qualifying dividends and capital gains is even more robust at 33% over prior-year rates.

Another alarming effect of the changes mandated by the ATRA is the reach of the higher tax rates to American businesses treated as "pass through" business entities for U.S. tax purposes. These entities, including S corporations, partnerships and multi-member limited liability companies, need to be part of the discussion when determining the impact on compliance (and business operations).

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The impact of the tax changes affect these businesses because the taxable income generated by those business entities is included, in many, if not most, instances, on individual taxpayer returns via Schedules K-1. As will be discussed later, the issue becomes even more cumbersome when owners of these businesses (and interests therein) do not materially participate in the businesses, causing the income to be characterized as passive.

Individual taxpayers finding themselves complying with the provisions of the ATRA for the first time in completing their 2013 income tax returns will have an even more difficult time due to the additional complexities associated with dealing with a second major tax law. Many of the most significant tax provisions of the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Acts, signed into law by President Obama in March, 2010, (together, the Affordable Care Act, or ACA) are effective for years beginning after 2012. As such, taxpayers we are in for the double trouble this tax filing season in complying with new laws in 2013.

The ACA imposes numerous new requirements for employers and individuals, but the greatest impact will likely be felt in two extended Medicare tax provisions. Specifically, the ACA imposes a 3.8% Medicare contribution tax on unearned income, effective for tax years beginning after December 31, 2012. The tax is imposed on the lesser of an individual's net investment income for the tax year, or his or her modified adjusted gross income in excess of a threshold amount. The threshold amounts for 2013 are $200,000 for single taxpayers, $250,000 for taxpayers filing jointly, and $125,000 for married couples filing separate income tax returns.

The legislation created this provision as an entirely new tax. For the first time, Medicare, (a social insurance tax) is imposed on unearned income. At the time of our 2013 presentation, much was unknown about this tax and how it might be applied. A greater level of clarity is now available as the Internal Revenue Service recently issued explanatory Treasury regulations as guidance.

In addition to the new tax on unearned income, the ACA also increased the individual/employee share of Medicare tax on his or her earned income or self-employment earnings. The increase is .9%, and is applicable only if the taxpayer's earned income is in excess of certain thresholds. Thus, the tax increase is only applicable to those single taxpayers with earnings in excess of $200,000; married, joint filers with earnings in excess of $250,000; and married couples filing separate returns, with earned income in excess of $125,000.

Given these broad, and sometimes hidden, tax increases in the ATRA, and specific taxpayer facts and circumstances, it is possible to reach a highest marginal tax rate in excess of 43%. In addition, the extension of the Medicare tax on unearned income, as a result of the ACA, could increase taxpayer rates on capital gains from 15% in 2012, to 23.8% in 2013, for a whopping net increase of over 58% percent from 2012 on the same capital gains.

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Our intent in today's program is to add as much clarification as we can to the new rules to better prepare each of our attendees to understand some of the nuances of each of these issues and how best to plan for them in dealing with 2013 income tax compliance, as well as planning for future years.

To accomplish this task, we have decided to provide a discussion on each of the above noted items as follows:

Chapter I Individual Tax Rate Changes

Chapter II Pease Limitation Provisions and the Individual Exemption Phaseouts

Chapter III Alternative Minimum Tax (AMT)

Chapter IV Medicare Tax on Unearned Income

Chapter VI Medicare Tax Surcharge on Earned Income

Chapter IV Effects of the ATRA on Pass Through Entities

Conclusion and Practical Considerations

Each chapter will include a detailed discussion and analysis of the applicable subject matter, as well as working examples to illustrate the expected effect of the provision(s). Lastly, we will include a brief summary of planning initiatives that will allow for mitigation and minimization of the impact from these many new provisions in the future. The new laws are some of the most complex passed in the last 30 years and, in some cases, seem to go completely against the goal of tax simplification. Our wish is that each of today's participants leaves with a better understanding of the new rules.

We thank you for your continued attendance at the Grossman Yanak & Ford LLP Continuing Legal Education series. The seminars have proven to be a great success, and we hope that by your continued support, you have found the content to be informative and helpful. Should you have questions after the session, as always, the presenters can be easily approached or later contacted.

Thank you for your attendance today and we look forward to working with you soon!

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Chapter I – *Understanding the Individual Tax Rate Changes*

Ordinary Income Tax Rates

The American Taxpayer Relief Act of 2012 (ATRA) makes permanent for 2013 and beyond, the lower Bush-era income tax rates for all taxpayers, excepting those with taxable income above $400,000 (single filers); $450,000 (married taxpayers filing jointly); and $425,000 (those filing as head of household). At these thresholds and above, taxpayers will be taxed at a fixed marginal income tax rate of 39.6%. As noted in the introduction, the impact of these rate increases is fairly evident. By excepting those taxpayers earning above a certain threshold amount from the Bush-era tax cuts, the new legislation effectively imposes a higher tax-rate regime for that group.

The graduated income tax system that was in place at the end of 2012 remains in place for the current year and forward. As such, for 2013 and forward, the individual marginal tax rates of 10%, 15%, 25%, 28%, 33% and 35% are applicable to varying ranges of taxable income. In addition, the ATRA adds a single additional income tax rate at 39.6%. The "range" to which this rate applies is simply a carve-out of the prior law's 35% range.

While the primary change in the tax rates was to increase the highest marginal tax rate from 35%, as was the case in 2012, to 39.6% in 2013 and forward, that rate level had already been part of the law prior to 2001. For certain levels of taxable income, the 39.6% tax rate had, in fact, been included as part of the Deficit Reduction Act of 1993 under President Clinton. That highest marginal rate remained in the law for all post-1993 years until it was eliminated in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) when President George W. Bush signed this legislation which reduced, over time, the top marginal income tax rate to 35%. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), accelerated the gradual rate reductions established in EGTRRA.

The following table illustrates the breadth of the rate changes under these two tax bills. As has been federal law for some time, the ranges of taxable income to which the different rates applies is adjusted annually to reflect the effects of inflation.

Income Tax Rate Reductions Under the 2001 and 2003 Tax Cuts

Prior Rates	New Rates
39.6%	35.0%
36.0%	33.0%
31.0%	28.0%
28.0%	25.0%

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Marginal Income Tax Rates – 2013

The tax rate schedule published by the Internal Revenue Service for 2013 are as follows (by filing status):

Single Filer
[Tax Rate Schedule X, Internal Revenue Code section 1(c)]

- 10% on taxable income from $0 to $8,925, plus
- 15% on taxable income over $8,925 to $36,250, plus
- 25% on taxable income over $36,250 to $87,850, plus
- 28% on taxable income over $87,850 to $183,250, plus
- 33% on taxable income over $183,250 to $398,350, plus
- 35% on taxable income over $398,350 to $400,000, plus
- 39.6% on taxable income over $400,000.

Married Filing Jointly or Qualifying Widow(er)
[Tax Rate Schedule Y-1, Internal Revenue Code section 1(a)]

- 10% on taxable income from $0 to $17,850, plus
- 15% on taxable income over $17,850 to $72,500, plus
- 25% on taxable income over $72,500 to $146,400, plus
- 28% on taxable income over $146,400 to $223,050, plus
- 33% on taxable income over $223,050 to $398,350, plus
- 35% on taxable income over $398,350 to $450,000, plus
- 39.6% on taxable income over $450,000.

Married Filing Separately
[Tax Rate Schedule Y-2, Internal Revenue Code section 1(d)]

- 10% on taxable income from $0 to $8,925, plus
- 15% on taxable income over $8,925 to $36,250, plus
- 25% on taxable income over $36,250 to $73,200, plus
- 28% on taxable income over $73,200 to $111,525, plus
- 33% on taxable income over $111,525 to $199,175, plus
- 35% on taxable income over $199,175 to $225,000, plus
- 39.6% on taxable income over $225,000.

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Head of Household
[Tax Rate Schedule Z, Internal Revenue Code section 1(b)]

- 10% on taxable income from $0 to $12,750, plus
- 15% on taxable income over $12,750 to $48,600, plus
- 25% on taxable income over $48,600 to $125,450, plus
- 28% on taxable income over $125,450 to $203,150, plus
- 33% on taxable income over $203,150 to $398,350, plus
- 35% on taxable income over $398,350 to $425,000, plus
- 39.6% on taxable income over $425,000.

The Importance of Understanding Marginal Income Tax Rates

Understanding marginal rates is critical to long-term financial planning. Moreover, it is important to fully understand the benefits afforded all taxpayers under the graduated income tax system in the United States.

Marginal tax rates should be considered in conjunction with analyzing economic decisions that are expected to add additional income to a particular tax year. In consideration of the additional income, the marginal tax rate on a taxpayer's "next" dollar of income is the rate which should be considered in conjunction with that decision.

For example, consider the following illustrations of how marginal income tax rates impact next dollar earnings.

Example 1:

- Couple Bill and Donna file a joint income tax return.
- Bill is a successful business executive and has earned taxable wages of $750,000. He expects the same wages in 2014.
- Donna, an attorney who has worked on and off while raising their family, would like to return to the workforce. However, she is not interested in a high-intensity situation and would like to try to find a job in the not-for-profit sector supporting a cause personal to her. As money is not a driver in the decision-making process, she would be willing to work for $60,000 annually.
- Assuming the couple's deductions do not result in reducing their taxable income below $450,000 for 2013 or 2014, the couple's marginal income tax rate on Donna's income is 39.6%.

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Example 2:

- Assume same facts as Example 1, but Donna will continue to work as a homemaker and volunteer her time.
- Bill receives a windfall of $100,000 and decides to invest it.
- In consideration of this decision, Bill's advisor provided a choice of investments:
  - — The first option is a federally tax exempt bond providing for an annual yield of 3.50%.
  - — The second option is a taxable corporate bond with an annual yield of 6.00%.
- In calculating which alternative is a better investment, assuming comparable risk, it is first necessary to assume that the couple will be required to pay tax on the taxable investment return at their top marginal income tax rate of 39.6%.
- Applying this rate to the higher (taxable) 6.00% rate of return provides a net yield of 3.62%, or just a slightly greater economic return than the federally tax exempt alternative investment.

These two simple examples help demonstrate the importance of understanding how marginal income tax rates affect your "next" dollar of income.

The Importance of Understanding Effective Income Tax Rates

While the importance of understanding the impact of marginal rates is critical to the financial planning decision-making process, it is also important to understand effective tax rates. Because the U.S. tax system is graduated, or progressive, the effective income tax rate is not a flat number. In fact, by definition, a taxpayer's highest marginal tax rate is only applied to that portion of the taxpayer's taxable income that falls within the range of income accorded that marginal rate.

Said another way, income taxes are figured based on the portion of taxable income that falls into the respective tax bracket, with the top rate you pay (based on the final bracket you fall in) being your marginal tax rate. Providing a simple example of this concept can better illustrate this point.

Example 3:

- Assume a single taxpayer, A, is expected to have an annual taxable income of $120,000.
- She would pay 10% on a portion of her taxable income, up to the 2013 expected bracket limit (for single taxpayers) of $8,925; 15% on the next portion of her taxable income, up to $36,250; 25% on the third portion of her taxable income, up to $87,850; and, then, 28% on the final portion.

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- Based on these facts, the taxpayer's marginal or top income tax rate is 28%. However, due to the progressive nature of the current tax regime, the effective income tax rate is that amount of income tax actually being paid, divided by total income. In this case, the income tax would be $24,093, and the effective income tax rate would be 20.08% ($24,093/$120,000).
- The difference between the marginal tax computed at the highest marginal tax rate of 28%, or $33,600, and the 20.08% effective income tax rate, is attributable to the graduated tax system and the net tax benefits of the personal exemption and the standard deduction (reducing her taxable income to $110,000).

A second example illustrating the effective income tax rate for a higher-income married taxpayer, filing jointly with her spouse, may bring the point into greater clarity.

***Example 4*:**

- Sarah makes $700,000 in 2013. Her husband has income of $50,000. Assuming no deductions for simplicity, the total income of $750,000 is well into the range subject to a 39.6% marginal income tax rate (for incomes in excess of $450,000).
- Taking advantage of the progressive nature of the rate schedule, the combined income of this couple is subject to an actual tax payment of $244, 646. This tax equates to an effective income tax rate for this couple of 32.6% ($244,646/$750,000).
- Realistically, couples at this income level likely have adjustments to adjusted gross income, such as employee contributions to an employer-sponsored 401(k) plan and itemized deductions for state and local income taxes, real estate taxes, qualifying mortgage interest and charitable contributions. As such, the effective income tax rate for this particular couple is likely lower than 32.6%.

Planning consideration **– In circumstances such as those imposed in an environment of major tax increases and higher base income rates, it becomes important to focus on the old and reliable income shifting-strategies to the extent they are legitimate and legal. These strategies, at their core, can be divided into two separate and distinct planning routes. The first is to determine if there are strategies that allow for acceleration of deductions. The second is to determine whether strategies exist to allow for the deferral of income.**

In accelerating deductions, a standard practice for tax planning for individuals (those on the cash basis of accounting) is to consider "bunching" deductible expenditures. This will allow the maximum value of the deduction by paying in that year which yields the greatest tax benefit.

If one assumes that the taxpayer is not subject to alternative minimum tax, it might be beneficial, for example, to pay the fourth quarter estimates, or any final amounts due for any particular tax year for state and local income taxes, on December 31st of that year, versus January 15th or April 15th of the following year.

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Further, assuming that the prior-year payments were made in the current year, this strategy provides for the bunching of these payments.

In deferring income, it is not uncommon to adopt strategies forgoing collection efforts in single-owner proprietorships in the latter part of the month of December. In addition, employees might consider deferring a portion of their current income through a nonqualified deferred compensation program, if available.

Finally, another proven strategy, which is more important than ever, is to defer the maximum available amounts into the employer's IRC section 401(k) plan.

Capital Gains Rates for Individuals, Estates and Trusts

The ATRA also increased the tax rates on net long-term capital gains for noncorporate taxpayers. However, as is the case with the ordinary income tax increases, Congress saw fit to impose this increase on higher-income taxpayers earning amounts over certain threshold levels.

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

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

Reduced Rates for Long-term Capital Gain

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

- Capital gains rate for individuals – beginning in 2013, the capital gains rates are as follows:
  - — A capital gains rate of 0% applies to the adjusted net long-term capital gains of individuals if the gain would otherwise be subject to the 10% or 15% ordinary income tax rate.

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- A capital gains rate of 15% applies to adjusted net capital gains of individuals if the gain would otherwise be subject to the 25%, 28%, 33% or 35% ordinary income tax rate.
- A capital gains rate of 20% applies to adjusted net capital gains of individuals if the gain would otherwise be subject to the 39.6% ordinary income tax rate beginning after December 31, 2012.

• Capital gains rates for estates and trusts – beginning in 2013, the capital gains rates are as follows:
  - A capital gains rate of 0% applies to the adjusted net capital gains of estates and trusts if the gain would otherwise be subject to the 15% ordinary income tax rate.
  - A capital gains rate of 15% applies to adjusted net capital gains of estates and trusts if the gain would otherwise be subject to the 25%, 28% or 33% ordinary income tax rate.
  - A capital gains rate of 20% applies to adjusted net capital gains of estates and trusts if the gain would otherwise be subject to the 39.6% ordinary income tax rate.

***Planning consideration* – Careful planning will be needed in situations where long-term capital gains are anticipated. As a result of the new legislation, the timing of a long-term capital gain, in conjunction with the timing of one's ordinary income, should be carefully considered.**

For example, if a taxpayer is in the 39.6% tax bracket in 2013, but will be in a lower tax bracket in 2014, the deferral of a long-term capital gain to tax year 2014 will enable the individual to pay tax on the capital gain at 15% versus 20%. The timing of both the long-term capital gain, as well as the ordinary income, should be equally considered to ensure that the benefit of the 15% capital gains tax rate can be realized.

Qualified Dividends Received by Individuals, Estates and Trusts

The taxation of qualified dividends of noncorporate taxpayers at the preferred long-term capital gains rates has been made permanent and will continue to apply in tax years beginning after December 31, 2012. Thus, qualified dividends will be subject to tax at a 0%, 15% or 20% rate beginning in 2013, depending on the taxpayer's ordinary income tax rate for the year. This particular provision is a tremendous benefit for the few American taxpayers who have substantial dividend income, including many wealthy, retired individuals.

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

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

Planning consideration **– Careful planning will be needed in situations where qualified dividends are anticipated. As a result of this new legislation, the timing of qualified dividend income expected, in conjunction with the timing of one's ordinary income, should be carefully considered. For example, if a taxpayer is in the 39.6% tax bracket in 2013, but will be in a lower tax bracket in 2014, the deferral of qualified dividend income to tax year 2014 will enable the individual to pay tax on the dividend income at 15%, versus 20%. The timing of both the dividend income, as well as the ordinary income, should be equally considered to ensure that the benefit of the 15% dividend tax rate can be realized.**

Comment: From a planning perspective it is critical to note that, in addition to the potential increased capital gains and dividend rates, higher-income taxpayers must also start paying the 3.8% additional Medicare tax on net investment income. This is discussed further in Chapter IV.

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Chapter II – *Understanding The Pease Limitation Provisions and the Individual Exemption Phaseouts*

The Pease limitation on itemized deductions, which was named after sponsoring Representative Donald J. Pease of Ohio, was first enacted temporarily under the Omnibus Budget Reconciliation Act of 1990 (OBRA90), and later extended without modification by the Omnibus Budget Reconciliation Act of 1993 (OBRA93). Under the Pease provision, otherwise allowable itemized deductions reflected on Schedule A of a taxpayer's individual income tax return are reduced by 3% of the amount by which the taxpayer's adjusted gross income (AGI) exceeds a specified threshold level, although the reduction cannot exceed 80% of the taxpayer's total itemized deductions. The original threshold level in 1991 was $100,000 for all filing statuses except married filing separately, for which the threshold was half that amount, or $50,000. By 2009, the threshold had increased to $166,800, due to indexing for inflation.

The OBRAs also introduced a similarly-computed personal exemption phaseout (PEP) that reduced the otherwise allowable personal and dependency exemptions by 2% for each $2,500 (or fraction thereof) that the taxpayer's AGI exceeds a specified threshold amount. Unlike the itemized deduction rules, whereby a taxpayer can only lose 80% of his or her deductions, the personal exemptions can be totally phased out. The original 1991 thresholds were set at $150,000 for married filing jointly; $100,000 for single filers; and $125,000 for heads of household. By 2009 the thresholds had increased (due to indexing for inflation) to $250,200, $166,800 and $208,500, respectively.

These two phaseout provisions are sometimes referred to as "stealth taxes" or disguised tax increases because they seem to have been specifically enacted in an attempt to raise additional revenue without explicitly raising the taxpayers' marginal income tax rates. The surprise, however, is that affected taxpayers do experience a sometimes-significant increase in their effective tax rates. In addition, the complexity of these provisions, as well as the overall complexity of the tax system, can obscure the true after-tax costs associated with taxpayers' planning options and lead to decisions based on incomplete or distorted data, which Public Finance Analyst Maxim Shvedov noted in an April 14, 2009, Congressional Research Service Report for Congress "can affect not only their own individual welfare but that of the economy as a whole."

The EGTRRA authorized a gradual reduction of the PEP and Pease phaseouts from 2006 through 2009, with a complete repeal for tax year 2010. This repeal was extended for two years (through 2012) by the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (Tax Relief Act of 2010). For the years 2010 through 2012, there was no limit to either itemized deductions or personal exemptions regardless of taxpayer AGI levels.

Due to the expiration of the temporary repeals under the above-mentioned Acts, the PEP and Pease phaseouts have been reinstated for tax years beginning after December 31, 2012. Therefore, 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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The effect of the ATRA and the reinstatement of these provisions will absolutely, and unequivocally, increase affected taxpayer's effective tax rates. While the new law is somewhat more generous than the old, by virtue of providing higher threshold levels, it still exacts a heavy price in increased income taxes. Following are the specific phaseout thresholds for the PEP and Pease provisions for both 2013 and 2014.

Pease Limitations

For 2013, the thresholds for the phaseout of itemized deductions are as follows:

- $300,000 for married taxpayers filing joint returns and surviving spouses,
- $275,000 for heads of households,
- $250,000 for other single taxpayers, and
- $150,000 for married taxpayers filing separate returns.

For 2014, the thresholds for the phaseout of itemized deductions are as follows:

- $305,050 for married taxpayers filing joint returns and surviving spouses,
- $279,650 for heads of households,
- $254,200 for other single taxpayers, and
- $152,525 for married taxpayers filing separate returns.

The following types of itemized deductions are not included in total itemized deductions for purposes of calculating the limitation on itemized deductions:

- Medical expenses,
- Investment interest expenses,
- Casualty or theft losses, and
- Allowable wagering losses.

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

Planning consideration **– In the case of married taxpayers, the itemized deduction limitation is a consideration in the decision to file separate returns if the couple's combined AGI exceeds the general applicable amount, the AGI of one spouse is less than the separate return applicable amount, and substantially all of the itemized deductions are allocable to the spouse with the lower AGI.**

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PEP Limitations

For 2013, the AGI thresholds for the personal exemption phaseout are as follows:

- For married taxpayers filing joint returns and surviving spouses, the phaseout begins when AGI reaches $300,000, and is complete when AGI reaches $422,500.
- For heads of households, the phaseout begins when AGI reaches $275,000, and is complete when AGI reaches $397,500.
- For other single taxpayers, the phaseout begins when AGI reaches $250,000, and is complete when AGI reaches $372,500.
- For married taxpayers filing separate returns, the phaseout begins when AGI reaches $150,000, and is complete when AGI reaches $211,250.

For tax years beginning in 2014, the AGI thresholds for the personal exemption phaseout are as follows:

- For married taxpayers filing joint returns and surviving spouses, the phaseout begins when AGI reaches $305,050, and is complete when AGI reaches $427,550.
- For heads of households, the phaseout begins when AGI reaches $279,650, and is complete when AGI reaches $402,150.
- For other single taxpayers, the phaseout begins when AGI reaches $254,200, and is complete when AGI reaches $376,700.
- For married taxpayers filing separate returns, the phaseout begins when AGI reaches $152,525, and is complete when AGI reaches $213,775.

All thresholds are adjusted for inflation each year.

Practical Examples

The following exhibits are provided to illustrate the effects of the reinstatement of the Pease and PEP limitations. The taxpayers in these examples are married with two dependent children and file a joint return.

- Exhibit I (page 14) illustrates the effects of the PEP and Pease limitations on the taxpayers if their AGI falls within the phaseout range, so that they are subject to partial phaseout of both their personal exemptions and itemized deductions.
- Exhibit II (page 15) illustrates the effects of the PEP and Pease limitations if the taxpayers' AGI exceeds the phase-out range for the personal exemption, so that they are subject to total phaseout of their personal exemptions.
- Exhibit III (page 16) illustrates the effect of the 80% maximum reduction to itemized deductions under the Pease limitation.

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Exhibit I – Demonstration of Phaseouts

	2012	2013		Change
Adjusted Gross Income (AGI)	400,000	400,000		-
Personal Exemptions	(15,200)	(3,120)	<1>	12,080
Itemized Deductions:				
Taxes (Real estate/income)	(32,000)	(32,000)		-
Mortgage Interest	(20,000)	(20,000)		-
Contributions	(15,000)	(15,000)		-
Subtotal	(67,000)	(67,000)		-
3% AGI Floor (phase-out)	-	3,000	<2>	3,000
Total Itemized Deductions	(67,000)	(64,000)		3,000
Taxable Income	**317,800**	**332,880**		**15,080**

<1> Personal exemption phaseout is calculated as follows:

AGI	400,000
Threshold for 2013	(300,000)
AGI in excess of threshold	100,000
Tentative phaseout:	
AGI in excess of threshold / $2,500	40
2 % x (AGI in excess of threshold / $2,500)	80 %
*If this number exceeds 100%, exemptions are totally phased out	
Personal exemptions otherwise allowable	15,600
Times limitation percentage (lesser of 2% calc above or 100%)	80%
Dollar limitation	12,480
Remaining exemption	**3,120**

<2> Itemized deduction phaseout is calculated as follows:

AGI	400,000
Threshold for 2013	(300,000)
AGI in excess of threshold	100,000
Tentative 3% phaseout	3,000
Total itemized deductions	67,000
Phaseout limited to 80%	80%
Maximum limitation	53,600
Phaseout of itemized deductions (lesser of tentative 3% or maximum 80%)	**3,000**

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Exhibit II – AGI above PEP Range

	2012	2013		Change
Adjusted Gross Income (AGI)	515,000	515,000		-
Personal Exemptions	(15,200)	-	<1>	15,200
Itemized Deductions:				
Taxes (Real estate/income)	(32,000)	(32,000)		-
Mortgage Interest	(20,000)	(20,000)		-
Contributions	(15,000)	(15,000)		-
Subtotal	(67,000)	(67,000)		-
3% AGI Floor (phase-out)	-	6,450	<2>	6,450
Total Itemized Deductions	(67,000)	(60,550)		6,450
Taxable Income	**432,800**	**454,450**		**21,650**

<1> Personal exemption phaseout is calculated as follows:

AGI	515,000	
Threshold for 2013	(300,000)	
AGI in excess of threshold	215,000	
Tentative phaseout:		
AGI in excess of threshold / $2,500	86	
2 % x (AGI in excess of threshold / $2,500)	172	%
*If this number exceeds 100%, exemptions are totally phased out		
Personal exemptions otherwise allowable	15,600	
Times limitation percentage (lesser of 2% calc above or 100%)	100%	
Dollar limitation	15,600	
Remaining exemption	**-**	

<2> Itemized deduction phaseout is calculated as follows:

AGI	515,000
Threshold for 2013	(300,000)
AGI in excess of threshold	215,000
Tentative 3% phaseout	6,450
Total itemized deductions	67,000
Phaseout limited to 80%	80%
Maximum limitation	53,600
Phaseout of itemized deductions (lesser of tentative 3% or maximum 80%)	**6,450**

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Exhibit III – Itemized Deduction Reduction Limited to 80%

	2012	2013		Change
Adjusted Gross Income (AGI)	3,000,000	3,000,000		-
Personal Exemptions	(15,200)	-	<1>	15,200
Itemized Deductions:				
Taxes (Real estate/income)	(32,000)	(32,000)		-
Mortgage Interest	(20,000)	(20,000)		-
Contributions	(15,000)	(15,000)		-
Subtotal	(67,000)	(67,000)		-
3% AGI Floor (phase-out)	-	53,600	<2>	53,600
Total Itemized Deductions	(67,000)	(13,400)		53,600
Taxable Income	**2,917,800**	**2,986,600**		**68,800**

<1> Personal exemption phaseout is calculated as follows:

AGI	3,000,000	
Threshold for 2013	(300,000)	
AGI in excess of threshold	2,700,000	
Tentative phaseout:		
AGI in excess of threshold / $2,500	1,080	
2 % x (AGI in excess of threshold / $2,500)	2,160	%
*If this number exceeds 100%, exemptions are totally phased out		
Personal exemptions otherwise allowable	15,600	
Times limitation percentage (lesser of 2% calc above or 100%)	100%	
Dollar limitation	15,600	
Remaining exemption	**-**	

<2> Itemized deduction phaseout is calculated as follows:

AGI	3,000,000
Threshold for 2013	(300,000)
AGI in excess of threshold	2,700,000
Tentative 3% phaseout	81,000
Total itemized deductions	67,000
Phaseout limited to 80%	80%
Maximum limitation	53,600
Phaseout of itemized deductions (lesser of tentative 3% or maximum 80%)	**53,600**

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Additional Planning Considerations

The takeaway from those provisions relating to the limitation on itemized deductions and the phaseout of personal exemptions is that they are based on taxpayer levels of adjusted gross income (AGI). As such, once AGI is determined, as illustrated in the above examples, there are no further limitations imposed.

While the law allows no ability to "shift" the timing of personal exemptions, there is some latitude in dealing with itemized deductions. Once the threshold for the itemized deductions limitation has been set; that is, taxpayer AGI is determined, further itemized deductions will be fully deductible. This being the case, there is room, given individual taxpayer circumstances, to potentially "bunch" multiple year itemized deductions in a single year.

An example of such a strategy might be to combine two years of charitable contributions to a favorite charity into a single year. If the AGI threshold has already been attained, further charitable contributions will not be further limited under the rules. Alternatively, paying the second year's charitable contribution in year two could lead to having a portion of those deductions eliminated under the rules. In addition, current-year deductibility versus future-year deductibility allows greater time-value-of-money advantages.

In using bunching strategies, care must be given to other elements of the Internal Revenue Code. The provision that first comes to mind is the alternative minimum tax (AMT). While bunching state and local income taxes into one calendar year might work to reduce income tax under the regular tax system, for example, the same strategy could result in exposing the taxpayer to AMT. Again, such planning must be done by detailed analysis of taxpayer facts and circumstances.

Finally, another planning strategy is to take steps to decrease AGI. For example, the provision (currently expired) allowing for direct distributions from an IRA to a charitable institution (rather than taking the distribution, reporting it in the computation of AGI and then deducting the contribution) offers advantageous outcomes in planning for the limitations on itemized deductions. Other income deferral opportunities, if available, work effectively and in the same way.

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Chapter III – *Alternative Minimum Tax*

Background and Overview

The alternative minimum tax (AMT) is an alternative tax system that is intended to ensure that no taxpayer who has substantial economic income avoids tax liability by using exclusions, deductions and credits. It is a separate and distinct, but parallel, system of income taxation. Generally, all taxpayers subject to regular tax are also subject to the AMT. However, small corporations are exempt.

The AMT applies at rates of 26% and 28% (depending on the amount of taxable excess) of the excess of the taxpayer's alternative minimum taxable income (AMTI) over his AMTI exemption amount. The 26% rate applies to the first $175,000 ($87,500 if the taxpayer is married filing separately) of taxable excess, and the 28% rate applies to taxable excess exceeding $175,000 ($87,500 for married individuals filing separately).

AMTI is taxable income recomputed in a way that takes account of adjustments and preferences that are designed to eliminate the favorable tax treatment given to some items of income, deductions and exclusions under the regular tax. A taxpayer is liable for the AMT if his AMT liability exceeds his regular tax liability.

The favorable tax treatment available under the regular tax is curtailed for the AMT by a system of adjustments and preferences. Adjustments and preferences are similar in that both involve modifications to deductions or exclusions which are preferential in the sense that they permit the taxpayer to pay tax on an amount less than his economic income. The primary distinction between the two categories of modifications is that adjustments may increase or decrease AMT income relative to taxable income, while preferences can only increase AMT income.

AMT adjustments and preferences include cost recovery adjustments and preferences, loss adjustments, timing adjustments, tax-exempt or excluded income preferences and adjustments to itemized deductions.

Cost recovery adjustments include depreciation allowable on some property placed in service after 1986, mining exploration and development deductions, amortization of pollution control facilities placed in service after 1986, and deductions for circulation and research and experimental expenditures. Cost recovery preferences include depletion deductions in excess of basis, excess intangible drilling and development costs (IDC), rapid depreciation, and amortization of pollution control facilities placed in service before 1987. However, independent oil and gas producers and royalty owners do not include the excess percentage depletion on oil and gas wells as a tax preference item.

A taxpayer other than an integrated oil company can expense or capitalize its IDC without having to treat any amount of its IDC deduction, however computed, as a tax preference item to be added in computing AMTI. A taxpayer

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other than an integrated oil company cannot claim the alternative tax energy preference deduction. These adjustments and preferences generally adjust the rapid cost recovery allowed for regular tax purposes to reflect actual economic cost recovery. Taxpayers can avoid the adjustments or preferences for deductions for circulation and research and experimental expenditures, IDC, and mining exploration and development costs by electing to amortize these expenses at a slower rate for the regular tax.

Timing adjustments required for AMT purposes are the use of the percentage-of-completion method to report income on long-term contracts, and the recognition of gain at the exercise of incentive stock options. These adjustments cause taxpayers to recognize income that is deferred for regular tax purposes in the year in which it is realized.

The tax-exempt or excluded income preferences cause taxpayers to include in income, for AMT purposes, amounts that are excluded from taxation under the regular tax. Amounts that must be included are the income from some tax-exempt private activity bonds, and the difference between the adjusted basis and fair market value of capital gain property donated to charity. Taxpayers can avoid recognizing income on the donation of capital gain property by electing to deduct only the adjusted basis of the property for regular tax purposes. However, the difference between the fair market value and the adjusted basis of donated tangible personal property is not treated as a tax preference.

The standard deduction and personal exemption are not allowed for AMT purposes. The itemized deductions allowed are limited to those other than miscellaneous itemized deductions, and the deductions for taxes, medical expenses and interest are more limited than for regular tax purposes. The limitation on itemized deductions for high income taxpayers does not apply in computing AMTI.

An AMT credit equal to the amount of AMT that is attributable to adjustments and preferences that represent changes in the timing of income rather than an increase in the amount of income included is available to offset regular tax liability in years after a taxpayer has been subject to the AMT. The credit is intended to prevent taxpayers from paying excess tax only because they are taxed under the AMT in some years and the regular tax in others. This credit can arise when a taxpayer is subject to the AMT in a year after 1986. In earlier years, the tax benefit rule applied to accomplish the same purpose. The tax benefit rule may also apply in limited circumstances after 1986.

The AMT is reported and paid with the regular income tax. It is subject to the same procedural rules, including filing requirements, payment of estimated taxes and record-keeping requirements.

Recent Developments

A perennial problem with the AMT had been that there was no provision in the law to index the exemption amounts for inflation each year. Without such a provision, a growing number of middle-class taxpayers were at risk for becoming subject to the AMT each year because their income items and regular tax brackets were adjusted annually for inflation but the AMT exemption amounts were not, decreasing the real value of the AMT exemption. To temporarily mitigate this effect, the exemption amounts were indexed one or several years at a time, but only on a temporary basis, as part of broader tax legislation. This temporary fix to the indexation problem, known as the "AMT patch," was provided by EGTRRA for tax years beginning in 2001 through 2004. Following EGTRRA, further legislation extended and enhanced these amounts for the 2005 through 2011 tax years. The most recently issued AMT patch was provided by the Tax Relief Act of 2010.

Fortunately for taxpayers and tax practitioners alike, the ATRA removed one major uncertainty from year-end tax planning by providing permanent AMT exemption amounts, which will be annually adjusted for inflation for tax years beginning after December 31, 2012.

For tax year 2013, the AMT exemption amounts are:

- $80,800 for married individuals filing a joint return and surviving spouses;
- $51,900 for unmarried individuals and heads of household, other than surviving spouses; and
- $40,400 for married individuals filing separately.

Not all taxpayers potentially subject to the AMT are able to benefit from the AMT exemption amount because the exemptions are phased out as taxpayers reach high levels of AMTI. Generally, the exemption amounts are phased out by an amount equal to 25% of the amount by which an individual's AMTI exceeds a threshold level. Although the AMT exemption amounts for individuals have historically increased via the AMT patch, the threshold levels for calculating the exemption phaseout remained unchanged for 2012 and prior years. However, for tax years beginning on or after January 1, 2013, the threshold amounts are being adjusted for inflation. The calculation of the phaseout amount is affected by the amount of AMTI exempted; therefore, an increase in the exemption amount also increases the maximum amount of AMTI a person can have before the exemption amount is phased out.

For 2013, the threshold levels for calculating the exemption phaseout are:

- $153,900 in the case of married individuals filing a joint return and surviving spouses (complete phaseout at $477,100);
- $115,400 in the case of unmarried individuals and heads of household, other than surviving spouses (complete phaseout at $323,000); and
- $76,950 in the case of married individuals filing separate returns (complete phaseout at $238,550).

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For purposes of AMT, a taxpayer must reduce AMTI by the applicable exemption amount and by the amount of the long-term capital gain subject to the 20%, 15%, or 0% capital gains rates. A tentative minimum tax is computed on the AMTI as reduced by the exemption amount and long-term capital gain. The tentative minimum tax is then increased by the amount of tax paid on the long-term capital gain for regular tax purposes.

The taxpayer's minimum tax liability is the difference between regular tax liability and the tentative minimum tax liability as increased by the regular tax paid on the long-term gain. What this generally means is that the reduction in the maximum capital gains rate should not cause a taxpayer to become subject to the AMT. The mechanism for achieving this result is provided by the calculations required by the Internal Revenue Code, effective for tax years ending after May 6, 1997.

Planning Notes

Perhaps the most important planning technique for taxpayers who are borderline candidates for the AMT is to make all efforts to maintain this situation. Bunching itemized deductions into one year causes the taxpayer to lose the value of these deductions in the regular tax year. If deductions are not evenly distributed, and the taxpayer has AMT and non-AMT years, the taxpayer should shift preference items from the AMT year to the non-AMT year until the taxpayer arrives at the brink of AMT liability, thus, reducing regular tax to the point where it equals the tentative tax. This technique provides the maximum benefit of preference deductions.

AMT liability is only triggered when the taxpayer's tentative minimum tax exceeds regular tax liability for a particular tax year. Therefore, a taxpayer can recognize AMT adjustments and tax preference items up to the point in which the tentative minimum tax is equal to regular tax without incurring AMT liability. This is the AMT crossover point. For married taxpayers filing jointly, the AMT crossover point generally occurs when 26% of the first $175,000 of taxable excess, as indexed for inflation, is greater than the taxpayer's regular tax (half of this amount, or $87,500, for married taxpayers filing separately).

The AMT crossover point and an individual taxpayer's AMT liability depend on a comparison of:

- The regular tax rate with the AMT tax rate; and
- The tax base for regular tax with the tax base for the AMTI.

Individuals subject to the AMT commonly benefit by timing their tax items, deferring certain items and accelerating others. It is best to accelerate items of income into AMT years and postpone deductions into non-AMT years.

Various strategies for reducing AMT liability include:

- Delaying payment of tax preference items, such as state and local income taxes, property taxes, medical expenses, and miscellaneous expenses (provided this does not impair credit status or business standing or cause the taxpayer to incur late charges);
- Postponing charitable contributions;
- Avoiding the exercise of incentive stock options in the year in which a taxpayer is subject to the AMT; and
- Making use of any available AMT credit.

Other strategies to consider when planning to minimize the effect of the AMT include the following:

- ***Timing strategies*** – Timing strategies may be effective for nonpreference adjustments. If the taxpayer is subject to the AMT in one year and not in the next, the marginal rate for the regular tax year should be determined. If the rate is more than 26% or 28%, nonpreference deductions should be shifted to the regular tax year. If the regular tax rate is 15%, this strategy should be reversed with nonpreference deductions shifted to the AMT year. One way to take advantage of the rate differentials between an AMT year and a non-AMT year is to accelerate items of income into the AMT year and postpone deductions into the non-AMT year. Following this strategy should result in overall tax savings.
- ***Accelerating income*** – Income can be accelerated by:
  - Taking prepayments of salary and bonuses;
  - Redeeming Series EE savings bonds;
  - Recognizing short-term capital gains;
  - Converting tax-free bonds to higher yielding taxable bonds; and
  - Withdrawing money from an IRA and other retirement funds.
- ***Deferring deductions*** – Deductions can be deferred by:
  - Depreciating rather than expensing business furniture and equipment; and
  - Delaying the payment of non-AMT deductible items to a year when the AMT does not apply.
- ***Medical expenses*** – Taxpayers with itemized medical expenses should determine if their employer has a pre-tax medical deduction plan or cafeteria plan. Medical expenses paid on a pre-tax basis are not included in taxable wages or deducted as itemized deductions, which reduces both AMT and regular tax.

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- ***Real estate and state income taxes*** – In a year in which the taxpayer is subject to AMT, prepaying real estate or state income taxes does not provide any benefit. If the taxpayer lives in a state where income taxes are high, then the taxpayer is likely to be subject to the AMT. Instead of prepayment, payment should be delayed to another year, if possible.

- ***Mortgage interest*** – Because interest on mortgage borrowings used for purposes other than to buy, build or improve the taxpayer's home is not deductible under the AMT, taxpayers that are subject to the AMT achieve no advantage from using a home equity line of credit to purchase a car or make some other expenditure. However, if the car is used in the taxpayer's business, a taxpayer may be able to deduct some of the auto loan interest or other costs as a business expense on Schedule C.

- ***Employee business expenses*** – Taxpayers with unreimbursed employee expenses who are subject to the AMT should consider asking their employer to start reimbursing them for their business expenses. If the employer refuses this request, the taxpayer may be better off negotiating a lower salary in exchange for payment of the business expenses.

- ***Miscellaneous itemized deductions*** – A taxpayer who is not subject to AMT each year should keep in mind that miscellaneous itemized deductions do not reduce AMTI. However, some itemized deductions, such as cash charitable contributions, home mortgage and other qualified interest, medical expenses, casualty and theft losses, gambling losses, and estate taxes act to reduce AMTI. Consequently, a taxpayer should attempt to maximize the allowable deductions in any tax year in which AMT might be imposed.

- ***Incentive stock options*** – Taxpayers who exercise incentive stock options (ISOs) during the year but do not sell the stock are subject to AMT on the hypothetical profit. Before exercising any ISOs, taxpayers should carefully calculate the impact of their potential gain, as shares may need to be sold in the year of exercise to pay the tax due. Taxpayers should also evaluate their minimum tax credit situation. The payment of AMT due to the exercise of ISOs gives rise to a credit that can be claimed in later years. This credit can be claimed without selling the shares if regular income tax is larger than the tax figured under the AMT rules, although the sale of the shares will generally result in a larger AMT credit. Taxpayers that have been subject to AMT due to the exercise of ISOs should file Form 8801, *Credit for Prior Year Minimum Tax*.

- ***Tax-exempt income*** – Taxpayers subject to AMT should invest in tax-exempt bonds that are not private-activity bonds. Private-activity bonds are not tax-exempt for AMT purposes, although certain bonds issued after July 30, 2008, and bonds issued in 2009 and 2010 are not considered private activity bonds, as discussed above.

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Some Final Thoughts About the AMT

As previously noted, there are many different adjustments and/or preferences that may cause one to have an AMT problem. From our experience, the primary adjustments that cause our clients problems are related to the state tax addback, the loss of personal exemptions, timing differences related to depreciation deductions for pass-through entities and AMT issues related to the exercise of incentive stock options.

For most taxpayers, the AMT is not a problem and does not come into play. However, if your income is within the "danger" zone, the AMT is a very real issue that should cause you to be alert to the potential tax hit that will be forthcoming. From our experience, the "danger" zone is generally for those taxpayers who:

- ***Have taxable income in the range of $100,000 - $600,000*** – Note that taxpayers who are below this range are generally exempted because they fall under the AMT zone. Taxpayers over this range are generally outside the scope of the AMT zone because their tax rate is in excess of the top AMT rate. While this is not always the case, it is generally true.

- ***Have taxable income in excess of the $600,000 noted above and have significant capital gains*** – The concern here is the level of ordinary income. If a taxpayer's ordinary income still falls within the $100,000 - $600,000 range he/she is within the AMT danger zone. Since capital gains are generally taxed at the same rate for regular tax and AMT purposes, one needs to exclude the capital gains in the calculation of tax for regular and AMT purposes. As a result, even a taxpayer with several million dollars of taxable income, could have an AMT problem if a large percentage of the taxable income is taxed at capital gains rates.

- ***Live in high state taxing jurisdictions*** – Unfortunately, Pennsylvania is one of those states. This is not necessarily caused by the state personal income tax rate, but is actually a function of the gross combined taxes that we pay in Pennsylvania. The combination of the state income tax plus the local income tax, combined with very high property taxes, will cause an AMT problem in many situations. Why? The issue is due to the fact that all of these taxes are deducted for regular tax purposes as itemized deductions, but these same amounts are not deductible for AMT purposes. Because of this increase to AMTI, additional (AMT) tax often will result.

- ***Have several dependents (kids)*** – So you thought that having a bunch of kids would save you on tax day? You were right, unless you are subject to AMT. A married couple with five kids would qualify for seven exemptions and a total tax deduction of $27,300. This is a huge tax deduction unless you are subject to AMT. For AMT purposes, this deduction may be fully eliminated, costing you thousands of dollars of additional tax. Ouch!

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- ***Large tax bills to state taxing jurisdictions as a result of a one time event*** – We have seen this situation numerous times over the last several years. For example, a business owner sells his entire interest in his business in year one and recognizes a large gain on the sale. As a result of some thoughtful tax planning, the business owner decides not to pay his state taxes on the gain until year two. In many cases, his tax advisor has convinced him to hold onto his cash as long as possible and keep his money invested until April 15th of the following tax year.

  This can be a great idea for holding onto cash, however, it can create a huge AMT issue in year two. This is especially true if taxable income is significantly less in year two. The huge state tax liability paid in year two is out of sync with the business owner's tax position in year two, and as a result of AMT, he will not get a tax deduction for those state taxes that were paid in year two for the year one state tax liability.

  The better decision would have been to pay the state taxes in year one and properly match the income in year one with the state tax deduction in year one. This would have allowed a tax deduction in the year of the transaction and would have saved federal taxes in the year of the transaction, resulting in a savings of as much as 40% on the business owner's tax bill in the year of the transaction.

  We see this mistake being made over and over again. One must also consider the AMT when determining the timing of state tax payments, especially in a year in which income is unusually high (or low).

The AMT is often considered the "monster in the closet." It is not always a problem, but when it comes out, it can be very destructive and painful. It is important to be aware of the issue and carefully plan for the many adjustments that can cost you tax dollars. It is often beneficial to get professional advice with respect to AMT, as it can be a very complex technical issue.

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Chapter IV – *Understanding the Medicare Tax on Unearned Income*

Introduction

While much of the focus in the early part of last year was on the sweeping changes that would impact the individual tax provisions in 2013 as a result of the ATRA, the impact of two new Medicare taxes introduced by the ACA are expected to affect a larger number of taxpayers. The new Medicare taxes, while passed into law in 2010, became effective on January 1, 2013, and impact taxpayers at a much lower income threshold than the levels noted in Chapter I related to the new top marginal rate brackets (39.6% on ordinary income; 20% on capital gains) and the levels noted in Chapter II related to the Pease limitation and itemized deduction phaseouts.

The focus of the first new Medicare tax is on investment income of taxpayers (individuals, trusts and estates). This new tax is referred to using a variety of terms, but mostly as the "Net Investment Income Tax," "Unearned Income Medicare Contribution Tax," "Medicare Surtax," or simply the "additional 3.8% Medicare tax." While proposed regulations related to this Medicare tax were issued in 2012, much uncertainty still surrounded the application of these new rules. Finally, on November 26, 2013, the IRS released final regulations that clarified many issues and provided numerous detailed examples to assist taxpayers and their advisors.

While the final regulations help to provide some clarity, complete resolution on certain questions has been promised in 2014. This new Medicare tax on investment income is considered by many in the tax community to be a whole new animal. The introduction of any new tax concept nearly always brings some level of questions and uncertainty as it begins to be implemented.

Overview of Net Investment Income (NII) Tax

The Net Investment Income (NII) tax was enacted under Section 1411 of the Internal Revenue Code on March 30, 2010, as part of the ACA. The tax was added as part of a new Chapter 2A, and currently Section 1411 is the only Code section in that Chapter. Although enacted in conjunction with the various provisions in the ACA, and the name might suggest that the funds raised by this tax are earmarked to be contributed to the Medicare Trust Fund, these funds are actually paid into the General Fund of the United States Treasury.

Basic calculation

While at first glance the basic calculation (on the following page) appears to be fairly straightforward and relatively simple to calculate, as one may expect, the complexities of this new tax lie in the determination of the various

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components of the equation. In particular, taxpayers and their advisors will be required to closely analyze the nature of various types of income and the taxpayer's level of participation in the activities that are producing income for the taxpayer. The calculation for this new tax is as follows:

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.

Modified adjusted gross income (MAGI)

For purposes of the NII tax, an individual's modified adjusted gross income (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.

Thus, MAGI for NII tax purposes, is modified only for certain U.S. citizens or residents who live abroad. For most taxpayers, MAGI is simply AGI as calculated for other federal tax purposes.

Thresholds

The applicable threshold amounts for purposes of the NII calculation are $250,000, in the case of a married taxpayer filing a joint return or a surviving spouse; $125,000 for a married taxpayer filing a separate return; and $200,000 for individuals filing as a single taxpayer. It is important to note that these amounts are not currently indexed for inflation.

The threshold amount for trusts and estates is the start of their 39.6% tax bracket, which is $11,950 and $12,150 for 2013 and 2014, respectively.

Net investment income (NII)

NII, for purposes of the above calculation, is the excess of the sum of the following items, less any otherwise allowable deductions properly allocable to such income or gain:

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(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;

(ii) Other gross income from either: (a) a trade or business that is a passive activity with respect to the taxpayer, or (b) a trade or business trading in financial investments or commodities; and

(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.

Note that all income and net gain from a trade or business that is a passive activity with respect to the taxpayer, or is derived from a trade or business of trading in financial instruments or commodities, is NII. In general, such income is category (ii) income.

General exceptions

NII does not include:

- Gross income from interest, dividends, annuities, royalties, rents, substitute interest payments and substitute dividend payments, if it is derived in the ordinary course of a trade or business that is not a passive activity or a trade or business of a trader trading in financial instruments or commodities (ordinary course of trade or business exception);
- 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.

Additional types of income that are not NII are wages, unemployment compensation, Social Security benefits and alimony.

Income that is normally excluded from adjusted gross income, such as gain from the sale of a house, veterans benefits, life insurance proceeds or tax exempt bond income, is not counted as NII (nor is it counted toward meeting the MAGI threshold). Note that the exclusion of proceeds on the sale of an active interest in a partnership or S corporation depends on the sale completing before the seller retires.

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Trade or business exclusion from category (i) income

Trade or business income is generally excluded from category (i) if it meets three requirements:

1. There must be an activity that rises to the level of a trade or business under Code Sec. 162;
2. The income must be derived from that trade or business (i.e., incidental income unrelated to the trade or business would not qualify for the exception); and
3. The taxpayer must materially participate in that trade or business along the lines required under Code Sec. 469 for nonpassive treatment of income.

Passive activities

The NII tax rules for passive activities generally adopt the Code Sec. 469 rules for passive activities losses. The standard for a passive activity under these rules is whether the taxpayer materially participates in the trade or business on a regular, continuous and substantial basis.

Under the final regulations, to the extent that any income or gain from a trade or business is recharacterized as "not from a passive activity," such trade or business does not constitute a passive activity with respect to that income or gain for these purposes. Similarly, to the extent that any gain from a trade or business is recharacterized as "not from a passive activity" and does not constitute portfolio income, such trade or business does not constitute a passive activity with respect to such recharacterized gain. However, to the extent that any income or gain from a trade or business is recharacterized as "not from a passive activity," and is further characterized as portfolio income, then such trade or business constitutes a passive activity for these purposes, solely with respect to such recharacterized income or gain.

Taxpayers may do a one-time regrouping in the first year they are subject to the NII tax, and (under the final regulations) this may be done on an amended return if the taxpayer was not subject to NII tax on the original return.

Rental activity and the trade or business exception for category (i) income

Rental activity does not necessarily rise to the level of a trade or business. Its categorization as such depends on a number of factors, including the type of property, the number of properties rented, the day-to-day involvement of the owner or agent and the type of rental.

Under the passive activity rules, rental activity of real estate or equipment is deemed to be passive. There are a number of regulatory exceptions that treat certain rental activities as not falling under this general rule. For example, the rental activity of a real estate professional (i.e., someone for whom more than half of his/her personal services performed in trades or businesses are performed in real property trades or businesses in which the taxpayer materially participates, and who performs more than 750 hours of service during the tax year in that real property trade) is not treated as a passive activity under the passive activity rules.

Just because a taxpayer qualifies under a passive activity rental exception does not mean that the trade or business qualifies for the category (i) trade or business exception. The activity must also rise to the level of a trade or business. For example, a real estate professional who spends most her time as a realtor, but also has rental income on the side, will be able to avoid the passive activity loss rules on her income taxes, but the rent (minus expenses) may, nevertheless, be considered as category (i) net investment income for lack of a trade or business of renting property.

The final relegations provide a safe harbor under which real estate professionals may qualify for the trade or business exception. To qualify, the taxpayer must either (a) participate in rental real estate activities for more than 500 hours per year, or (b) have participated in rental real estate activities for more than 500 hours per year in five of the last 10 tax years (one or more of which may be tax years prior to the effective date of the NII tax). If the safe harbor applies, the real property is considered to be used in a trade or business for purposes of calculating category (i) net gain. Failure to satisfy the safe harbor requirements, however, does not preclude a taxpayer from showing that he or she did, in fact, have a trade or business from which the income was derived.

Self-charged interest and rent

Unless a trade or business is in the business of lending money or renting property, self-charged interest and self-charged rent would not readily qualify as income derived in the course of the trade or business for purposes of the trade or business exception. However, the final regulations provide relief. In the case of self-charged interest received from a nonpassive entity, a taxpayer may exclude from NII an amount equal to the taxpayer's allocable share of the flow-through entity's interest deduction. For purposes of self-charged rental income, the final regulations provide that, to the extent that gross rental income is recharacterized as nonpassive, or as a consequence of a taxpayer grouping a rental activity with a trade or business, such income is deemed to be derived in the ordinary course of a trade or business and, thus, is excluded from NII.

Income from working capital

NII includes any income, gain or loss, which is attributable to an investment of working capital, that is treated as not derived in the ordinary course of a trade or business.

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Ownership levels at which trade or business income is determined

To determine whether gross income from interest, dividends, annuities, royalties, rents, substitute interest payments and substitute dividend payments under category (i) above is derived in a trade or business, the following rules apply:

- For individuals, estates or trusts that own or engage in a trade or business directly (or indirectly through ownership of an interest in an entity that is disregarded as an entity separate from its owner), the determination of whether category (i) gross income is derived in a trade or business is made at the individual, estate or trust level.
- 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.
- 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 of a trader trading in financial instruments or commodities is made at the entity level. If the entity is involved in the business, the income retains its character when passing through to the taxpayer.

Multiple trades or businesses

In the case of a trade or business, the NII tax applies if it is a passive trade or business with respect to the taxpayer. The tax does not, however, apply to other trades or businesses conducted by a sole proprietor, partnership or S corporation.

Category (ii) trade or business income treated as NII

Category (ii) income is income from a trade or business that is a passive activity with respect to the taxpayer, or a trade or business of financial trading. Generally, category (ii) income is income from the normal operations of a trade or business, as distinguished from side income that falls under category (i) (i.e., incidental income unrelated to the trade or business), or category (iii) gain (i.e., disposition of working capital assets).

Under the final regulations, all trading gains or losses are assigned to category (iii), which is a change from the 2012 proposed regulations under which category (ii) included all gross income from a trade or business trading in financial instruments or commodities that is not category (i) income.

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Category (iii) gain from disposition of nonbusiness property

Category (iii) NII comprises 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. Common types of gain that are generally included in category (iii) income include 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 gain from 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.

Category (iii) losses

Category (iii) net gain cannot be less than zero. The final regulations allow suspended losses from former passive activities to 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.

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).

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. The net gain component of the computation only includes that portion of the gain or loss on the disposition of an interest in a partnership or S corporation that equals the amount of the net gain or loss that would be taken into account by the partner or shareholder if all property of the partnership or S corporation were sold at fair market value immediately before the disposition of the interest. Under the 2013 proposed regulations, the gain is the lesser of:

- The seller's overall gain or loss on the sale of the partnership interest or S corporation stock determined under normal income tax rules; or
- The seller's share of a hypothetical asset sale gain that would be included in NII because the assets were passive with respect to the seller or not used in a trade or business.

The 2013 proposed reliance regulations also provide a simplified calculation method for taxpayers who qualify.

Payments to retiring partners

Under the 2013 proposed reliance regulations, payments to retiring partners are NII, however, if the partner is nonpassive, an exclusion may apply. Gain or loss relating to payments is category (iii) income regardless of whether the payments are classified as capital gain or ordinary income. For payments that are paid over multiple years, the characterization of gain or loss as passive or nonpassive is determined for all payments as though all payments were made at the time that the liquidation of the exiting partner's interest commenced and is not retested annually. For payments for unrealized receivables and goodwill, the portion (if any) of the payment that is allocable to the unrealized receivables and goodwill of the partnership is category (iii) income as gain from the disposition of a partnership interest. Payments not for unrealized receivables or goodwill are characterized as payments for services or as the payment of interest in a manner consistent with the payment's characterization.

Properly allocable deductions

Properly allocable deductions that can be taken against NII include rent or 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.

Certain itemized deductions qualify as properly allocable deductions. The IRS has provided the following list:

- Investment interest expenses
- Investment expenses,
- Taxes,
- Items with respect to the last year of an annuity,
- Estate and generation skipping taxes,
- Expenses in connection with determination, collection or refund of tax,
- Amortizable bond premium, and
- Fiduciary expenses for an estate or trust.

Reporting Requirements

Taxpayers will generally calculate their NII on Form 8960, *Net Investment Income Tax*, which will be included in their personal income tax returns. This form was released by the IRS in late 2013. The instructions for Form 8960 were released on January 7, 2014, and provided 20 pages of explanation to assist with the preparation of the one-page form. Again, this demonstrates the complexities of the NII tax.

Additionally, pass through entities (such as partnerships and S corporations) now have additional reporting requirements on the Schedules K-1 that are issued to their owners. The amount of pass through income that is subject to the NII tax for each owner is required to be reported to the owner on his/her Schedule K-1. This increased reporting obligation will undoubtedly require more time from the individuals responsible for the tax filings for the pass through entities, as well as their advisors.

Planning Considerations

As the facts and circumstance of every taxpayer's tax position are very different, planning for the new NII tax must be customized for each individual or entity. What may be an effective planning tool for one taxpayer may not have a significant impact on another. That being said, the most important focus in planning will generally be on minimizing the applicable components (MAGI or NII) to which the 3.8% Medicare tax applies.

MAGI considerations

As noted earlier, the NII tax is calculated on the lesser of an individual's NII or MAGI for the tax year, over the applicable threshold amount. Accordingly, to the extent that a married taxpayer does not have MAGI over $250,000, he/she should not be impacted by the new NII tax. In these situations, it is generally not necessary to invest significant time in evaluating all of the complex components of NII because the taxpayer's MAGI does not exceed the respective threshold. Instead in these circumstances, time spent on tax planning that targets the reduction to a taxpayer's MAGI is more beneficial.

Certain strategies, such as selling securities that have unrealized losses to offset gains, would serve to reduce both NII and MAGI. Other strategies, such as making deductible contributions to tax-favored retirement accounts, would target MAGI alone. This tactic would reduce a taxpayer's MAGI and potentially allow him or her to avoid the NII tax. Education-related expenses such as tuition, student loan interest and educator's expenses will also serve to reduce MAGI.

Taxpayers that have MAGI close to their respective threshold amounts should evaluate timing considerations with regard to items in which there is some discretion as to the receipt of the income. To the extent taxpayers can defer or spread out their income in a particular tax year to stay below the applicable thresholds, they may be able to avoid being subject to the NII tax.

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Example 1:

- Jack and Jill Smith are married taxpayers, filing a joint tax return.
- Jack is retired and receives annual social security benefits of $15,000 and $25,000 in retirement plan distributions.
- Jill is the sole shareholder in an S Corporation that she has owned and operated for two decades and is considering selling the business. Jill draws a salary from the business of $75,000, and the pass through earnings that are expected to be reported to Jill on her Schedule K-1 are $50,000 in the current year.
- The couple is expected to have $40,000 of income from investments they have built up over the years.
- Accordingly, based on the above fact pattern their MAGI is expected to be $205,000. Although Jack and Jill have $40,000 of investment income, their MAGI is currently under the $250,000 threshold for married taxpayers and, therefore, would not be subject to the NII tax on their investment income.
- As noted, Jill is evaluating the sale of her business and retirement. She received an offer from an interested party to purchase the company for approximately $500,000. She has the option to receive a lump sum payment in the current year or enter into an installment sale where she can receive payments over the course of three years.
- If Jill sells her business in the current year for the lump sum payment of $500,000, the couple's MAGI would increase to $705,000. This would cause their MAGI to exceed the threshold, and the couple would now be subject the 3.8% NII tax on their $40,000 of investment income, which would result in additional NII tax of approximately $1,500.
  - This does not consider the additional tax increases that would result from the Pease and itemized deduction phaseouts discussed in earlier chapters, as well as the higher rates (39.6%/20%) for taxpayers in the top marginal tax rate bracket.
  - It is important to note that even though the additional income of $500,000 was not, in and of itself, subject to the NII tax, it does, however, serve to push the taxpayers over the applicable threshold and subjects the $40,000 of other investment income to the new Medicare tax, which was not previously applicable.
- Jill should give careful consideration to the installment sale option if the other financial terms are acceptable. Additionally, she would want to consider waiting until after the end of the current year to sell the business and receive the first installment.
  - Presumably, after the sale of the business, she will no longer be drawing her salary of $75,000 or have the pass through income of $50,000. Accordingly, if all other factors remain consistent, the couple's MAGI (before accounting for the sales proceeds) would be reduced to $80,000. If you then assume that they receive three equal annual installments of $166,667, this would increase their MAGI to approximately $247,000, and they would avoid the NII tax, as well as the impact of the other tax rate increases and phaseouts.

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NII considerations

Most tax planning for the NII tax will likely be focused on targeting the categories of income included in NII. Taxpayers who have MAGIs that are expected to exceed their applicable thresholds, and have limited means for modifying the MAGI, will need to focus on ways in which to minimize their NII.

As previously noted, some strategies, such as selling securities that have unrealized losses to offset gains, will work to reduce both MAGI and NII. It may also be worthwhile to evaluate new investment strategies such as targeting tax-exempt investments or life insurance products.

In situations where taxpayers are selling an investment property such as a vacation home, if possible, they may wish to consider a Section 1031 exchange for another qualifying property. This would allow the taxpayers to defer the gain for now and, at least temporarily, escape the NII tax.

Another strategy includes gifting appreciated securities to either children or charitable organizations. In either instance, this serves to remove the gains on the appreciated securities from the parent's tax return.

As previously noted, deductions that are properly allocated are permitted as a reduction to NII. Accordingly, selecting a method for determining deductions allocable to gross investment income that will maximize the reduction to NII would be recommended.

One of the most significant planning strategies that could have an impact on a taxpayer's NII relates to their participation in any rental or business activity in which they may be involved. This includes ownership in pass through entities such as partnerships and S corporations. As noted earlier in this chapter, all income and net gain from a trade or business that is a passive activity with respect to the taxpayer is considered NII.

Because the various determinations of what qualifies as a trade or business, as well as qualifications for active versus passive, are based on specific facts and circumstances, there is a tremendous amount of planning that can be undertaken in certain scenarios to minimize a taxpayer's NII.

To the extent a taxpayer can establish his/her active participation in a trade or business, he/she has the ability to exclude that income from his/her NII and avoid the 3.8% Medicare tax. If the taxpayer can meet the active participation tests, not only can significant tax savings be derived by avoiding the NII tax on the pass through income, but potentially more-significant savings can also result from the ultimate sale of the taxpayer's interest in the pass through entity.

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Example 2:

- John and Julie are brother and sister, and both own 20% respectively of the family business that their parents started. The parents still hold the other 60%.
- Julie has worked full-time for the family business her whole life, but John pursued a career outside of the family business. He has only spent a few days a month actively working in the family business over the course of the past few years.
- Accordingly, John's pass-through income from the family business has been considered from a passive trade or business. However, because the business has been profitable, his classification has not been a concern. (If the business had been passing through losses, John would have been required to consider passive activity limitations).
- Without anything changing, because of John's passive involvement with the family business, effective January 1, 2013, if his MAGI is over $250,000 (and assuming that he is married), he would be subject to the new NII tax on the income that passes through to him from the family business.
- Accordingly, even though John and Julie have identical ownership in the family business and receive the same amount of pass-through income, John could presumably pay 3.8% more in tax than Julie owes on the income (assuming they are both in similar tax brackets).
- Depending on the particular facts and circumstances of the situation, it may be in John's best interest to take steps to become more involved in the business, so that he can meet the active participation requirements.

Please keep in mind, that if the above family-owned business is in the form of an S corporation, it is required to make distributions to its shareholders proportionately. Generally, pass through entities will make cash distributions to their owners to cover the tax obligations associated with the pass through income, so that the owners are made whole and not out of pocket for any of the tax liability. One can see in the above example how it may also benefit the family business if John were to become active. John is the only member of the family that is passive and, thus, subject to the 3.8% Medicare tax on the pass-through income. However, to make him whole the business would need to distribute any extra 3.8% of taxable income to John, and as a result of S corporation distribution requirements, they would also need to make equivalent distributions to Julie and their parents (to be pro rata). This results in an additional cash outflow of approximately 4% of the business's income.

Not only can significant tax savings be derived by avoiding the NII tax on the pass-through income if the taxpayer can meet the active participation tests, but perhaps more significant savings can result on the ultimate sale of the taxpayer's interest in the pass-through entity, as illustrated in the following example.

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Example 3:

- Assume similar facts as noted in Example 2, except John and Julie's parents are now planning on retiring in a few years, and neither John nor Julie are interested in taking over the family business. Accordingly, the business will likely be sold to an outside party, and based on the business's current position, the expected sales price is approximately $5,000,000.
- As discussed earlier, Category (iii) for NII purposes includes net gains that are attributable to the disposition of property other than property held in an active trade or business. Since the participation is determined at the taxpayer level, John's associated tax liability on his share of the gain ($1,000,000) would be significantly more (approximately $38,000) than his sister's if he were to remain passive.
- Accordingly, in situations where a sale of the business may be in the near future, owners should give careful consideration to the implications the NII tax may have on the transaction and take potential tax proactive steps to minimize the impact on NII.

Summary and Final Thoughts

Over the course of the upcoming tax filing season, we suspect that a lot of taxpayers will be surprised by the impact of the new Medicare tax on unearned income. Despite becoming effective at the beginning of 2013, the NII tax was overshadowed by much of the discussions surrounding the "fiscal cliff" and "sequestration." With the enactment of the ATRA and all of the changes to the 2013 individual tax provisions associated with that Act, this new Medicare tax certainly adds to the challenges being faced by taxpayers and their tax advisors heading into the filing season.

Fortunately, with the recently-issued final regulations and form instructions from the IRS, taxpayers and their tax advisors now have additional guidance to clear up much of the uncertainty that existed for the majority of 2013. Surely there will continue to be additional questions for which guidance will be needed, however, as with most new taxes, there will continue to be many opportunities for taxpayers to be proactive in their tax planning and to take steps to minimize their overall tax liability.

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Chapter V – *Understanding the Medicare Tax Surcharge on Earned Income*

In addition to the 3.8% Medicare contribution tax on unearned income as discussed previously in Chapter IV, the ACA also increased the Medicare tax on the combined earned income and self-employment earnings of "higher-income" individuals/employees (and their spouses) over certain threshold amounts for years beginning after 2012. Several details related to this additional tax must be considered to better understand its effect on individual tax liability.

Looking for guidance into the new year, it was only late in November when the Internal Revenue Service issued final regulations on this tax (as noted in the previous chapter). Thankfully, the final regulations generally track the earlier-released proposed regulations, while offering some need clarification.

This new 0.9% Medicare surtax is imposed on an individual's total wages, other compensation, and self-employment income; it does not apply to corporations, estates or trusts. The tax increases the employee's portion of hospital insurance (HI; i.e. Medicare) tax by 0.9%, from 1.45% in recent prior years to 2.35% for years beginning after 2012. Unlike the base 1.45% Medicare payroll tax for which both employer and employee are responsible, the additional 0.9% applies only to the "employee" portion of Medicare tax; the employer's portion of the Medicare tax is not affected. Thus, for self-employed individuals, who are responsible for paying both the employer and employee portion of Medicare payroll tax on their earnings from self-employment, the surtax increases the Medicare payroll tax rate (2.9% in recent prior years) by 0.9% "only once" to 3.8%, for the employee portion. Note that this 3.8% rate is entirely unrelated to the 3.8% Medicare tax on unearned income as discussed previously; the equivalency in % is merely coincidental. The additional Medicare tax also applies to Railroad Retirement Tax Act (RRTA) income; however, that topic is beyond the scope of this chapter.

Unlike the general 1.45% Medicare tax, the new 0.9% Medicare surtax is only imposed on wages earned by employees in excess of $200,000 for single tax filers ($250,000 for married taxpayers filing jointly; $125,000 for each married taxpayer filing separately). Also unlike the general 1.45% Medicare tax, for married taxpayers filing jointly, the 0.9% surtax is based on the couples' combined earnings. This appears to be the first time in the nation's history that a taxpayer's marital status has affected the collection of Medicare payroll tax, as the ACA provides that an employee is responsible for withholding the 0.9% Medicare surtax on wages in excess of $200,000 only on behalf of the specific employee, without consideration of the earnings of the employee's spouse. In fact, the employer is not responsible for determining whether the employee is married. This may pose a significant risk to married couples with more than one earner, as reflected in the example below.

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***Example 1*:**

- John and Mary, a married couple filing jointly, each earn $150,000 in wages.
- Although neither earns wages in excess of the $200,000, their combined earned income of $300,000 makes them responsible for 0.9% of their earnings in excess of $250,000, or $450 (0.9% x $50,000).

Planning consideration **– As illustrated in Example 1, when calculating the quarterly estimated tax liabilities, married taxpayers with more than one earner will need to consider any potentially unpaid Medicare surtax liability resulting from situations similar to that outlined above. Alternatively, one or both taxpayers may request that their respective employers withhold additional Medicare tax from their gross wages.**

Special consideration must be given to situations in which individuals have both wages and self-employment income. Generally, the applicable surtax threshold for self-employment tax (i.e., $250,000, $200,000 or $125,000) is reduced (but not below zero) by the amount of wages taken into account in determining the 0.9% Medicare surtax with respect to the taxpayer. Calculation of applicable Medicare taxes should be performed in three steps:

1. Calculate the 0.9% Medicare surtax on any wages in excess of the applicable threshold for the filing status, without regard to whether any tax was withheld;
2. Reduce the applicable threshold for the filing status by the total amount of Medicare wages received (but not below zero);
3. Calculate the additional Medicare tax on any self-employment income in excess of the reduced threshold.

The effects of these procedures are illustrated in the following examples.

***Example 2*:**

- Addy, a single filer, has $130,000 in self-employment income and $0 in wages.
- She is not liable to pay additional Medicare tax.

***Example 3*:**

- Michael, a single filer, has $220,000 in self-employment income and $0 in wages.
- He is liable to pay additional Medicare tax on $20,000 ($220,000 in self-employment income minus the threshold of $200,000).

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Example 4:

- Karl, a single filer, has $145,000 in self-employment income and $130,000 in wages. His wages do not exceed $200,000, so Karl's employer did not withhold additional Medicare tax. However, the $130,000 of wages reduces the self-employment income threshold to $70,000 ($200,000 threshold minus $130,000 of wages).
- Karl is liable to pay additional Medicare tax on $75,000 of self-employment income ($145,000 in self-employment income minus the reduced threshold of $70,000).

Example 5:

- Edward, who is married and files a joint return, has $140,000 in self-employment income. Edward's wife, Frances, has $130,000 in wages.
- Frances' wages are not in excess of $200,000, so her employer did not withhold additional Medicare tax. However, her $130,000 in wages reduces Edward's self-employment income threshold to $120,000 ($250,000 threshold minus the $130,000 of wages).
- Edward and Frances are liable to pay an additional Medicare tax on $20,000 of Edward's self-employment income ($140,000 in self-employment income minus the reduced threshold of $120,000).

Example 6:

- Donald, who is married and files separately, has $150,000 in self-employment income and $200,000 in wages.
- Donald's wages are not in excess of $200,000, so his employer did not withhold additional Medicare tax. However, the $200,000 of wages reduces the self-employment income threshold to $0 ($125,000 threshold minus the $200,000 of wages).
- Donald is liable to pay an additional Medicare tax on $75,000 of wages ($200,000 in wages minus the $125,000 threshold for a married filing separately) and on $150,000 of self-employment income ($150,000 in self-employment income minus the reduced threshold of $0).

On a related front, it is also important to note that partnership income flowing through to a general partner of a partnership is treated as self-employment income. If this income (or this income plus other earned income) exceeds the applicable thresholds, the 0.9% surtax applies. However, partnership income allocated to a limited partner is not treated as self-employment and would not be subject to the 0.9% surtax. Furthermore, income that flows through to S corporation shareholders is currently not treated as earned income and would not be subject to the Medicare surtax, although there have been proposals to change this treatment of S corporation income.

Planning consideration **– In response to this new 0.9% Medicare surtax, a business owner might consider setting up his/her business entity as an S corporation, rather than as a partnership, so that the entity's income allocable to owners is not treated as earned income. If an entity is operating as a partnership, the owners could convert it to an S corporation.**

Also to be considered starting in 2013 is maximizing the amount of compensation that can be contributed pre-tax to a qualified retirement savings plan. Such amounts are not subject to employment taxes, including the new Medicare surtax, at the time of contribution or at the time funds are later distributed in retirement.

Concluding Thoughts

Little opportunity is available for planning to eliminate this new tax. As it is compensation-based, for most individuals affected by the tax, it is doubtful that deferral of that compensation from employers will be desirable, or even helpful. For that reason, and the clarity of the provision and newly-minted Treasury regulations, it is likely that most taxpayers will simply have to comply with this tax increase and move on.

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Chapter VI – *Effects of the ATRA on Pass Through Businesses*

The politics associated with the ATRA focused on increasing the "fair share" of tax paid by individual taxpayers with earnings in excess of certain threshold levels. The primary impetus for this thinking was that those making greater amounts of personal income could share in funding a greater portion of the federal tax burden. There was no overriding intent to tax business income as a result of this bill, and the fact that pass through business entities are "caught" paying a greater portion of their earnings as taxes on business income as a result of its passage has proven, as was discussed last year, to be a major drag on the economic recovery of these businesses.

Pass through business entities are those businesses that are organized for state and federal tax purposes as corporations that have elected S corporation status, general partnerships, limited partnerships, "multi-member" limited liability companies that are, by default, tax partnerships, and limited liability partnerships. Pass through businesses also include proprietorships and single-member limited liability companies owned by individuals. Generally, the pass through entity reference means that the entity-level income is "passed through" to the individual owners of equity in proportion to their ownership in the business. The income that is passed through generally is reported to the equity owners on a Schedule K-1, reporting their proportionate share of all entity-level tax items. These items, then, are reported on the taxpayer's individual income tax return, usually Form 1040, and the tax is "paid" with that return.

The issue that arises in this flow of income, under ATRA, is that, owners of pass through business entities often receive passed-through entity-level income items, but cash distributions rarely match the level of the income items passed through. The outcome is that the equity owners report what is essentially phantom income on their tax returns, and they rely upon the entity to distribute sufficient cash to meet the tax obligation on the passed-through income items.

***Example 1*:**

- Assume Mike is a 25% partner in the ABC partnership, which has a single income item for 2013 of ordinary income in the amount $1,000,000. When the ABC partnership return is prepared, it will include a Schedule K-1 for Mike that shows the share of income that he must report on his Form 1040 is $250,000.
- The $250,000 is not cash, and Mike's tax liability under ATRA (assuming he is in the highest bracket) is $99,000 (top marginal rate of 39.6% x $250,000). Mike could pay the tax liability associated with the ABC pass through income from personal savings if the funds are available, but the more common and more economically appropriate source of the funds to pay this liability is ABC partnership.
- If ABC does not distribute the funds, its cost of capital will increase because drawing investors to the company would not be possible at lower costs of capital if the equity owners would be expected to pay the tax.

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Given the above information, it is painfully obvious that pass through entity income included on equity owners' income tax returns will be subject to the individual income tax rates, and to the extent that this income pushes the taxpayer over the threshold levels to fall into the income range for the highest individual income tax rates, that marginal rate will be the 39.6% rate.

Thus, even though it was repeatedly noted throughout the debate over the Fiscal Cliff bill that the tax rate would not affect businesses, it does in fact, affect this segment of businesses in the United States in a major way.

Referring to the earlier discussion in Chapter I on marginal income tax rates, it is important to understand that the "next" dollar of income concept plays an important role in assessing the effect of the ATRA on pass through entity income. While the thresholds finally adopted for application of the 39.6% marginal rate ($400,000, for taxpayers filing single, $425,000 for taxpayers filing as head of household and $450,000 for taxpayer's filing jointly) are higher than the President might have liked, they are not so high that the impact of the rate changes will not affect these businesses.

***Example 2*:**

- Assume Rita owns 100% of an S corporation and takes from the corporation a salary of $350,000. After deducting the salary, the S corporation's taxable income is $325,000.
- Clearly, in this case, Rita has just $350,000 of "cash" income, and the appropriate income tax would be withheld by the S corporation on her wages. However, given the tax regime for pass through entity taxation, she must also include the $325,000 of S corporation income. Note that this income does NOT represent cash flow to Rita.
- As a result of this treatment, the tax liability associated with the $325,000 of S corporation income is paid by Rita. This liability/obligation represents a "real" economic cash outflow for her. As such, normal business practice dictates that the cash necessary to fund the income tax on the S corporation income will be distributed from the S corporation to pay the income tax.
- As the addition of the S corporation income to the Rita's salary income raises her income to $675,000, she is well above the income threshold for the maximum marginal tax rate of 39.6%. If the S corporation funds this tax through corporate distributions, it is evident that the income tax increase has, indeed, impacted the business.

The problem worsens, as one might expect, as pass through business income rises. In many instances, especially in growing enterprises requiring greater amounts of cash flow from operations to be reinvested in the business, the need to distribute significantly greater amounts of cash flow generated from operations is counter intuitive to economic growth and job creation.

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As complex as this issue already is with higher tax rates, the treatment of pass through business income is further complicated by the expansion of the new 3.8% Medicare tax on net investment income, as discussed in Chapter IV. The reach of the new tax (via a new definition of net investment income) now stretches to passive activity income. The result of that new definition is that, activities which are considered passive activities under the passive activity rules, and which generate positive income, will be subjected to an additional 3.8% Medicare tax on top of the marginal income tax rate increase for taxpayers in the higher tax brackets.

As a result of these two changes in combination, pass through entities need to distribute even higher amounts for equity holder tax liabilities. If the tax applies, it may be necessary to distribute 39.6% for regular tax purposes, 3.8% for the expanded Medicare tax, and 3.08% for Pennsylvania income tax – for total tax distribution of 47%. Should pass through entities wish to make equity owners whole, they may also be inclined to distribute an additional 1% to 2% of earnings to compensate equity owners for the loss of personal exemptions and itemized deductions.

To fully determine the effect of including any pass through business entity income on a taxpayer's income tax return, it is first necessary to complete the entire tax return calculation, with and without the effects of the income. Only in this manner is one able to fully quantify each of the elements of the two new pieces of legislation and the impact of the pass through business entity income to the taxpayer. This process can also establish, for the pass through entity, that the proper amounts of distributions have, or have not, been distributed to the equity owners.

It is noteworthy that in most cases, pass through entities distribute cash in proportion to the owners' ownership interest percentages. Specific to S corporations, this is a technical requirement under statute to prevent the formation of a second class of stock (not permitted under those rules). In these cases, where distributions are intended to fully compensate pass through business entity equity holders for including that entity's income on their income tax returns, distributions may be even greater because all equity holders will receive the distributions at the highest marginal income tax rate, even though all equity holders may not be at that income level. In addition, in those pass through business entities that are comprised of both passive and active owners, distributing greater amounts to reimburse the passive equity holder for this new tax may result in "windfalls" to those active equity holders that are not required to pay the tax.

***Example 3*:**

- Mike, Bill and Sue are siblings in a family that owns an S corporation business. Bill and Sue work in the family business. Mike is a medical doctor practicing in another city and is not active in the family business.
- In 2013, the business makes $900,000 of income that will be passed through equally to the three shareholders.

- Assuming Mike is passive, and that his wages from the practice of medicine are $400,000, he will be subject to the highest marginal tax rates. In addition, he will be subject to the 3.8% Medicare tax on NII.
- Given these circumstances, the Company decides to distribute 48% of the year's income. As such, each shareholder will receive $144,000.
- Of this tax distribution, approximately $11,400 will be used by Mike to fund the Medicare tax on the NII he receives from the business.
- Bill and Sue will not be subject to the Medicare tax, as they are active in the business. For them, the $11,400 will represent an excess tax distribution, providing them with a small windfall.

Planning Considerations

The primary focus of planning for the additional tax liabilities generated by ATRA and the Medicare tax will be on the business-entity level. Reducing pass through income will be paramount to saving these taxes. As with individual income taxation discussed in Chapter I, the standard planning construct will center around deferral of income and acceleration of deductions. However, given that those pass through business entities generating income at levels substantial enough to be problematic under the new tax laws are most likely to be using the "accrual" method of accounting for income tax purposes, use of these strategies is more difficult than for cash basis taxpayers.

Planning for tax minimization at the pass through business-entity level must first start with the overriding precept that all amounts deducted as expenses are ordinary and necessary under the law and, that expenditures taken as tax deductions are reasonable in amount. While each of these terms is subject to interpretation under the tax law, conceptually, they are easily understood.

The key to reducing income at the pass through business-entity level is to first take advantage of the beneficial provisions afforded under the Internal Revenue Code that do not result in a "shift" of income from the business entity to the equity owner. Examples of these types of planning opportunities can be as overt as ensuring that the business has taken advantage of all depreciation and expensing provisions (IRC section 179) for its fixed assets, or much more subtle planning ideas, which can include revisiting all of the business entity's accounting methods to ensure that those methods currently being employed by the business entity put the Company in its lowest possible taxable income position.

Other examples of more overt planning should include reviewing research and development and energy tax credit qualification, while the more subtle avenue might delve into how the Company reports income and how best to make any required accounting method change. Another subtle, but critical, planning strategy is to ensure that the Company takes advantage of all qualified retirement plan deferral opportunities, including possibly combining a discretionary profit sharing plan with its current 401(k) plan, ensuring that all owners receive the greatest tax deferral possible while securing a current tax deduction for the pass through business entity. Note, however, anti-discrimination rules present a challenge to such strategies.

After affording the Company of all beneficial provisions allowable under the Internal Revenue Code, looking to planning strategies resulting in income shifts might still be helpful in limited circumstances. With respect to these strategies, however, planners are just beginning to understand the full impact of the laws. While reducing the taxable income at the pass through business-entity level will result in lower "pass through" income, any benefit associated with the lower pass through is likely to be offset by the receipt of that income at the equity-owner level. As such, little of this shifting will yield any discernible tax advantage.

The problem may be compounded in the event that the income shift is accompanied by a recharacterization of that income. Assume, for example, that the equity owner is an active participant in a pass through business entity. Assume, further, that the equity owner owns that real property that is used by the business in its operations outside of the pass through business entity. If the traditional method of paying greater rents is used to reduce the pass through business entity income, not only will there be no net change in the overall taxable income of the equity owner (thus, his marginal rate will not decrease), he may be required to pay the additional 3.8% Medicare tax on that income as it is now characterized as rental income which is, by definition, passive, and part of net investment income.

The same general effect is associated with paying greater compensation to the equity owners. While the pass through business entity income is lower, the tax shift does not result in lower taxes. In fact, if the entity is an S corporation, such an approach adds both the employer and the employee Medicare tax to the equation.

One way to get around these outcomes might be to reconsider enhancing tax-free employee benefits. For example, increasing the employer share of health care premiums will serve as a direct reduction in entity-level income without increasing equity-owner taxes. However, these plans generally cannot discriminate in favor of the equity ownership and will require inclusion of non-owners, as well.

In addition, there may be opportunities for accrual-basis pass through business entities to deduct certain compensatory items such as bonuses to holders of less than 50% interests in any pass through business entity and exclude inclusion in the equity owner's returns. However, these opportunities are extremely limited by rules governing related party transactions and are somewhat compounded by ownership attribution rules.

As can be observed, strict rate change legislation does not provide a substantial amount of flexibility or enhanced planning opportunities by themselves. The best that most taxpayers can expect, especially those involved in pass through business entities, is to whittle away where possible using preferential tax opportunities under the Internal Revenue Code.

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Conclusion and Practical Considerations

The number of moving parts involved with the enactment of these many provisions is mind boggling. As a result, it is impossible to estimate the actual impact of these changes without undertaking a thorough analysis of a taxpayer's expected sources of taxable income and deductible items and preparing a detailed income tax projection.

One thing is certain. Deferral of a single dollar of income or payment of a single dollar for a tax deductible expenditure will still cost almost 55 cents on the dollar, as the rate of tax savings associated with that item for someone subject to all of the provisions is likely to be in the 45% range. While that is the highest rate that American taxpayers have been subject to for more than three decades, it is still lower than the some of the historical rates experienced in the 1960s and 1970s.

The other consideration that should not go unattended for pass through business entity owners is that appropriate tax planning must incorporate business entity tax planning, as well as individual tax planning. Thus, the complexity is somewhat increased, in that planning for tax liabilities in 2014 and beyond must consider not only all individual tax provisions within the Internal Revenue Code, but also those provisions applicable to corporations, S corporations and partnerships, as those statutes affect the ultimate equity-owner tax liabilities, now more than ever.

Finally, in addition to tax planning per se, it is critical that focus on cash flow planning be part of the discussion. Obviously, the higher tax liabilities associated with 2013 as a result of complying with the new tax laws will not only require substantial final payments on April 15, 2014, as most taxpayers have properly paid in "safe harbor" amounts based on 2012 tax rules, but they will also require tax payments for one half of their 2014 estimated taxes by June 15, 2014 (25% on April 15th and 25% two months later on June 15th). The 2014 safe harbor estimates, of course, will be based on the higher tax liabilities mandated under the new laws for 2013. As a result, affected taxpayers can expect significantly higher cash outflows relating to federal income taxes for 2014.

In consideration of making pass through business equity owners "whole" as a result of passing through entity-level income, the best practice is likely to first run equity-owner returns with the inclusion of all of the pass through business entity tax items and, then again, without those items. Such a process allows for an accurate understanding of the exact effect of those items on any particular taxpayer/equity owner.

For example, it is more than possible that inclusion of certain tax items coming from pass through business entities will not only work to drive equity owners into higher marginal rates, but will also lead to phaseouts of personal exemptions and a loss of itemized deductions, as these two provisions are predicated on equity owners' adjusted gross income levels. In addition, passive equity owners will likely find themselves subject to the additional 3.8% Medicare tax on net investment income.

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These changes, as well as others, can only be accurately measured by looking at completed calculations "with" and "without" the pass through business entity items. *An example of the "with and without" assessment is included as Illustration One in the Appendix to these materials.*

Once the determination of the "worst case" effect of the pass through business entity items is made, historical tax distributions can be evaluated to assess overpayments and underpayments by the corporation. Note that proportionate distribution rules for S corporations, and if so desired by partnerships, will work to allow certain equity owners "excess" tax distributions as discussed earlier in these materials.

The remaining item for consideration in planning for 2014 is the present and future status of the so-called "tax extenders." At midnight on December 31, 2013, more than 55 provisions of the Internal Revenue Code expired and have yet to be renewed. Once again, Congress is working to renew (albeit, temporarily) many of the expired provisions. Action is not expected on this bill (Senate Bill 1859) until spring, and no one knows which of the provisions will survive the final reconciliation process, but it is currently expected that most will be renewed. The problem, however, is that those provisions will be extended (under this bill, at least) only until December 31, 2014, when they will expire once again. It is the worst-possible business model from a tax planning standpoint.

The primary items expected to be extended under the Senate bill include:

- The Health Care Tax Credit
- Exclusion of up to $2,000,000 of cancellation of indebtedness from qualified principal residence
- Deduction for state and local taxes in lieu of income taxes
- Above-the-line deduction for qualified tuition
- Up to $100,000 of tax-free distributions allowed from an IRA directly to a charitable organization (only for taxpayers 70½ or older)
- The Research and Development Credit
- The New Markets Tax Credit
- 15-year depreciation life for qualified leasehold improvements, restaurant buildings and retail improvements
- 50% bonus depreciation
- The Section 179 limit would remain at $500,000 (currently scheduled to return to $25,000)
- 100% exclusion available for sale of qualified small business stock held longer than five years
- Abbreviated 5-year recognition period for S corporation built in gains

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Consensus seems to be that reenactment of all of these provisions is less than likely (www.govtrack.us gives the bill just a 20% chance of passing, as is). Mired down in political upheaval, some commentators do not expect action on these provisions until closer to year end, perhaps as late as September or October. Such a timeline makes planning a process that must be considered with, as well as without, the extenders.

Unfortunately, issues like the R & D Credit, the New Markets Credit, the bonus depreciation provision and the Section 179 expansion can all lead to substantially higher projections early in the year until the items are reinstated, leading to an accelerated payment of taxes under the estimated tax rules. Only a Congressional vote and sign-off by the President can bring certainty to the situation and prevent this acceleration of payments.

As can be seen, the federal government is doing little to make the Internal Revenue Code less complex. Furthermore, the political parties are so far apart that there is little or no real interest in major tax reform in 2014. Combined with the distance between party ideologies and the mid-term elections, our electorate seems to have little stomach for making hard decisions and striking a compromise in either direction.

Within this environment, taxpayers and owners of pass through business entities are left to struggle through an ever-increasing barrage of rule changes and tax increases, while trying to compete in a global economy. These challenges continue to be great, and while most individuals understand that the law changes are going to lead to higher tax liabilities, few seem to understand the actual impact. April 15th will cure that lack of understanding. Currently, we anticipate tax liability changes that will approach 15% to 20% on year-over-year tax liabilities from 2012 to 2013. Failure to reinstate certain extenders, such as the bonus depreciation and Section 179, could increase that change for 2014 over 2012 by as much as 30% year over year.

Given the significance of these increases, it is more critical than ever to carefully plan for and monitor tax liabilities, and the cash outflows associated with those liabilities. We are intimately involved with our clients' tax positions, and we take an active role in helping those individuals better understand and plan under an evolving tax regime. Should you require such assistance and/or know of someone struggling with this type of planning, we would greatly appreciate an opportunity to meet with them and provide the necessary guidance.

We understand that attending a two-hour program is insufficient to fully understand the impact of these rules, but it is our hope that the program will at least allow you to better understand the implications of these important tax changes for 2013 and help you, or your clients, better meet your 2013 income tax compliance obligations and plan for 2014.

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

Should you have further questions, please feel free to speak to us after the session or contact us via email or telephone at the email addresses and numbers indicated below.

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Final Illustrations and Examples

The complexities and broad applicability of the provisions of the recent tax changes are more easily illustrated through the use of simple case studies and illustrations. In this section, additional examples are provided to demonstrate the applicability of those rules as they are threaded through varying fact patterns.

It is important to understand that the examples set forth herein are based on the authors' current understanding of the recent tax changes, as well as current law. The authors have elected to set out specific fact patterns intended to drive home important points facilitated by the enactments of the ATRA and ACA.

Illustration One

As an example how one might approach the determination of pass through income, we include this example, which contemplates the following simple fact pattern. The taxpayer, Bill, files a joint return with his wife, Sarah. Bill is a business executive working for ABC Corporation, a Fortune 500 company. Sarah is a homemaker, currently caring for their two children. Bill's compensation is paid as wages and is included on his Form W-2. In 2013, Bill earned $300,000. Sarah has no earned income, but owns 35% of a family S corporation, XYZ, LLC, from which she is required to report her share of taxable income. In 2013, the share of income to be allocated to her is $515,000.

The couple's only other taxable income for 2013 is investment income of $50,000. They have $70,000 of itemized deductions, consisting primarily of charitable contributions, real estate and state and local income taxes and mortgage interest. Sarah has received $200,000 year-to-date in cash distributions from XYZ, LLC to fund the income tax liability on the expected pass through income.

The best way to assimilate these facts, and to determine the effect of including the XYZ, LLC income on the couple's joint return, is to look at their actual tax calculation "with" and "without" those items.

As can be seen in Exhibit I (on page 3), the couple's taxable income (without the pass through items, and illustrated in the column marked "Original") is $272,140. If pass through items are included, that number balloons to $811,950 (see "Adjusted" column on same report). The difference in the two amounts is $539,810, even though the pass through income is just $515,000.

The additional change in income attributable to the inclusion of the pass through entity income is due to a total loss of the couple's personal exemptions of $9,360. In addition, the couple loses an additional $15,450 in itemized deductions due to the inclusion of the XYZ, LLC income allocation to Sarah.

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The income passed through to Sarah clearly moves the couple's taxable income into the highest marginal income tax rate (39.6%). In addition, as the income is deemed passive, it is included in the net investment income calculation for purposes of the 3.8% Medicare tax on unearned income.

As a result, the "net" tax increase attributable to inclusion of the XYZ, LLC income is $218,823 ($290,872 less $72,049). This tax equates to an effective tax rate on this income of 42.49%. Notably, in this example, a portion of the XYZ, LLC income passed through was subject to marginal rates below the highest rate of 39.6%. Had it all been taxed at the highest rate, the overall effective rate would have been higher.

Keep in mind that state and local income tax, if applicable, would be in addition to the effective federal income tax rate.

Lastly, note that this particular member of the LLC has been distributed $200,000 to fund the tax liability. That distribution percentage is at 38.8% of the pass through income and likely would have sufficed in 2012. However, the new law results in a tax shortfall of $18,823 ($218,823 less $200,000). If the 2012 distribution was enough to meet the tax liability in that year, the difference equates to a nearly 10% increase year over year.

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Exhibit I – *Summary Report*

	Original	Adjusted	Difference
Income:			
Wages	300,000	300,000	0
Interest & Dividends	50,000	50,000	0
Passive Activity Income/Loss	0	515,000	515,000
Total Income	**350,000**	**865,000**	**515,000**
Total Adjustments	**0**	**0**	**0**
Adjusted Gross Income	**350,000**	**865,000**	**515,000**
Personal Exemptions	**9,360**	**0**	**-9,360**
Itemized Deductions:			
Charitable Contributions	5,000	5,000	0
Taxes	25,000	25,000	0
Interest Expense	40,000	40,000	0
3% AGI Floor	-1,500	-16,950	-15,450
Total Itemized	**68,500**	**53,050**	**-15,450**
Standard Deduction	12,200	12,200	0
Total Deductions from AGI	**77,860**	**53,050**	**-24,810**
Taxable Income	**272,140**	**811,950**	**539,810**
Regular Tax:			
Schedule or Table Tax	66,119	269,178	203,059
Appropriate Regular Tax	**66,119**	**269,178**	**203,059**
Net Alternative Minimum Tax	3,644	0	-3,644
High Income HI, Medicare & Other Tax	2,286	21,694	19,408
Total Federal Taxes	**72,049**	**290,872**	**218,823**
Net Federal Tax Due	**72,049**	**290,872**	**218,823**
Resident State Tax	10,745	26,556	15,811
Net Resident State Tax Due	**10,745**	**26,556**	**15,811**
Total Net Tax Due	**82,794**	**317,428**	**234,634**
Marginal Nominal Federal Rate	28	40	12
Marginal Federal Rate with Phaseouts	35	41	6
Marginal Resident State Rate	3	3	0

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Illustration Two

This example was prepared to illustrate the impact of the ATRA on taxpayers earning an income below the $450,000 level with additional income from a pass through entity.

Assume that the taxpayers, John and Lisa, are married, they file a joint federal tax return each year, and they have two dependent children. In this example, John earns $300,000, and Lisa earns $100,000. The other sources of income include interest income of $10,000, dividend income of $20,000 and capital gain income of $30,000.

Lisa works in an S corporation that is owned 50% by her, and 50% by an unrelated shareholder. She works at this company full time, and her wages are paid by this S corporation. The company plans to distribute only those funds required to pay the taxes on income reported to the shareholders and reserve the balance of its cash to fund the operational growth of the Company. The amount of "noncash" income passed through to Lisa from her interest in the S corporation in the current year is $2,000,000.

As a result of these assumptions, the couple's total income, also equal to AGI in 2013, is $2,460,000. These facts are illustrated in Exhibit II (on page 5).

As can be seen in below, the income tax alone is not the end of the story. The Medicare tax imposed by the ACA requires an additional tax of $2,280 on their investment income of $60,000. The lapse of the FICA tax decrease will require another $4,425 be paid by John and Lisa, and the additional .9% Medicare tax on earned income will require an additional $1,350. The total additional taxes this couple will pay in 2013 is $121, 288, or over 16% greater than their 2012 tax liability. Thus, in Illustration Two, the couple's effective rate is 37.1%; marginal rate is 39.6%; and marginal nominal rate "with phaseouts" is 40.8%.

Tax Increase Summary

Tax increase due to reduction in itemized deductions	$ 25,661
Tax increase due to reduction in personal exemptions	6,019
Tax increase due to adjustments to tax brackets, including top marginal rate of 39.6%	79,053
Tax Increase due to increase in capital gain/dividend rate to 20% for top tax bracket	2,500
Tax increase due to 3.8% Medicare tax on net investment income	2,280
Tax increase due to additional .9% Medicare tax on earned income	1,350
Tax increase due to increase in FICA wage base	151
Tax increase due to expiration of 2% FICA wage rate cut	4,274
Total Tax Increase	$ 121,288

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Exhibit II – *Pass-through Income (Active)*

	Prior Law	New Law	Change
Wages - Taxpayer	300,000	300,000	-
Wages - Spouse	100,000	100,000	-
Interest Income	10,000	10,000	-
Dividend Income	20,000	20,000	-
Capital Gain Income	30,000	30,000	-
Self-employed Income	-	-	-
Pass-through Income	2,000,000	2,000,000	-
Total Income	2,460,000	2,460,000	-
Adjustments	-	-	-
Adjusted Gross Income (AGI)	2,460,000	2,460,000	-
Personal Exemptions	(15,200)	-	15,200
Itemized Deductions:			
Taxes (Real estate/income)	(28,000)	(28,000)	-
Taxes (income - related to pass-through)	(61,000)	(61,000)	
Mortgage Interest	(20,000)	(20,000)	-
Contributions - personal	(10,000)	(10,000)	
Contributions - pass-through	(90,000)	(90,000)	-
Subtotal	(209,000)	(209,000)	-
3% AGI Floor (phase-out)	-	64,800	64,800
Total Itemized Deductions	(209,000)	(144,200)	64,800
Taxable Income	2,235,800	2,315,800	80,000
Tax Liability:			
Income Tax on Ordinary Income	734,170	844,903	110,733
Alternative Minimum Tax (AMT)	-	-	-
Income Tax on Capital Gains/Dividends	7,500	10,000	2,500
Medicare Tax on Investment Income	-	2,280	2,280
Soc. Sec. Taxes on Wages	8,824	13,249	4,425
Medicare Tax on Wages	5,800	5,800	-
Add'l Medicare Tax on Earned Income	-	1,350	1,350
Total Federal Tax Liability	756,294	877,582	121,288
Marginal Nominal Tax Rate	*35.0%*	*39.6%*	*4.6%*
Marginal Federal Rate with Phaseouts	*35.0%*	*40.8%*	*5.8%*
Effective Tax Rate	*33.2%*	*37.1%*	*3.9%*

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A critical part of the analysis of the situation in Illustration Two is the determination of how much of the total tax increase imposed by the new law is attributable to the pass-through income of the S corporation. Essentially, this analysis looks at the couple's tax position as if there was no pass-through income and calculates the tax liability under the new laws. The taxpayers' entire liability increase associated with the new laws, excluding the S corporation income, is $7,119. The increase in their liability, inclusive of the passed through S corporation income is $121,288. Thus, the tax increase attributable to the passed-through S corporation income is $114,169.

As the S corporation policy is to distribute cash sufficient to fund tax liabilities, the company will be required to distribute at least $228,338 (proportionate distributions to both shareholders) in additional cash to fund the tax. Assuming $4,000,000 of S corporation taxable income, the additional cash distribution equates to 5.7% of the yearly earnings. In an environment where cash flow is required for growth and expansion, or simply building reserves to allow for less risk in a sensitive economy, this additional distribution requirement can be critical.

Illustration Three

Illustration Three, as set forth in Exhibit III (page 7) mimics Illustration Two with one critical exception. In this case, the Lisa is presumed to work for someone other than the S corporation in which she holds a 50% ownership interest. As a result of her full-time employment elsewhere, she is unable to commit any personal efforts to the management and operation of the business conducted in that corporation. Thus, for purposes of Section 469 of the Internal Revenue Code, her ownership activity with respect to the S corporation will be deemed to be a passive activity, and any income passed through to her from this activity will be deemed to be passive income.

The primary difference between this illustration and Illustration Two is the requirement that passive income be subjected to the new Medicare tax of 3.8% of investment income. The statute defines investment income for these purposes as including income from passive activities. Given this definitional inclusion, the Medicare tax, which was not imposed under prior law, that must be paid on this income in 2013 is $78,280 This amount is an additional $76,000 increase to the $2,280 of the new Medicare tax due on the taxpayers' other investment income.

Understanding that this liability results from the pass-through of the $2,000,000 of passive income from the S corporation, the $76,000 must be added to the $114,169 set out in Illustration Two of additional tax increase already attributable to the S corporation pass-through under an "active" shareholder scenario, as can be seen in the tax increase summary on page 8.

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Exhibit III – *Pass-through Income (Passive)*

	Prior Law	New Law	Change
Wages - Taxpayer	300,000	300,000	-
Wages - Spouse	100,000	100,000	-
Interest Income	10,000	10,000	-
Dividend Income	20,000	20,000	-
Capital Gain Income	30,000	30,000	-
Self-employed Income	-	-	-
Pass-through Income	2,000,000	2,000,000	-
Total Income	2,460,000	2,460,000	-
Adjustments	-	-	-
Adjusted Gross Income (AGI)	2,460,000	2,460,000	-
Personal Exemptions	(15,200)	-	15,200
Itemized Deductions:			
Taxes (Real estate/income)	(28,000)	(28,000)	-
Taxes (Income - related to pass-through)	(61,000)	(61,000)	
Mortgage Interest	(20,000)	(20,000)	-
Contributions - personal	(10,000)	(10,000)	
Contributions - pass-through	(90,000)	(90,000)	-
Subtotal	(209,000)	(209,000)	-
3% AGI Floor (phase-out)	-	64,800	64,800
Total Itemized Deductions	(209,000)	(144,200)	64,800
			-
Taxable Income	2,235,800	2,315,800	80,000
Tax Liability:			
Income Tax on Ordinary Income	734,170	844,903	110,733
Alternative Minimum Tax (AMT)	-	-	-
Income Tax on Capital Gains/Dividends	7,500	10,000	2,500
Medicare Tax on Investment Income	-	78,280	78,280
Soc. Sec. Taxes on Wages	8,824	13,249	4,425
Medicare Tax on Wages	5,800	5,800	-
Add'l Medicare Tax on Earned Income	-	1,350	1,350
Total Federal Tax Liability	756,294	953,582	197,288
Marginal Nominal Tax Rate	*35.0%*	*39.6%*	*4.6%*
Marginal Federal Rate with Phaseouts	*35.0%*	*40.8%*	*5.8%*
Effective Tax Rate	*33.2%*	*40.4%*	*7.2%*

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Tax Increase Summary

	Tax Increase Attributable to S Corp Income (Active)	Tax Increase Attributable to S Corp Income (Passive)	Change
Tax increase due to reduction in itemized deductions	$ 24,077	$ 24,077	-
Tax increase due to reduction in personal exemptions	1,003	1,003	-
Tax decrease due to decrease in AMT	6,943	6,943	
Tax increase due to adjustments to tax brackets, including top marginal rate of 39.6%	79,646	79,646	-
Tax Increase due to increase in capital gain/dividend rate to 20% for top tax bracket	2,500	2,500	-
Tax increase due to 3.8% Medicare tax on net investment income	-	76,000	76,000
Tax increase due to additional .9% Medicare tax on earned income	-	-	-
Tax increase due to increase in FICA wage base	-	-	-
Tax increase due to expiration of 2% FICA wage rate cut	-	-	-
Total Tax Increase	$ 114,169	$ 190,169	$ 76,000

Including the new Medicare investment income tax of 3.8% on Lisa's passive income requires the corporation to distribute yet another $152,000 (as a result of the proportionate distribution requirement). This will likely evolve into a required strategy for most S corporations, at least, due to the need to distribute necessary cash to fund shareholder tax liabilities at proportionate ownership levels. Other pass through entities, primarily limited liability companies and partnerships, will have to establish policies that meet the "substantial economic effect" rules of Subchapter K, if they wish to do something other than proportionate distributions.

Adding the $152,000 additional distribution requirement to the S corporation moves the additional tax distribution to $380,338, or nearly 9.5% of the corporation's earnings for the year. Keep in mind that this additional distribution is in addition to the 40% to 42% that most S corporations and partnerships already distribute under prior law mandates!