CORDASCO
& COMPANY P.C.
Certified Public Accountants

2014

NEW DEVELOPMENT

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2014 NEW DEVELOPMENTS LETTER

INTRODUCTION

2014 has been an exceedingly busy year for tax changes and keeping up with these fast-paced developments is challenging! To help you with this task, we are sending this letter providing a summary of the key legislative, administrative, and judicial tax developments that we believe will have the greatest impact on our clients.

As a Preview – Some of the ***Major Tax Developments*** we highlight in this letter are: **1)** The ***new Shared Responsibility Tax ("SR Tax")*** for "individuals" who fail to maintain qualified health care coverage (including rules that allow an individual to apply for a ***"Hardship Exception"***); **2)** The ***new refundable Premium Tax Credit ("PTC")*** for qualifying individuals who purchased health insurance on the new government exchanges (Marketplaces); **3)** The new ***"3.8% Net Investment Income Tax" ("3.8% NIIT")*** that's generating much more scrutiny of the "passive" activity rules; **4) New** ***Capitalization Regulations*** that ***"must be"*** applied ***starting in 2014,*** establishing comprehensive rules for determining whether expenditures relating to business property (e.g., equipment, vehicles, buildings) must be capitalized and depreciated over time, or may be deducted immediately; and **5)** ***New Regulations*** containing significant ***"2015 only" Transition Relief*** from the ***new Excise Tax*** imposed on ***Certain Larger Employers*** for failing to offer qualifying health care coverage to full-time employees.

CAUTION!

We highlight only *selected* tax developments. If you have heard about other tax developments not discussed in this letter, and you need more information, please call our office for details. Also, tax planning strategies suggested in this letter may subject you to the alternative minimum tax (AMT). For example, many deductions are not allowed for AMT purposes, such as: personal exemptions, the standard deduction, state and local income taxes, and real estate taxes. Also, the AMT can be triggered by taking large capital gains, having high levels of dividend income, or exercising incentive stock options. Therefore, ***we suggest that you call our firm before implementing any tax planning technique discussed in this letter.*** You cannot properly evaluate a particular planning strategy without calculating your overall tax liability (including the AMT and any state income tax) with and without that strategy.

> **Please Note!** This letter contains ideas for Federal income tax planning only. ***State income tax issues are not addressed.***

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DEVELOPMENTS IMPACTING PRIMARILY INDIVIDUALS

INDIVIDUALS WITHOUT QUALIFIED HEALTH CARE COVERAGE MAY FACE NEW TAX

Background. As one of its key components, the Affordable Care Act (ACA) requires individuals to maintain qualified health care coverage, or pay a ***Shared Responsibility Tax ("SR Tax")*** with their individual income tax returns. Therefore, ***starting with the 2014 income tax return*** (e.g., Form 1040), individuals generally must pay an ***SR Tax*** if the individual or the individual's dependents are not covered by a ***"Qualified Health Plan"*** (i.e., a health plan or insurance policy providing **"**minimum essential coverage"). When filing a joint return, the penalty will generally apply where either the individual, the individual's spouse or a dependent is not covered by a **"qualified health plan."** However, individuals and their dependents will avoid the *SR Tax* if they qualify for a specifically-designated ***exemption.*** The IRS also says that an individual cannot avoid the *SR Tax* for someone who he or she may claim as a dependent, simply by failing to claim that person as a dependent on the individual's tax return. For example, if you and your spouse file a joint return and you each have qualified employer-provided health care coverage, but your dependent child is not covered by either employer's plan, you could be liable for the *SR Tax* for your child even if you chose not to claim the child as a dependent on your tax return. Consequently, to avoid the *SR Tax*, an individual (and anyone the individual may claim as a dependent) generally must either: **1)** Be covered under a ***"qualified health plan,"*** or **2)** Qualify for a specific ***"exemption"*** from the tax as discussed below.

What Must Individuals Report On Their 2014 Individual Income Tax Return? The ***Shared Responsibility Tax (SR Tax)*** is computed on a monthly basis and, therefore, generally applies for each "month" an individual is not covered by a *qualified health plan*, and does not qualify for an *"exemption*." Beginning with the 2014 income tax return (e.g., Form 1040), individuals will essentially have ***three alternative reporting requirements:*** **1)** If you, your spouse (if filing a joint return), and anyone you could claim as a dependent ***all were covered*** by a ***qualified health plan*** for ***every month*** of 2014, you will check a box on the 2014 income tax return, and you will not be subject to the *SR Tax*; **2)** If you, your spouse (if filing a joint return), or anyone you could claim as a dependent ***were not covered*** by a ***qualified health plan*** for ***every month*** of 2014 and no *"exemptions"* are available, the amount of your ***SR Tax*** is determined by completing a worksheet contained in the *"instructions"* to new ***Form 8965,*** and that amount will be reported on your Form 1040; **or 3)** If you, your spouse (if filing a joint return), or anyone you could claim as a dependent ***were not covered*** by a ***qualified health plan*** for ***every month*** of 2014 but at least one qualifies for an ***"exemption"*** (discussed below), a new Form 8965 ("Health Coverage Exemptions") must be filed with your return to disclose and claim the "exemption(s)."

Please Note! If an individual is *"exempt"* from the monthly *SR Tax* for some (but not all) of the months in 2014, the individual is required to: **1)** File a new Form 8965 to claim an exemption for the months the individual is exempt, and **2)** Use the worksheet contained in the Form 8965 instructions to compute the monthly *SR Tax that is owed for the months for which an exemption does not apply.*

What Constitutes A "Qualified Health Plan" (i.e., Minimum Essential Coverage)?" A ***"Qualified Health Plan"*** is generally defined as any health plan or health insurance policy that provides the individual with "minimum essential coverage." The IRS website states that: *"The **vast majority of coverage** that people have today counts as **minimum essential coverage**."* [Emphasis added]. For example, *"Qualified Health Plans"* would generally include health coverage under: **1) Government-Sponsored Plans** (e.g., *Medicare Part A and Medicare Advantage, Most Medicaid Coverage, CHIP*, *TRICARE* for life, *and coverage provided to Peace Corps* volunteers); **2) Most Employer-Sponsored Health Plans** including *self-insured plans, COBRA coverage and retiree coverage*; **3) Insurance Obtained From The New Government Health Insurance Exchanges ("Marketplaces"); 4) Health Insurance Purchased On The "Individual" Market;** and **5) Other Health and Human Services (HHS) - Approved Plans.** *Please see the IRS web site for a current listing of health coverage that is "minimum essential coverage."*

Who Is "Exempt" From The SR Tax? Certain individuals are generally ***exempt*** from the ***SR Tax*** if they fall into any of the following groups: **1)** Individuals in the U.S. illegally; **2)** Members of qualifying religious sects; **3)** Members of Federally-Recognized Indian tribes; **4)** Incarcerated individuals; **5)** Certain U.S. Citizens living abroad; **6)** Individuals with income below the threshold for filing an income tax return; **7)** Individuals who fail to have "qualified health plan coverage" for less than 3 months during a year; **8)** Individuals whose available health insurance is considered "unaffordable" because it would cost more than 8% of the individual's household income; and **9)** Individuals qualifying for a *"hardship exemption"* (discussed below).

Caution! Some of these exemptions require an individual to first apply for (and obtain) an "exemption certificate" from the new government health insurance exchange ("Marketplace"), while others are simply claimed without an exemption certificate when the income tax return is filed. The ***Instructions*** to new ***Form 8965*** ("Health Coverage Exemptions") contain a chart listing which exemptions require a "certificate," and which do not. The ***Form 8965 Instructions*** also describe each of these exemptions in detail.

Tax Tip. Applications for an "exemption certificate" may be obtained at www.HealthCare.gov.

"Hardship" Exemptions. The Department Of Health & Human Services (HHS) has released a list that says individuals may qualify for a ***"Hardship" Exemption.*** For example, individuals may qualify for an exemption **if they: 1)** Were homeless, **2)** Were evicted in the past 6 months or were facing eviction or foreclosure, **3)** Received a shut-off notice from a utility company, **4)** Recently experienced domestic violence, **5)** Recently experienced the death of a close family member, **6)** Experienced a fire, flood, or other natural or human-caused disaster that caused substantial damage to your property, **7)** Filed for bankruptcy in the last 6 months, **8)** Had medical expenses they couldn't pay in the last 24 months which resulted in substantial debt, **9)** Experienced unexpected increases in essential expenses due to caring for an ill, disabled, or aging family member, **10)** Expect to claim a child as a tax dependent who's been denied coverage in Medicaid and CHIP, and another person is required by court order to give medical support to the child (in this case, you do not have to pay the penalty for the child), **11)** Were pursuing an eligibility appeals decision from the Marketplace, **12)** Had an individual insurance plan that was cancelled and they believe other Marketplace plans are unaffordable, **13)** Are ineligible for Medicaid solely because the State does not participate in the Medicaid expansion under the Affordable Care Act, **14)** Purchased insurance through the Marketplace during the initial enrollment period but have a coverage gap at the beginning of 2014, **15)** Have two or more family members' and the aggregate cost of self-only employer-sponsored coverage exceeds 8 percent of household income, as does the cost of any available employer-sponsored coverage for the entire family; or **16)** Experienced another hardship in obtaining health insurance. **Please see the IRS web site for a more complete listing of possible "hardship" exemptions.**

> ***Note!*** *Except for items 14 and 15 (above), individuals must obtain an exemption certificate (discussed in the following paragraph) to utilize one of the above exemptions.*

- **Obtaining A "Hardship Exemption" Certificate!** If an individual seeking a "hardship" exemption must have an exemption certificate, the certificate is obtained by submitting a form entitled ***"Application for Exemption from the Shared Responsibility Payment for Individuals who Experience Hardships"*** to: Health Insurance Marketplace – Exemption Processing, 465 Industrial Blvd., London, KY 40741. This application form may be obtained on-line at www.HealthCare.gov. The Application states: *"We'll follow-up with you* ***within 1–2 weeks*** *and let you know if we need additional information. If you get this exemption, we'll give you an* ***Exemption Certificate Number*** *that you'll* ***put on your federal income tax return.***"

> **Tax Tip.** If you think you or anyone in your household may qualify for one of these hardship exemptions, we suggest you begin the application process as soon as possible. If your application is approved, be sure to provide our firm with your exemption certificate.

Amount Of The "SR Tax." The amount of the *SR Tax* is determined using a specific worksheet contained in the new Form 8965 Instructions. The *SR Tax* applies for ***each month*** that you, your spouse (if filing a joint return), or your dependents are not covered by a *qualified health plan* (and do not otherwise qualify for an exemption). Although the *SR Tax* is determined on a monthly basis, the ***maximum amount*** for the ***entire 2014 tax year*** is the ***greater of:*** **1)** ***$95*** per uninsured ***adult member*** of the household, plus ***$47.50*** per uninsured member of the household ***under age 18, not to exceed $285,*** or **2)** ***1% of "household income" in excess*** of the ***income threshold required for filing a Form 1040 return.***

However, the *SR Tax* **cannot** *exceed the national average premium for "bronze" level health insurance offered through the Marketplace*. Your *"household income"* for purposes of computing this *SR Tax* is your *modified* adjusted gross income (generally, adjusted gross income plus tax-exempt interest plus the foreign earned income exclusion), plus the modified adjusted gross income of any person whom you claim as a dependent and who is also required to file an income tax return.

> **Planning Alert!** Spouses filing a joint return are jointly liable for any *SR Tax* on the joint return even if the penalty applies to only one spouse. A taxpayer is also liable for the *SR Tax* attributable to any person who is eligible to be claimed by the taxpayer as a dependent.

- **Example.** Assume that for the ***entire 2014 year,*** Mary is an uninsured, single 30-year old professional who earned ***$70,150*** (also assume that this represents Mary's "*household income*"). The ***income filing threshold in 2014*** for a single taxpayer (under age 65) ***is $10,150.*** If Mary is not covered by a *qualified health plan* and does not qualify for an *"exemption,"* her excise tax for the entire ***2014 tax year*** would be the *greater of*: **1)** $95, or **2)** $600 (1% of $60,000 [i.e., $70,150 less $10,150]). Therefore, Mary's *SR Tax* ***for the entire year of 2014 would be $600,*** since the national average **annual premium for "bronze" level health insurance** for a single individual offered through the Marketplaces **is $2,248 for 2014.**

> **Planning Alert!** This excise tax increases for ***2015,*** and increases again in ***2016.***

INDIVIDUALS PURCHASING HEALTH INSURANCE ON NEW GOVERNMENT EXCHANGES ("MARKETPLACES") – MAY QUALIFY FOR NEW "REFUNDABLE" PREMIUM TAX CREDIT

Background. As discussed above, a *"qualified health plan"* (for purposes of avoiding the *Shared Responsibility Tax*) includes individual health insurance coverage purchased through one of the *new government health insurance exchanges* (the ***"Marketplace"). Beginning in 2014,*** the Affordable Care Act (*ACA)* provides for a tax credit (the ***"premium tax credit"*** or ***"PTC"***) for eligible low-and-middle income individuals. The *PTC* is ***only available to "qualified" individuals*** who purchase health insurance through the *Marketplace.* The *PTC* is "refundable." This generally means that, to the extent the credit exceeds the taxes that you would otherwise owe with your individual income tax return without the credit, the IRS will actually send you a check for the excess. However, unlike the classic refundable credit which is paid directly to the taxpayer, the *PTC* is generally (but not always) paid ***in advance during the year directly to the insurer.*** These payments to the insurer are generally referred to as ***"Advance Payments"*** of the *PTC*.

> **Planning Alert!** It has been reported that a large majority of individuals who purchased health insurance during 2014 through the Marketplace opted for *Advanced Payments* of the PTC to be made to the insurer.

<u>Who Qualifies For The "Premium Tax Credit" (PTC)?</u> An individual *generally* qualifies for the *"premium tax credit"* (PTC) ***for 2014*** only if the individual's ***"household income"*** for ***2014*** is ***at least 100%*** and ***not more than 400%*** of the ***"2013"*** Federal Poverty Line (FPL) for the individual's family size. ***For example,*** using the ***2013*** FPL, a family of four could qualify for at least some *PTC* ***<u>with "2014" household income of up to $94,200!</u>*** For purposes of the ***PTC,*** your **"*household income"*** starts with your ***adjusted gross income*** on your income tax return (plus the adjusted gross income of any person who you properly claim as a dependent and who is also required to file an income tax return), and then certain exclusions on the return are added back. More specifically, tax-free social security benefits, tax-exempt interest, and the foreign earned income exclusion are ***added back*** to ***adjusted gross income in determining "household income."***

<u>Individuals Must Reconcile Their "Advance Payments" Of The 2014 PTC With Their "Actual" PTC.</u> For 2014, *Advance Payments* of the *PTC* were determined by the Marketplace based on an individual's ***"projected"*** 2014 household income. However, an individual is ultimately entitled to a PTC based on the individual's ***"actual"*** 2014 household income. Therefore, all individuals for whom *Advance Payments* were made for 2014 ***are required to file*** a ***2014 income tax return*** that reconciles: **1)** The amount of the ***"actual"*** *PTC* (based on ***"actual"*** *2014 household income),* with **2)** The amount of the ***Advance Payments*** of the *PTC* (based on ***"projected"*** *2014 household income*). If the individual's ***"actual"*** PTC for the 2014 taxable year ***exceeds*** the ***Advance Payments*** made to the insurance company, the excess will reduce the taxes otherwise shown on the individual's income tax return (e.g., Form 1040). To the extent the PTC exceeds the taxes shown on the return (before the credit), the IRS will send the individual a check for the excess. On the other hand, if the ***Advance Payments*** for the 2014 taxable year exceed the ***"actual"*** *PAC* (based on "actual" 2014 *household income*), the excess will be added to the individual's other taxes due with the return or reduce any refund. In this latter situation, there is a cap on this "additional tax liability," depending on the taxpayer's *household income* for 2014.

<u>IRS Releases New Forms For Computing, Reporting, And Reconciling The PTC.</u> Any individual who purchased health insurance for 2014 through the Marketplace should receive a ***Form 1095-A*** (*"Health Insurance Marketplace Statement"*) by January 31, 2015. This form contains the amount the **gross monthly premium** paid to the insurance company, as well as the amount of the monthly ***Advance Payments*** of the individual's *PTC* to the insurance company. This information will be used to complete new ***Form 8962*** ("Premium Tax Credit") which reconciles the individual's *Advanced Payments* of the PTC with the *"actual"* PTC*,* as discussed above.

> **<u>Tax Tip.</u>** If an individual purchased health insurance through the Marketplace but received no *Advance Payments* of the PTC, new Form 8962 will also be used to compute the amount (if any) of the actual PTC, based on the individual's 2014 household income.

<u>PTC Not Allowed To Certain Individuals.</u> Certain individuals are not allowed to take the PTC. For example, an otherwise qualifying individual will ***generally not qualify for the PTC*** if the person is married and files a separate return.

Thus, couples who are married at the end of 2014, received *Advance Payments* of the PTC, but file married filing separately for 2014, must generally pay all (or a portion) of the *Advance Payment* back as an ***"additional income tax liability"*** when they file their 2014 returns.

> **Planning Alert!** The IRS has announced that, in certain situations, spouses who are victims of spousal abuse or spousal abandonment will not be required to pay the *Advance Payment* back. As mentioned above, an individual will only qualify for the PTC if insurance is purchased through the Marketplace. However, even if insurance is purchased through the Marketplace, an individual will not qualify for the credit if the individual is eligible for "minimum essential coverage" (e.g., affordable coverage offered by an employer that provides minimum value). In addition, individuals that are claimed as a dependent on someone's return do not qualify for the PTC.

THE 3.8% NET INVESTMENT INCOME TAX INVITES GREATER SCRUTINY OF THE "PASSIVE ACTIVITY" RULES

Background. ***Starting in 2013,*** the ***Affordable Care Act*** (*ACA*) imposed *new* ***3.8% Net Investment Income Tax (3.8% NIIT)*** on *net investment income* of higher-income individuals. This tax applies to individuals with modified adjusted gross income (MAGI) exceeding the following ***"thresholds"*** (which are ***not indexed*** for future inflation): ***$250,000*** for ***married filing jointly; $200,000*** if ***single;*** and ***$125,000*** if ***married filing separately.*** The 3.8% NIIT is imposed upon ***the lesser of*** an individual's: **1)** Modified adjusted gross income (MAGI) in excess of the ***threshold,*** or **2)** Net investment income. ***Trusts and estates*** are also subject to the ***3.8% NIIT*** on the ***lesser of*****: 1)** The adjusted gross income of the trust or estate in excess of $12,150 (for 2014), or **2)** The undistributed net investment income of the trust or estate.

The 3.8% NIIT generally applies to the traditional types of investment income, such as interest, dividends, annuities, royalties, and capital gains. However, the 3.8% NIIT also applies to trade of business income taxed to the owner of a business (e.g., partnership income, S corporation income, proprietorship income) where the income is "passive income." Generally, the income is treated as "passive income" to an owner of a business if the owner does not ***"materially participate"*** in the business as determined under the traditional ***"passive activity loss"*** rules. There are **seven alternative "material participation" standards.** The most commonly-applied standard treats the owner as ***materially participating*** if the owner spends ***more than 500 hours*** working in the business during the year. Another standard treats the owner as materially participating if he or she spends more than 100 hours working in the business ***and,*** based on all of the ***facts and circumstances,*** the individual participates in the business activity on a ***regular, continuous, and substantial basis*** during such year.

Traditionally, business owners have focused on the passive activity rules largely in the context of ***avoiding the*** rigid passive ***"loss"*** restrictions. Now that passive ***"income"*** can be subject to the ***3.8% NIIT,*** business owners are seeking ways to ***avoid*** passive ***"income"*** classification. In light of this new tax, the IRS has even more incentive to argue that a business owner is not *"materially participating"* in the business activity, thus causing the net business losses, or the net business income, to be "passive."

Recent Cases Addressing "Material Participation." In each of the following three cases, the IRS recently took business owners to Court arguing that the owners had not "materially participated" in their business operations:

- **Lawyer's Losses From Racehorse Activity Were Not "Passive" Because He "Materially Participated" In The Activity.** In this case, the Tax Court concluded that an attorney practicing as a sole proprietor, passed the more-than-500-hour "material participation" test with respect to his out-of-state thoroughbred horse breeding and racing activity. The Court found that the attorney consulted with experts in an attempt to make the horse breeding and racing activity more profitable. Using telephone records, credit card receipts, and other contemporaneous materials, the attorney prepared a detailed summary of his activities in preparation for trial. IRS argued the attorney's summary was unreliable because it was prepared solely for litigation and was based on memory. But, after examining the detailed evidence and testimony of the attorney's out-of-state contacts, the Tax Court found that the attorney's summaries were largely credible and that he was ***directly involved*** in the ***day-to-day management and operations*** of the activity. Therefore, the Court said that time spent on the activity should ***not be disregarded*** under the "material participation" rules.

  Planning Alert! This case is notable in that it is one of the rare cases where a Court allowed the taxpayer to demonstrate "participation hours" ***after the fact,*** and without maintaining a contemporaneous record of hours worked in the activity. Individuals should keep contemporaneous record of their participation in such business activities to prevent an IRS challenge.

- **Founder Of Family-Owned Businesses Maintained Active Role After Turning Management Over To Son And "Materially Participated" In Companies.** Here, the Tax Court found that an owner of a family-owned business who moved out of state, and turned the day-to-day operations over to his adult son, still *"materially participated"* in the business even though he did not work more than 500 hours during the year. The Court concluded that the owner satisfied the ***"regular, continuous, and substantial basis requirements"*** test for material participation. This test in essence requires that an individual participate in the trade or business for more than 100 hours and, based on all of the facts and circumstances, the individual participates in the activity on a *"regular, continuous, and substantial basis"* during such year.

Although the owner lived out of state, the Court found that he made three trips to visit the business when it was having financial difficulties, during which he assured the employees that operations would continue. He also significantly increased his research and development efforts that were critical in helping the business survive its financial troubles.

> **Planning Alert!** Although not addressed in this case, the passive activity regulations provide that an owner is ***"deemed"*** to ***"materially participate"*** in the business for the current year, if the owner in fact *"materially participated"* in the business during ***any 5 taxable years of the preceding 10 taxable years.*** This test may be helpful where the founder of a business steps down and turns the reins over to someone else. In this situation, if the owner had materially participated for the 5 years before stepping down, the owner would be deemed to materially participate for the next 6 years.

- **Tax Court Concludes That Trustees' Participation In Business Owned By Trust Counts As "Participation" By The Trust.** The IRS, Courts, and taxpayers continue to wrestle with the issue of determining when the participation of a trustee of a trust or the executor of an estate in a business owned by the trust or estate will qualify as participation by the trust or estate for purposes of the "material participation" tests. The IRS has consistently taken the position that a trust or estate "materially participates" in a trade or business activity owned by the trust or estate only if a "trustee" or "executor" materially participates in the trade or business in his or her *"representative capacity."* For example, according to the IRS, if a trustee works for the trust-owned business as an employee of that business, the hours the trustee works as an employee do not count as material participation by the trust. However, in a 2014 Tax Court case, the Court allowed the hours worked by trustee(s) in their capacities as employees of the trust-owned business, to count as "participation" in the business by the trust. Furthermore, based upon the hours worked in the business by the trustees, the Court concluded that the trust had *"materially participated"* in the business operations. The Court reached its decision, in part, by concluding that the trustees retained their fiduciary responsibilities to the trust even while they were working as employees of the trust-owned business.

IRS Contesting "Qualified Real Estate Professional" Classification. Generally, any income or loss from renting real estate, where the average period rented is more than seven days, is deemed for tax purposes to be "passive" income or loss. Passive activity losses (PALs) are generally suspended, and are not allowed unless and until you have qualifying "passive" income to offset the losses. Passive activity income in excess of passive activity losses could be subject to the 3.8% NIIT. However, if you are a "qualified real estate professional" (*QREP*) and **meet certain "material participation" tests,** you will be able to deduct losses from your rental real estate activities even if you do not have passive income (e.g., the losses could offset your W-2 compensation, interest, dividend income, and income from businesses in which you materially participate). In addition, if the rental real estate activities produce net income, the income generally would not be subject to the 3.8% NIIT (as discussed in more detail below).

Generally, to be a *QREP* you must: **1)** Perform ***more than 750 hours of services*** during the year in ***real estate businesses*** in which you materially participate, AND **2)** ***More than 50%*** of your personal services performed in businesses during the year are performed in ***real estate businesses*** in which you materially participate. Also, as a *QREP*, you are allowed to make a "tax" election to treat all of your rental real estate activities as a "single" rental real estate activity. If you are a QREP and have multiple rental properties, this election is often necessary for you to meet the required "material participation" tests for all of your rental real estate properties.

- **IRS Closely Scrutinizing "QREP" Classification.** The IRS has recently taken several individuals to Court contesting their "QREP" classification. The IRS has prevailed where the taxpayer could not provide adequate documentation that the individual spent more than 750 hours and over 50% of their work time in qualifying real estate activities. Although the Courts generally did not strictly require taxpayers to maintain daily logs of time spent on real estate activities, the Courts rarely accept "after-the-fact ballpark estimates" of the time spent. To minimize exposure to IRS attacks, individuals who must qualify as a QREP in order to deduct their rental real estate losses, or to exempt rental real estate income from the 3.8% NIIT, should contemporaneously document their hours worked on real estate activities (e.g., by recording their hours in a daily or weekly calendar).

  Planning Alert! The IRS and the Courts are especially suspicious of taxpayers who are full-time employees of a business that do not involve real estate activities, but who argue that they are QREPs with regard to the rental real estate properties they own.

- **Recent Regulations Provide Opportunities For QREPs To Exempt Income From Rental Real Estate Activities From The 3.8% NIIT.** Subject to limited exceptions, "rental income" is classified as ***"investment income"*** for purposes of the 3.8% NIIT. However, the IRS has released regulations providing that a ***QREP*** may ***exclude*** income from rental real estate activities from the 3.8% NIIT, if the QREP: **1)** Participates ***more than 500 hours*** in the rental real estate activity during the current year, ***OR*** **2)** Participated ***more than 500 hours*** in the rental real estate activity in ***any 5 taxable years*** (whether or not consecutive) ***out of the 10 taxable years*** preceding the current taxable year.

  Tax Tip. If a QREP plans to sell highly-appreciated rental real estate in the current year, taking steps to satisfy the 500-hour requirement in the year of sale could exclude the entire gain on the sale from the 3.8% NIIT.

OTHER NEW CASES, RULINGS, AND REGULATIONS

IRS And Courts Apply The One-Rollover-Per-Year Limitation For IRAs As If All IRAs Are One IRA Beginning In 2015. Individuals generally may avoid paying tax on a qualifying IRA distribution by rolling over the distribution to the same IRA or to another IRA within the 60-day period beginning with the date the distribution is received. Generally, an individual is allowed only one 60-day, tax-deferred IRA rollover during the one-year period, beginning on the day the

Taxpayer received the distribution. If this ***One-Rollover-Per-Year Limitation*** is violated, the rollover amount is treated as a fully taxable distribution and is possibly subject to the 10% early distribution penalty (e.g., if the taxpayer is under 59½). For years, an IRS publication provided that ***each IRA*** had a separate *One-Rollover-Per-Year Limitation.* However, the Tax Court recently ruled that this 1-year limitation applies ***as if all IRAs (other than Roth IRAs) are one IRA.*** For example, under this new interpretation, if an individual takes a distribution from an IRA and rolls that distribution into another IRA within 60-days from the date of receipt, the individual may not rollover another distribution from any IRA (other than a Roth IRA) within the one-year period beginning with the date of the qualifying rollover distribution. However, the IRS has announced that it will not apply this new position to any IRA rollover that *involves* ***a distribution occurring before January 1, 2015.***

> Practice Pointer! The IRS and Courts both agree that there ***is no limit on the number of trustee-to-trustee IRA transfers.*** Consequently, taxpayers may transfer IRA funds by means of direct trustee-to-trustee transfers as often as they wish.

> Caution! To effect a trustee-to-trustee transfer, the *distribution should be made directly from the old trustee to the new trustee*. For example, if the distribution is made by check, the **check should be written by the old trustee to the new trustee.** The check should not be written to the owner of the IRA.

Tax Court Disqualifies Self-Directed IRA Where IRA Owner Was Paid Compensation By IRA-Owned Business. Individuals who like more control over their retirement fund investments sometimes choose to maintain their IRAs as "self-directed" IRAs. A self-directed IRA generally allows owners to "self direct" the investment options to best fit their specific investment objectives. However, owners of any IRA (especially a self-directed IRA) must be careful not to involve the IRA in an investment that is classified as a "prohibited transaction." Generally, **if an IRA engages in a prohibited transaction,** the IRA loses its tax-deferred status and the **entire value of the IRA is taxed** to the holder as a distribution. In addition, the distribution may trigger a 10% early distribution penalty (e.g., where the owner is under 59½). A "prohibited transaction" includes the direct or indirect transfer of the IRA income or assets to the IRA owner for his or her own benefit.

- **Tax Court Concludes That Compensation Paid By IRA-Owned Business To IRA Owner Was A Prohibited Transaction.** The Tax Court has held that an individual's receipt of **$9,754 of wages** from a business owned by his self-directed IRA constituted a "prohibited transaction." This "prohibited transaction" caused the IRA to lose its tax-exempt status, and resulted in the Taxpayer having to pay aggregate **penalties and taxes of $195,260 on the IRA account balance of $321,366.**

Planning Alert! This case illustrates that it is critically important for owners of self-directed IRAs to seek advice from reputable tax advisors before engaging in any transaction with the IRA to avoid violating the "prohibited transaction" rules. This is particularly important if the IRA owner has any personal financial connection with the investments owned by the IRA.

Recent Case Highlights Planning Opportunity For "Principal Residence" Converted To Rental Property Before Sale. If an owner of a principal residence qualifies for the home-sale exclusion (i.e., has owned and used the residence as the owner's "principal residence" for at least 2 of the previous 5 years), the owner could move out and rent the residence for a period of no more than 3 years, sell the residence, and still qualify for the home-sale gain exclusion (except to the extent of any depreciation taken). In that situation, if the rental of the home generated a "loss," the loss would generally be suspended as a "passive loss" under the passive activity rules unless: **1)** The individual had other "passive" income to absorb the loss, **or 2)** The individual disposed of the residence in a transaction where all "realized" gain or loss on the residence was "recognized." In a recent IRS Chief Counsel Advice, IRS addressed a situation where the gain from the sale of a former residence with a suspended passive activity loss qualified for the §121 home-sale exclusion (except to the extent of any depreciation taken). In this ruling, the IRS said that the suspended passive activity losses generated by the rental of the residence were "freed-up" upon the sale and could be used to offset non-passive income for the year of the disposition. The IRS treated the disposition of the residence as a disposition where all "realized" gain was "recognized," even though the gain on the residence was fully excluded from income under the home-sale exclusion rule.

Tax Tip. This IRS position is indeed good news for individuals who move out of a home that qualifies for the home-sale exclusion, but want to temporarily rent out the home (not more than 3 years) before they sell it.

Tax Court Decision Creates Potential Tax Trap For Homeowners Who Sell Their "Principal Residence" Using Owner Financing. In a recent Tax Court case, the Court essentially concluded that an individual who sells his or her principal residence in a transaction that qualifies for the home-sale exclusion, ***may retroactively lose*** that exclusion, if: **1)** The owner sells the home using an ***owner-financing arrangement*** retaining a mortgage on the home, **2)** The buyer defaults, **3)** ***The original owner re-acquires*** the home, ***AND*** **4)** The original owner ***does not re-sell the home within one year*** of re-acquiring the home. If the exclusion is lost because of the owner's repossession of the residence, the homeowner could qualify for the home-sale exclusion on a subsequent sale by using the home as the individual's principal residence again for at least two years.

Planning Alert! In light of this case, individuals should try to avoid selling their principal residence using seller-financing where: **1)** The seller has a significant gain excluded from income under §121, and **2)** The seller believes there is more than a minimal possibility that the buyer might default in the future.

IRS Releases Final Regulations Addressing Trust and Estate "Income" Tax Deductions. The IRS has released final regulations that require, among other things, a trust or estate that pays a "bundled" fee to "break out" any portion of the fee that relates to expenses subject to the "so called" 2% limitation. The 2% limitation provides that certain expenses are only deductible to the extent the expenses exceed 2% of the trust's or estate's adjusted gross income (AGI). A "bundled fee" is generally a single fee that covers both costs that are subject to the 2% limitation and costs that are not. For example, a "bundled" fee would include a single fee to a trustee that includes both: **1)** Compensation for administering the trust (generally not subject to the 2% limitation), and **2)** Compensation for investment advisory services (generally subject to the 2% limitation).

> **Planning Alert!** The final regulations requiring the proration of "bundled" fees ***are effective for taxable years beginning after December 31, 2014.*** Thus, if a trust or estate incurs a "bundled" fee for a ***tax year beginning before January 1, 2015,*** it can generally avoid the 2% limitation for the "bundled" fee if the fee is "paid" on or ***before the end of it's 2014 year*** (e.g., ***by 12/31/14*** for a trust or a calendar-year estate).

IRS Confirms That 30% Energy Credit Available For A "Newly-Constructed" Home And A "Second Residence." Individuals are generally allowed an energy credit of 30% of the cost (with no overall dollar cap) of a qualifying solar water heater, solar electric generating property, a geothermal heat pump, or small wind energy property *installed in a taxpayer's residence* located in the U.S. Recent IRS guidance confirms that a taxpayer is allowed this credit for a newly-constructed home. The amount qualifying for the credit is equal to the amount of the home's purchase price properly allocated to the qualifying energy-efficient property contained in the home. In addition, the credit may be taken with respect to the purchase of solar electric property, solar water heating property, small wind energy property, and geothermal heat pump property installed in a "second" home (e.g., a vacation home).

> **Tax Tip.** If you are the initial purchaser of a newly-constructed residence that contains qualifying energy-efficient components (e.g., solar water heater, solar electric generating property, geothermal heat pump), you should ask the builder to provide you with the cost of the home attributable to the qualified energy property (including labor costs for the on-site preparation, assembly, and installation of the property).

IRS And The Courts Are Rigidly Enforcing The Documentation Requirements For Charitable Contributions! Whether you are contributing property or cash, the easiest and most effective way for the IRS to disallow your charitable contribution deduction is to find that you failed to comply with the documentation rules for the contribution. For example, IRS can disallow your charitable contribution deduction ***if it is $250 or more*** and you fail to receive a ***qualifying written receipt*** from the charity ***by the earlier of:*** **1)** The date you file your return **or, 2)** The due date of your return [including extensions].

The *qualifying written receipt* must contain the following information**: 1)** The amount of cash and a description (but not value) of any property other than cash you contributed to the charity, **2)** A statement as to whether the charity provided you with any goods or services in return for your contribution, and **3)** A description and good faith estimate of the value of any goods or services, if any, the charity provided to you (or, if applicable, a statement that the goods and services consisted solely of intangible religious benefits). In addition, for all noncash contributions, the receipt must contain the date of the charitable contribution and a description of the property contributed.

> **Note!** *Contributions of cash in any amounts are not deductible unless a receipt is obtained.* However, a ***cancelled check*** is sufficient to document a contribution by check ***if less than $250.***

If you contribute non-cash property of a similar type ***valued over $500,*** you must maintain and report with your return certain additional information, including the date you acquired the property, your basis in the property, your valuation method, etc.

> **Planning Alert!** If you are claiming a deduction of ***more than $500*** for a ***vehicle, a boat, or an airplane*** that you contributed to charity, the law requires that you obtain a *Form 1098-C* as well as a *qualifying written receipt* from the charity in order to deduct your contribution.

To take a charitable contribution deduction for property ***valued in excess of $5,000,*** you must generally have both a ***qualifying written receipt*** (as just described) ***AND*** an ***appraisal by a qualified appraiser.*** However, an appraisal is not required for securities for which market quotations are readily available or for nonpublicly traded stock valued at $10,000 or less.

- **Tax Court Denies $27,767 Charitable Contribution Deduction For Clothing, Furniture, And Electronic Equipment Even Though Court Acknowledged Contributions Were Made.** In a recent case, the Tax Court denied an individual's charitable deduction for clothing ($14,487), household furniture ($11,730), and electronic equipment ($1,550) that were made to AMVETS (a charity supporting veterans). The only receipts the individual received from AMVETS were blank signed forms, that were later filled out by him. The individual provided an undated spreadsheet that he prepared listing the property he contributed. Although the Court stated that *"The Court has no doubt that [taxpayer] did donate property to AMVETS*," it still denied the deduction altogether. The Court said it had no authority to allow any deduction since the individual had failed to obtain proper receipts for any of the contributions and failed to obtain appraisals for the $14,487 contribution of clothing and the $11,730 contribution of furniture.

<u>Some Estates Need To File "Late" Estate Tax Returns Before 2015 In Order To Make "Portability" Election.</u> Over the years, gift and estate taxes have generally been imposed only on estates and aggregate lifetime gifts exceeding a certain dollar amount (the "exclusion amount"). For 2014, the lifetime estate and gift tax *exclusion amount* is $5.34 million, and will be adjusted annually based on inflation. For individuals ***dying after 2010,*** the executor of a deceased individual's estate may *elect* for any of the exclusion amount that is not used to reduce the decedent's taxable estate (i.e., the *"deceased spousal unused exclusion" amount*) to be added to the *"exclusion amount"* of the *surviving spouse*. This is sometimes referred to as the "portability election." If the "portability election" is not made, any exclusion amount not needed in the deceased spouse's estate is lost.

> **<u>Caution!</u>** Generally, the "portability" election must be made on ***a timely filed estate tax return (Form 706) for the deceased spouse.*** This filing is required even though the deceased spouse's estate is not large enough to otherwise require the filing of an estate tax return. An estate tax return generally must be filed ***within 9 months*** of a decedent's death, unless the estate timely obtains a 6-month filing extension.

<u>Good News!</u> The IRS has announced that it ***will generally allow estates of individuals who died in 2011, 2012, or 2013*** (who were not otherwise required to file a Form 706) ***to file a "late" Form 706 to make the portability election,*** provided the ***return is filed before 2015.***

> **<u>Planning Alert!</u>** If you think you or someone in your family may benefit from this time-sensitive relief, please call our firm for additional information.

<u>DEVELOPMENTS IMPACTING PRIMARILY BUSINESSES</u>

<u>IRS ISSUES LONG-AWAITED FINAL "CAPITALIZATION" REGULATIONS DEALING WITH THE ACQUISITION, PRODUCTION, AND MAINTENANCE OF TANGIBLE BUSINESS PROPERTY</u>

<u>Survey Of Rules.</u> Most businesses, regardless of size, continually deal with the tax issue of whether an expenditure for acquiring, producing, or maintaining depreciable business property (e.g., machinery, equipment, vehicles, buildings, etc.) is currently deductible or must be capitalized and depreciated. In this segment, we refer to this "capitalization" vs. "expense" issue as the "capitalization" issue. Historically, the detailed rules for determining whether such expenditures should be "capitalized" or deducted as a current "expense" were found in various court decisions. However, in December 2011, the IRS released ***"temporary"*** regulations which outlined the rules for determining whether expenditures relating to the acquisition, production, or maintenance of ***tangible business property*** must be ***"capitalized"*** and depreciated over the life of the property or could be deducted in the tax year paid or incurred. In these ***temporary*** regulations, the IRS attempted to bring together in one place the body of existing case law concerning the "capitalization" issue.

In addition, the IRS attempted to clarify certain "capitalization" issues that were previously unclear. The IRS originally said the effective date of the ***temporary*** regulations was for tax years beginning after 2011. However, in November 2012, the IRS announced that it planned to issue the ***final*** "capitalization "regulations ***during 2013,*** and that taxpayers ***were not required*** to apply either the "temporary" or the "final" regulations ***until tax years beginning after 2013.*** However, the IRS allowed taxpayers to apply the ***temporary*** regulations or the ***final*** regulations to tax years beginning in 2012 and 2013 if they wished.

As promised, on September 13, 2013, the IRS released the ***"final"*** capitalization regulations addressing expenditures relating to the acquisition, production, or maintenance of ***tangible business property*** (e.g., machinery, equipment, vehicles, buildings, etc.). The ***"final"*** capitalization regulations are ***effective for tax years beginning after 2013.***

> **Note!** In addition to the "capitalization" vs. "expense" issue, the ***final*** regulations also provide rules for the timing of the deduction for ***"materials and supplies"*** (including the timing of the deduction for rotable, temporary, and emergency spare parts).
>
> **Caution!** The ***final*** regulations are "massive" (filling more than 200 pages) and, therefore, are impossible to cover in detail in this letter. However, since these new regulations will have a significant impact on many businesses ***beginning with the 2014 tax year,*** we highlight below selected provisions of the regulations that we believe are noteworthy:

- **Complying With These Regulations Most Likely Will Require Taxpayers To Apply To The IRS For An Accounting Method Change.** Starting with the ***first tax year beginning after 2013,*** at least ***13 of the provisions*** of the ***final "capitalization" regulations*** require businesses to apply for an "automatic" accounting method change with their income tax return, *if they are not currently in compliance with the regulations*. ***Some believe that almost every business with significant tangible business property or with materials and supplies will need to file Form 3115 for their first tax year beginning after 2013.*** The IRS has issued a formal procedure (i.e., Revenue Procedure 2014-16) outlining the rules for applying for such automatic accounting method changes which require, among other things, the completion and submission of ***Form 3115*** with a taxpayer's income tax return, and with the IRS's Ogden campus.

Good News! Generally a user fee of up to $7,000 is charged for requesting an accounting Method change. However, there is ***no user fee*** for "automatic" accounting method change requests (Forms 3115) submitted in accordance with Revenue Procedure 2014-16.

- **Complying With The Final Regulations May Require "Current" Income Adjustments For Transactions That Occurred Prior To 2014.** Although the ***final*** regulations are ***"effective"*** for ***tax years beginning after 2013, 6 of the 13*** possible ***required accounting method changes*** (mentioned above) require a ***"cumulative adjustment"*** to income in order to comply with the final regulations.

This is called a ***"§481(a) adjustment."*** **For example,** assume that in 2010 a business with only one heating and air conditioning system (i.e., a single heat pump) replaced the heat pump with a new one, and ***"deducted"*** the costs of the new heat pump in 2010. The final regulations seem to say that the costs of the replacement heat pump should have been capitalized. Thus, if the business files Form 3115 with its 2014 tax return to comply with the final regulations, there should be a §481(a) adjustment for the difference between: **1)** The ***deduction*** taken in 2010, and **2)** The depreciation deductions that would have been allowed through the first day of the 2014 tax year, had the replacement heat pump been properly capitalized under the requirements of the final regulations.

> **Planning Alert!** If the taxpayer in this example makes this accounting method change for the 2014 tax year, the taxpayer should also make a ***"late disposition election"*** (as discussed below) in order to deduct the remaining tax basis of the old heat pump that was replaced in 2010.

If the cumulative adjustment for an accounting method change in 2014 results in ***"additional income,"*** 1/4 of the adjustment is included in income for the tax year beginning in 2014, and 1/4 of the adjustment is included in income in each of the three following years. Therefore, in the heat pump example above, ***only 1/4*** of the ***additional income*** resulting from "capitalizing" the 2010 heat pump ***is included in the 2014 return,*** and an additional 1/4 of the income from the adjustment would be reported with the 2015, 2016, and 2017 returns, respectively. If the §481(a) adjustment results in a ***"subtraction from income"*** (i.e., a deduction), the ***entire deduction*** is taken ***in the tax year beginning in 2014*** (i.e., no proration of the deduction to future years is required).

> **Observation!** These ***cumulative §481(a) adjustments*** may be ***difficult to determine*** since the expenditures in question may have occurred several years prior to 2014.

> **Planning Alert!** There should generally ***be no §481(a) adjustment*** attributable to a depreciable asset if: **1)** The asset is ***not on hand*** at the ***beginning of the 2014 tax year,*** or **2)** The asset is fully depreciated or would have been ***fully depreciated*** as of the ***beginning of the 2014 tax year*** had the expenditure been capitalized and depreciated**.**

- **Some Changes Required By The Final Regulations Do Not Require Income Adjustments For Transactions That Occurred Before 2014.** *Seven of the thirteen possible required accounting method changes* mentioned above, require the completion of **Form 3115 but do not "require" a §481(a) adjustment** *if made for the first tax year beginning after 2013.* So, if a business changes its accounting method to comply with these seven provisions of the final regulations for its first tax year beginning after 2013, the business must simply apply the regulations for tax years after 2013 and ***no adjustment*** is required for prior tax years. ***An example*** of an accounting method change that does not require a §481(a) adjustment (if applied for the ***first tax year beginning after 2013),*** is the rule for the treatment of non-incidental materials and supplies.

For tax years ***beginning after 2013,*** taxpayers are required to deduct non-incidental materials and supplies (generally materials and supplies for which a record of consumption is kept) when ***"consumed,"*** rather than when ***"paid"*** (for cash-basis taxpayers), or when ***"incurred"*** (for accrual-basis taxpayers). Therefore, if a business has deducted non-incidental materials and supplies when ***paid*** or ***incurred*** in years before 2014, ***beginning with the 2014 return,*** the business should deduct the non-incidental materials and supplies when ***consumed*** rather than when ***paid or incurred.*** In addition, the taxpayer should file a properly completed ***Form 3115*** with the ***2014 return.*** However, in this case, there would be ***no current year "§481" adjustment*** for transactions that ***occurred before 2014.***

Final Regulations Dealing With The "Disposition" Of MACRS Property. On December 23, 2011, the IRS issued ***"temporary"*** regulations outlining the rules dealing with accounting for and the ***"disposition"*** of ***MACRS*** property (generally, tangible depreciable property). On **August 14, 2014,** the IRS issued the ***"final"*** regulations dealing with ***dispositions.*** Taxpayers ***"may"*** apply the Temporary or the ***"Final"*** Regulations for tax years beginning in ***2012 and 2013.*** However, taxpayers ***"are required to"*** apply the ***Final*** Regulations for ***tax years beginning after 2013.*** These ***"Final"*** regulations deal with the issues involved upon the disposition of MACRS property including: **1)** Determining if there is a ***"disposition"*** of an asset or a portion of an asset; **2)** Determining ***the basis*** of the asset upon its disposition; **and 3)** Properly ***reporting gain or loss*** upon the disposition of an asset.

- **The "General Asset Account" (GAA) Dilemma Under The Previous "Temporary" Regulations.** The earlier ***"temporary"*** regulations provided a new pro-taxpayer provision. Prior to 2012, if a business capitalized an expenditure relating to an asset (e.g., where the business replaced the entire roof of a building), the IRS's position was that the old roof must continue to be depreciated and could not be "written-off." In a welcomed change to this harsh rule, the "temporary" regulations allowed the remaining basis of the old roof to be "written-off." However, in order to write-off the remaining basis of the old roof, the temporary regulations first required the business to elect for assets (i.e., buildings) to be placed in a ***"General Asset Account" (GAA).*** The ***"Final"*** regulations have once again changed the rules for these "partial dispositions." Under the final regulations, ***GAA elections*** are ***no longer needed*** and, in fact, generally *prevent a business from writing-off the remaining basis of a portion of an asset when a portion of an asset (*e.g., a roof) *is retired* and the new roof is capitalized. But, the "final" regulations provide that ***if the asset*** (e.g., building – including its roof) ***is not in a general asset account,*** the remaining basis of the old roof may be written-off if the business makes a *timely* ***"partial disposition election."*** *The partial disposition election must generally be made by the due date, including extensions, of the tax return of the business for the year of the partial disposition.*

- **IRS Allows Retroactive Partial Disposition Elections For Dispositions Occurring Before 2014 Tax Year Via An Accounting Method Change Filed With The "2014" Return.** The IRS issued a formal procedure (i.e., Revenue Procedure 2014-54) providing the rules for automatic accounting method changes to comply with the "final" disposition regulations.

This Revenue Procedure ***allows businesses to treat a late "partial disposition election" as an accounting method change*** if the change (i.e. election) is made with a timely filed tax return for a tax ***year beginning before 2015.***

> **Planning Alert!** Businesses that have ***capitalized*** an expenditure relating to an MACRS asset (e.g., the roof of a building) ***prior to the 2014 tax year*** and ***have not written-off the remaining basis*** of the portion of the asset replaced (e.g., the old roof), can generally write-off the remaining basis ***with the 2014 tax return*** as long as Form 3115 is property completed and submitted with a timely filed (including extensions) ***2014 return,*** and a copy of Form 3115 is mailed to the IRS's Ogden campus.

- **Some Businesses Required To "Revoke" Earlier GAA Election To Make "Partial Disposition" Election For 2014 – And Future Years.** After the issuance of the "temporary" regulations on December 23, 2011, it was clearly advisable for taxpayers to make a GAA election with 2012 and future returns (by checking the box on page 1 of Form 4562). By making this GAA election on a pre-2014 return, the taxpayer obtained the ability to write-off the remaining basis of a "portion" of an asset if the asset was later discarded (e.g., the basis of an old roof where the new roof is capitalized and depreciated). However, ***for tax years beginning after 2013,*** under the ***"Final"*** regulations, taxpayers ***will not be able*** to write-off the remaining basis of a "portion" of an asset where the asset is in a GAA account. Therefore, where a business made a GAA election solely to enable the business to write-off a portion of the asset upon a partial disposition under the previous "temporary" regulations, the GAA election should now be revoked. Normally, a GAA election may only be revoked by filing a private letter ruling request which requires payment of an IRS user fee. However, businesses may revoke a GAA election by applying for an ***"automatic"*** accounting method change ***for a tax year beginning before 2015.*** Therefore, where a business made a GAA election ***for a prior year*** solely to enable the business to write-off a portion of the asset upon a partial disposition of the asset, the ***GAA election*** should now be revoked by following the automatic accounting method change procedures outlined in Revenue Procedure 2014-54 (including the timely submission of Form 3115) ***with the timely filed 2014 income tax return.***

Failing To Change Accounting Methods For Tax Years Beginning In 2014. The general revenue procedure dealing with changing accounting methods suggests that taxpayers failing to request an accounting method change to comply with the final regulations could be subject to penalties. For example, the 20% accuracy penalty under §6662 could possibly apply. Therefore, businesses should make a reasonable, conscientious attempt to comply with the final regulations, including changing accounting methods with their 2014 returns to comply with the final regulations. Some of these changes may result in additional deductions on the 2014 return (e.g., writing-off the remaining basis of a portion of an asset where there was a prior-year partial disposition), while others may result in additional income spread over 4 years (e.g., capitalizing and depreciating an item that was deducted as a repair in a prior year).

<u>More Time Required For Year-End Planning And For Preparing 2014 Business Returns.</u> These new final regulations pose challenges for businesses and for those of us assisting with business tax planning and tax return preparation. We suggest you begin the process of evaluating the effects of these final regulations on your business and, particularly, on the 2014 return for the business as soon as possible. We anticipate that complying with these massive changes will require more time for year-end planning and for 2014 return preparation (including the preparation of required Forms 3115). As always, we will gladly assist you in evaluating the effects of these new regulations.

<u>NEW REGULATIONS PROVIDE "2015 ONLY" TRANSITION RELIEF FROM THE EXCISE TAX IMPOSED ON CERTAIN LARGER EMPLOYERS FAILING TO OFFER QUALIFIED HEALTH CARE COVERAGE TO EMPLOYEES</u>

The Affordable Care Act (*ACA)* generally provides that ***"applicable large employers"*** (using a 50-employee threshold) who do not offer *qualified health care plan* coverage to full-time employees could face a ***nondeductible excise tax*** (the so-called *play-or-pay* penalty). The tax only applies, however, if at least one full-time employee purchases medical insurance through the Marketplace and receives a premium tax credit or a cost-sharing subsidy. The employer ***"excise tax"*** for failure to offer such a plan to employees applies only to *"applicable large employers*." Although *ACA* states that this provision becomes effective in 2014, last year the IRS announced that it will not impose this excise tax on "applicable large employers" ***until 2015.***

> **<u>Planning Alert!</u>** Earlier this year, the IRS announced additional transition relief for certain "applicable employers" for ***"2015 Only."*** Therefore, *no employers are subject to the excise tax for 2015.* And for 2015, IRS has provided additional limited relief from the tax for certain employers. There are too many of these 2015 transition relief provisions to address them all in this letter. However, the following are two relief provisions having broad application:

- **<u>Employee Threshold For "Applicable Large Employer" Classification Temporarily Increased From 50 To 100.</u>** An ***"applicable large employer"*** for purposes of the excise tax is generally an employer that employed on average ***50 or more employees*** (determined by adding together the number of "full-time employees" and the "full-time equivalent employees") during ***each month*** of the ***entire preceding calendar year*.** However, ***for 2015,*** the IRS has provided temporary relief from the penalty for applicable large employers that are below a 100 (instead of 50) employee threshold. More specifically, for a qualifying "applicable large employer" that employed on average ***less than 100*** (instead of 50) ***full-time employees*** (including full-time equivalent employees) during the ***preceding calendar year*** (i.e., the 2014 calendar year), no excise tax will be imposed for any calendar month ***during 2015*** and for any month in 2016 for a ***plan year beginning in 2015.***

- **<u>"Testing Period" Temporarily Reduced From 12 Months To 6 Months.</u>** Generally, to determine whether an employer is an *"applicable large employer"* for the ***current calendar year,*** the ***"Testing Period"*** for applying the ***"50-employee threshold"*** is the ***<u>entire</u> preceding calendar year*** (i.e., an *"applicable large employer"* for the ***"current" year*** is an employer that met the *50-employee threshold* ***during the entire preceding calendar year).*** Thus, under this "general rule," the ***"Testing Period" for "2015,"*** would be the ***<u>entire</u> "2014" calendar year.*** However, for ***2015,*** employers can determine whether they had, for example, more than 99 employees (including full-time equivalent employees) in the previous year by reference to a period of ***at least 6 consecutive months.*** Thus, for determining whether an employer is an *"applicable large employer"* ***for 2015,*** this transition relief allows employers to use a ***"Testing Period"*** as short as ***6 consecutive months*** (instead of 12 calendar months) during ***the 2014 calendar year*** to determine whether the employer is within the ***50 to 99 employee*** threshold for temporary transition relief from the excise tax, as discussed above.

  <u>Example.</u> Let's assume your business began hiring additional employees during the summer of 2014, which caused it to exceed the 99 average-monthly-employee threshold for the entire year of 2014. Under this transition rule, your business could, for example, use only the first 6 months of 2014 to compute your average-monthly employees for 2014. If this 6-month Testing Period puts your business below the 100-employee threshold, your business would not be subject to the excise tax for 2015.

<u>OTHER RECENT CASES, RULINGS, AND REGULATIONS</u>

<u>Recent Developments Highlight Need For Timely Documentation When Shareholders Loan Money To Their S Corporations.</u> Two recent developments highlight how important it is for an S corporation shareholder to properly and timely document any loans to the S corporation. ***The first development*** is a recent Tax Court decision holding that an S corporation's pay back of an undocumented shareholder loan should be treated as "taxable compensation" to the shareholder (resulting in the imposition of FICA taxes and a penalty for failure to file payroll tax returns). The Court reached this conclusion, at least in part, because the shareholder could provide no contemporaneous documentation supporting his argument that he intended his original "advance" to his S corporation to be a "loan." ***Secondly,*** the IRS recently issued Final regulations that generally require a loan from a shareholder to an S corporation to be ***"bona fide indebtedness"*** of the S corporation before the loan will constitute basis for allowing the shareholder to deduct pass-through losses from the S corporation. In both of these situations (i.e., whether a shareholder "intended" a loan to the S corporation, or whether the S corporation has a "bona fide indebtedness" to the shareholder), the Courts and the new final regulations apply a "facts and circumstances" determination. However, at a "minimum," shareholder loans to an S corporation should be documented by issuing contemporaneous promissory notes and should provide interest.

<u>Rules For Treatment Of Pass-Through Business Income From LLPs And LLCs For S/E Tax Purposes Continue To Evolve.</u> "General" partners of businesses operating as partnerships are subject to Social Security and Medicare taxes (S/E tax) on their business income from the partnership. By contrast, "limited" partners are generally exempt from S/E tax on the partnership's business income (except for "guaranteed payments" the limited partners receive). However, it has never been entirely clear whether and to what extent pass-through business income to the owner of a Limited Liability Company (LLC) or Limited Liability Partnership (LLP) is subject to S/E tax. In 2011, the Tax Court concluded that pass-through business income to an owner in a personal service ***"limited liability partnership"*** (a law firm) was not exempt from S/E tax where the limited liability partner was not a mere investor and was active in the business of the personal service limited liability partnership. In a 2012 case, the Tax Court indicated that it will apply the same judicial standard to a member in a ***"limited liability company*.**" Now, the Chief Counsel's Office of the IRS has recently concluded that the members of a management LLC that served as the investment manager for a family of investment funds must treat their distributive shares of the LLC's business income as S/E income. The Chief Counsel's Office reached this conclusion even though the LLC had paid what it argued was "reasonable compensation" to the LLC members.

> **<u>Planning Alert!</u>** Despite these developments, there is still some uncertainty as to the tests that apply in determining whether an owner of an LLP or an LLC is subject to S/E tax on the entity's pass-through business income.

<u>Tax Court Addresses Whether "Goodwill" Is Owned By The Shareholder Of A Corporation Or By The Corporation.</u> Over the last several years, we have witnessed a series of cases where the IRS has argued that goodwill related to a corporate business operation ***should not be*** treated as a personal asset of a shareholder. Most of these cases involve situations where: **1)** A buyer purchases the operating "assets" of a closely-held C corporation, excluding the goodwill (e.g., going concern value), and **2)** The buyer purchases the goodwill of the business from the shareholder in a separate transaction. If the shareholder, rather than the C corporation, owns the goodwill and sells the goodwill in a separate transaction, this prevents the gain on the sale of the goodwill from being taxed twice (once at the corporate level, and a second time when the sales proceeds are distributed to the shareholder). In a recent Tax Court case, the issue of "personal" versus "corporate" goodwill arose in a situation involving the "winding down" of Dad's wholly-owned corporation, in combination with the establishment of a similar business in a newly-formed corporation owned by his Sons. The IRS argued that the "winding down" of Dad's corporation was a *de facto* ***"distribution"*** of that ***corporation's business goodwill,*** taxable to both the corporation and to Dad – its sole shareholder. The IRS additionally argued that Dad then made a ***taxable "gift" of the distributed goodwill*** to his ***Sons –*** who then used it in their newly-formed corporate business operation.

> **<u>Planning Alert!</u>** Although the Tax Court ultimately ruled that the goodwill belonged to Dad and not to his C Corporation, this case serves as a valuable reminder that the IRS has by no means abandoned its attempts to treat "goodwill" as a corporate asset, rather than a personal asset of a shareholder.

Tax Court Endorses A Rigid View Of The "Placed-In-Service" Date For Purposes Of Taking Depreciation And/Or §179 Deductions. Generally, depreciation and/or the §179 deduction is allowed for the taxable year in which the depreciable asset is "placed-in-service" (i.e., the asset is in a condition or state of readiness and available for a specifically assigned function). The Tax Court has recently held that an airplane was not "placed-in-service" during the year at issue even though the airplane was generally flight worthy and was actually flown on a trip before year-end. The taxpayer took possession of the airplane on December 30th of the year in issue, and on that same day flew the plane from Portland to Seattle, then to Chicago, and then back to Portland. He said the trips were for business meetings. However, a few days after making that one-day trip, the taxpayer had the plane flown back to a plant in Illinois for modifications which were not completed until about a month later. The modifications included the installation of such things as a conference table and large screens which the taxpayer testified were necessary for him to use the plane as intended (e.g., making presentations to potential clients). In concluding that the airplane had not been "placed-in-service" for the year in issue, the Court reasoned that it was not yet *"available for its intended use on a regular, ongoing basis until those modifications were installed"* in the following tax year.

> **Planning Alert!** This Court conceded that case law ***does not require*** that an asset actually ***"be used"*** before it is regarded as "placed-in-service." However, the Court also concluded the asset must be ready and available – ***for its intended use.*** Thus, to ensure that depreciation and/or the section 179 deduction can be taken on qualifying property received late in the year, taxpayers should make any necessary or desired modifications before year-end.

Tax Court Nixes Depreciation Deduction For Motor Home Used Partially For Personal Purposes. Section 280A of the Internal Revenue Code provides that an individual cannot deduct expenses "*with respect to the use of a dwelling unit which is used by the taxpayer during the taxable year as a residence*." Section 280A also generally provides that "*a taxpayer uses the dwelling unit during the taxable year as a residence if he uses such unit (or portion thereof) for personal purposes for a number of days which exceeds the greater of—**(A)** 14 days, or **(B)** 10 percent of the number of days during such year for which such unit is rented at a fair rental*." In this case, the taxpayer used his Winnebago approximately two-thirds for business (i.e., driving to RV rallies to sell RV insurance). The Court, however, denied the depreciation deduction altogether under section 280A, because the Court viewed the vehicle as a "dwelling unit." Thus, the Court said no depreciation was allowed unless the taxpayer's personal-use days ***did not exceed*** the greater of: **1)** 14 days, or **2)** 10% of the days the property was rented for fair market value. The taxpayer's "personal-use" days exceeded both of those thresholds.

IRS Continues To Take Businesses To Court Over "Worker Classification" Issues. Many businesses hire independent contractors ("ICs") for project and specialty work in lieu of hiring additional employees. For tax purposes, a worker generally must be classified as either an "Employee" or "IC." The income tax consequences flowing from proper classification may be substantial.

Likewise, the tax penalties for a mis-classified worker can be costly. The rules for determining proper worker classification generally apply a "facts and circumstances" test commonly known as the ***"common law"*** standard. This ***"common law"*** standard is complex, at times inconsistently applied, and frequently unpredictable.

- **Recent Court Cases Continue To Focus On Seven Factors.** There were several "worker-classification" court cases this year where the Courts attempted to apply the "common law" standard to various work-place situations. Most of these cases seemed to focus principally on the following seven factors: **1) Control Over Details -** The degree of control exercised over the details of the work; **2) Investments -** Which party invests in the tools and facilities used in the work; **3) Profit/Loss -** The opportunity for the worker to generate a profit or loss; **4) Right To Discharge -** Whether the principal has the right to discharge the worker; **5) Regular Business -** Whether the worker is part of the principal's regular business; **6) Permanency -** The permanency of the relationship; and **7) Intent -** The relationship that the principal and worker intend to create.

- **Planning Alert!** Once fully implemented, the ***Affordable Care Act*** (ACA) may require an ***"applicable large employer"*** to provide qualified health care coverage to its "employees," in order to avoid an excise tax. This health care coverage requirement does not apply to workers who are properly-classified as "independent contractors," as determined under the traditional "common law" standard. Consequently, the ACA provides an incentive for businesses (and unfortunately, the IRS) to scrutinize the worker classification rules with even more intensity than in the past.

FINAL COMMENTS

Please contact us if you are interested in a tax topic that we did not discuss. Tax law is constantly changing due to new legislation, cases, regulations, and IRS rulings. Our firm closely monitors these changes. In addition, please call us before implementing any planning ideas discussed in this letter, or if you need additional information.

> **Note!** The information contained in this material represents a general overview of tax developments and should not be relied upon without an independent, professional analysis of how any of the items discussed may apply to a specific situation.