CORDASCO
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Certified Public Accountants

2015

YEAR-END INCOME TAX PLANNING FOR CORPORATE AND NON-CORPORATE BUSINESSES

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INTRODUCTION

It's that time of year when businesses should consider year-end planning strategies. This task is particularly challenging for 2015 due to the long list of popular, temporary business tax breaks that ***expired at the end of 2014.*** In the past, Congress has retroactively extended the vast majority of these tax breaks after they expired. However, ***as we complete this letter,*** Congress has not passed legislation to extend the expired provisions. **Planning Alert!** It is worth noting that these tax breaks previously expired at the end of 2013, however legislation retroactively extending the provisions through the end of 2014 ***was not signed into law until December 19, 2014.*** So, don't be surprised if it is mid-December before Congress gets around to voting on legislation to extend these tax provisions. We closely monitor Congressional tax legislation, so ***please call our firm*** if you need a ***status report.*** **Tax Tip!** Due to the uncertainty of the status of these expired business tax breaks, we believe the best approach for year-end planning is to be ***prepared to act quickly near the end of 2015*** in case Congress passes legislation to extend these provisions late in the year. Consequently, the first segment of our letter below highlights the business tax breaks that expired at the end of 2014 – but could be retroactively extended later this year.

Even though the status of the expired business tax provisions creates uncertainty, there continues to be many *traditional* year-end tax planning strategies allowing businesses to save taxes (whether the business operates as a regular "C" corporation, "S" corporation, partnership, LLC, or as a self-employed individual). Therefore, we are sending you this letter to remind you of these time-tested, year-end tax planning strategies. This letter also highlights *new* tax planning opportunities available to businesses due to recent law changes.

CAUTION!

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

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BUSINESS TAX BREAKS THAT EXPIRED AT THE END OF 2014

List Of Selected Business Tax Provisions That Expired At The End Of 2014. It seems that every year or two Congress allows a long list of tax breaks to expire, and this year is no exception. We are again faced with a series of popular tax provisions that benefit businesses that ***expired at the end of 2014.*** Although Congress is currently considering "extenders" legislation that would extend most, if not all, of these provisions at least through 2015, as we complete this letter, Congress has not yet extended these tax breaks. Don't be surprised if Congress doesn't get around to passing the currently proposed extenders bill until this December.

The following are some of the more popular tax breaks that have been available to businesses over the past several years that ***expired after 2014*****: 1)** 50% §168(k) First-Year Bonus Depreciation; **2)** Expanded §179 Deduction; **3)** 15-Year (Instead of 39-year) Depreciation Period For "Qualified" Leasehold Improvements, Restaurant Property, And Retail Improvement Property; **4)** Work-Opportunity Tax Credit For Hiring Workers From Certain Disadvantaged Groups; **5)** 7-Year Depreciation Period For Certain Motor Sports Racetrack Property; **6)** Research And Development Credit; **7)** Employer Differential Wage Credit For Payments To Military Personnel; **8)** Favorable S Corporation Charitable Contribution Provisions Involving Capital Gain Property; **9)** Various Tax Benefits For Qualified Energy-Efficient Expenditures And For Qualifying Investments In Empowerment Zones; **10)** Election For C Corporations To Exchange Bonus Depreciation For Refundable AMT Credits; **11)** Parity Between Employer-Provided Parking And Employee Transportation Fringe Benefits; **12)** Enhanced Charitable Contribution Rules For Qualifying Business Entities Contributing Food Inventory; **13)** 100% Exclusion (Instead Of 50% Exclusion) For "Qualified Small Business Stock"; **14)** Reduction Of The S Corporation 10-Year Built-In Gain "Waiting Period" To 5 Years; **15)** Up-Front Deduction Of Up To $1.80 Per Square Foot Of Qualified Energy-Efficient Property Installed In A Commercial Building; and **16)** Credit For Builders Of Energy-Efficient Homes.

- **Planning Alert!** Two of the above-listed business tax breaks that are most commonly used and have the broadest impact are the ***50% §168(k) First-Year Bonus Depreciation*** and the ***Expanded §179 Deduction.*** Most observers believe that Congress will eventually extend these two provisions at least through 2015. This prediction is based, in part, on proposed legislation currently being considered by the House and the Senate. Later in this letter we discuss year-end planning strategies that could save your business taxes – even if these provisions are not ultimately extended through 2015. ***Please note*** that we monitor proposed legislation closely, so ***please call our firm*** if you need a ***status report.***

AFFORDABLE CARE ACT'S IMPACT ON EMPLOYERS FOR 2015 – HIGHLIGHTS

Employer Health Coverage Mandate Is Here. 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* (***"Excise Tax"***). This *Excise Tax* only applies, however, if at least one full-time employee purchases medical insurance through a government-sponsored health insurance exchange

(Exchange) and receives a premium tax credit or a cost-sharing subsidy. Although *ACA* states that this provision becomes effective in 2014, last year the IRS announced that it would not impose the tax on *"Applicable Large Employers" (ALEs)* ***until 2015.*** So, this is the first year that *ALEs* are exposed to the excise tax. **Planning Alert!** Last year, the IRS also announced additional ***transition relief*** for certain *ALEs* for ***"2015 Only."*** 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:

- **Employee Threshold For Excise Tax Exposure Temporarily Increased From 50 To 100.** An ***ALE*** 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 "full-time equivalent employees") during ***each month*** of the ***entire preceding calendar year.*** However, ***for 2015,*** the IRS has provided temporary relief from this *Excise Tax* for employers that have fewer than 100 (rather than 50) employees. More specifically, ***for 2015,*** a qualifying *ALE* 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) ***will generally be exempt*** from the *Excise Tax* for any calendar month ***during 2015,*** and for any month in 2016 for a ***plan year beginning in 2015.***

  •• **Planning Alert!** Last summer, Congress enacted legislation providing that, ***effective for months beginning after 2013,*** an employee ***will not be counted*** when determining whether an employer is an ***Applicable Large Employer*** for any month that the employee has medical coverage under ***TRICARE or VA health care.*** Therefore, when evaluating whether your business is an *ALE* for 2015, be sure to exclude from your 2014 monthly employee count all employees that were covered by *TRICARE* or *VA health care during that month.* ***Please note*** that this rule applies after 2015 as well.

- **"Testing Period" Temporarily Reduced From 12 Months To 6 Months.** Generally, to determine whether an employer is an *ALE* for the ***current calendar year,*** the ***"Testing Period"*** for applying the ***"50-employee threshold"*** (or 100-employee threshold for 2015) is the ***entire preceding calendar year.*** Thus, under this "general rule," the ***"Testing Period" for "2015,"*** would be the ***entire "2014" calendar year.*** However, for ***2015,*** employers may determine whether they had, for example, more than 99 employees (including full-time equivalent employees) in 2014 by reference to a period of ***at least 6 consecutive months.*** Thus, ***for 2015,*** this transition rule 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 has ***fewer than 100 employees*** and qualifies for the 2015 relief from the *Excise Tax*. **Example.** 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 use only the first 6 months of 2014 to compute its 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.

IRS Releases Insurance Coverage Reporting Forms That "Applicable Large Employers" Must Furnish To Full-Time Employees And File With The IRS. The Affordable Care Account (ACA) generally requires ***Applicable Large Employers*** (***ALEs***) to furnish new insurance coverage reporting forms (new ***Form 1095-C***) to its full-time employees, and to file copies of ***Forms 1095-C*** and ***1094-C*** with the IRS. **Planning Alert!** As discussed above, for the ***2015 tax year only,*** the IRS has generally waived the *Excise Tax* for *an ALE* that fails to offer qualified health care coverage to its full-time employees, unless the *ALE* employed ***100 or more*** employees (instead of 50 or more). Unfortunately, ***for 2015*** (and after), *ALEs* meeting the ***50-employee*** threshold (not the 100-employee threshold) are required to file the new ***Forms 1094-C*** and ***1095-C.*** For example, if your business is determined to have employed 75 employees (including full-time equivalent employees) during 2014 (i.e., the Testing Period for 2015), it may be exempt from the *Excise Tax* for 2015, but it would still be required to file Forms 1094-C and 1095-C for 2015.

These new filing requirements were "optional" for calendar-year 2014, but ***are required for calendar year 2015.*** A ***Form 1095-C*** is furnished to each ***full-time employee*** and reports to the IRS and to the employee the months in 2015 for which the full-time employee, dependents, etc., were offered medical coverage by the *ALE.* The form also includes the employee's share of the lowest cost monthly premium for self-only coverage and indicates if the employer qualifies for any *ACA* safe harbors. ***Form 1095-C*** is used in determining if the employee qualifies for the *"Premium Tax Credit*" for insurance purchased on the government-sponsored health insurance exchanges, and whether the *ALE* may owe the *Excise Tax* for failing to offer qualified health care coverage to its full-time employees.

Form 1094-C is required to be filed with the IRS by an *ALE* and serves a dual purpose. The form serves as a transmittal for the Forms 1095-C filed by the *ALE*. In addition, Form 1094-C is used to help the IRS determine if the employer may be subject to the *Excise Tax* for failing to satisfy the *ACA* requirements for qualified health care coverage. Part II of the form is used to indicate if the *ALE* is subject to any of the 2015 transition rules exempting the employer from the *Excise Tax*. Moreover, an *ALE* must indicate in Part III of Form 1094-C whether the *ALE* offered minimum essential medical coverage to its full-time employees for each month of the year. Part III also provides a listing of the total full-time employees and the total employees for each month of the year. If the *ALE* is a member of a controlled group of employers, the other members of the group are listed in Part IV of Form 1094-C.

The following frequently-asked questions and answers address the basics of this new reporting requirement (Please call our firm if you need additional details):

- **Must An ALE Furnish Form 1095-C To Every Employee?**

  Answer – *ALEs* must furnish Form 1095-C to ***each employee*** who was a ***"full-time employee"*** for ***any month*** of ***2015.*** Generally, a ***full-time employee*** is an employee who, for a calendar month, worked an average of at least 30 hours per week, or worked 130 hours during the calendar month. **Caution!** An *ALE* must complete information ***for all twelve months*** of the calendar year for any of its employees who were full-time employees for at least one calendar month.

- **When Are Forms 1094-C And 1095-C Due?**

  Answer - *ALEs* are required to furnish a ***2015 Form 1095-C*** to ***each full-time employee*** by ***February 1, 2016,*** and submit ***Forms 1094-C and 1095-C to the IRS*** by ***February 29, 2016*** (if filing by paper), or by ***March 31, 2016*** (if filing electronically). If an *ALE* fails to furnish Form 1095-C to its full-time employees and also fails to file with the IRS, it faces a penalty of up to $500 for each Form 1095-C it failed to file. **Planning Alert!** The IRS says that it will not assess penalties for ***incorrect or incomplete information reported in 2016*** (for the ***2015 calendar year***) so long as the *ALE* makes ***a good faith effort to comply.*** However, this relief ***does not apply*** if the form is ***not filed timely.***

- **If A Business Is Not An ALE – Does That Mean It Will Have No New Health Care Information Reporting Obligations Under ACA For 2015?**

  Answer – Not necessarily. Starting with the 2015 tax year, smaller employers that are not *ALEs* may have to file a new information ***Form 1095-B*** if they provide certain ***"self-insured"*** health care arrangements to their employees. The immediately following segment discusses this potential filing requirement.

A Small Employer That Provides Certain "Self-Insured" Arrangements May Have To File New Form 1095-B Even If It Is Not An "Applicable Large Employer." Generally, ***beginning with the 2015 calendar year,*** providers of health care coverage that qualifies as ***"Minimum Essential Coverage"*** under the Affordable Care Act (ACA) must file new information ***Form 1095-B*** with both the covered individual and the IRS, disclosing certain information about the coverage. The primary purpose of ***Form 1095-B*** is to provide information to the IRS about individuals who have health care coverage that constitutes *"Minimum Essential Coverage"* (MEC). If an individual has MEC, he or she will not be subject to the "*Shared Responsibility Tax"* (SR Tax) imposed on individuals who fail to obtain qualified health care coverage.

This Form 1095-B should be filed by health insurance carriers or sponsors for insured plans, and by government agencies that provide health care coverage under a government-sponsored program. However, in certain situations, Form 1095-B must be filed by a private employer (even if not an *ALE*) if the employer provides employer-sponsored *"self-insured group health plan coverage."* Although the IRS has yet to provide a precise definition of ***"self-insured group health plan coverage,"*** it is clear from the instructions to Form 1095-B that this term includes an employer-sponsored ***"health reimbursement arrangement"*** (HRA). The IRS defines an ***HRA*** as an arrangement funded solely by an employer that reimburses an employee for qualified medical care expenses up to a maximum dollar amount. The IRS has recently announced that sponsoring employers (regardless of the number of workers it employs) must file a Form 1095-B for each employee covered by an HRA, unless the employer satisfies a specific exception. For example, the IRS says that an employer would not have to file a Form 1095-B for an HRA that is provided only to employees who are also covered by an insured health plan sponsored by the same employer. **Caution!** As discussed in more detail in the next segment, an HRA covering two or more

employees is generally deemed to violate the requirements of ACA unless the employer also sponsors an ACA compliant health plan along with the HRA and could expose the sponsoring employer to a penalty of $100 per day for each covered employee.

- **Tax Tip.** If an HRA is sponsored by an *Applicable Large Employer* (ALE) and requires reporting, the *ALE* would report information for the HRA by filling out ***Part III*** of Form ***1095-C*** (and would generally not file Form 1095-B).

- **Planning Alert!** *Employers* that sponsor ***"self-insured group health plan coverage,"*** and that don't meet an exception, are required to furnish a ***2015 Form 1095-B*** to ***each employee "covered by" the plan*** by ***February 1, 2016,*** and submit **Form 1095-B** along with transmittal ***Form 1094-B to the IRS*** by ***February 29, 2016*** (if filing by paper), or by ***March 31, 2016*** (if filing electronically). If the employer fails to furnish this form to its ***"covered"*** employees and also fails to file with the IRS, it faces a ***penalty of up to $500*** for each Form 1095-B it failed to file.

- **Caution!** These rules are extremely technical and can be quite confusing – so please call our firm if you have additional questions concerning these new reporting rules.

Potential Penalties For Employers Sponsoring "Health Reimbursement Arrangements" Or "Employer Payment Plans." Any employer, regardless of size, that sponsors a ***"Health Reimbursement Arrangement"*** (*HRA*) or an "***Employer Payment Plan"*** (*EPP*) could face a $100 per day penalty for each covered employee. As noted in the previous segment, the IRS defines an ***"HRA"*** as an arrangement (funded solely by an employer) that reimburses an employee for qualified medical care expenses incurred by the employee up to a maximum dollar amount for a coverage period. The IRS defines an ***"Employer Payment Plan"* (*EPP*)** as an arrangement where the employer reimburses an employee's substantiated premiums for the employee's individual medical insurance coverage (i.e., non-employer sponsored medical insurance coverage), or where the employer pays the premiums directly to the insurance company. The IRS has provided several *"safe harbors"* for certain HRAs and for EPPs that could protect employers from this harsh $100 a day penalty in certain situations. For example, the IRS says an HRA that only covers employees who are also covered by an ACA compliant employer-sponsored health plan, will generally be exempt from the $100 a day penalty. The IRS also says that an ***Employer Payment Plan*** will be exempt from the $100 a day penalty, where an "S" corporation reimburses or pays the premiums for individual health insurance coverage for a shareholder/employee who owns more-than-2% of the S corporation – ***at least through December 31, 2015.*** In order for the payments by the S corporation to the more-than-2% shareholder to qualify for this exemption, the premiums reimbursed or paid by the S corporation must be properly included in the S corporation shareholder's W-2. In addition, if this is handled properly, the shareholder is allowed an above-the-line deduction for the insurance premiums included in his or her W-2.

- **Planning Alert!** Although the two safe harbors discussed above have the broadest application, ***please note*** that the IRS has also provided for ***other narrow safe harbors*** that could exempt an HRA or EPP from the $100 a day penalty**.** Some of these safe harbors are

permanent, while others are temporary. These safe harbor provisions can be complicated and tricky. If you think your business might possibly run afoul of these rules, please contact our firm and we will help you determine whether you meet one of the safe harbors.

IMPACT OF RECENT LEGISLATION ON BUSINESSES

Background. Over the last twelve months, Congress has passed several bills containing a variety of tax provisions (***"Recent Tax Legislation"***) that impact businesses of all sizes. This segment provides an overview of these provisions which may have an impact on you or your business activities. **Caution!** Some of these changes ***will first apply to the 2015 tax years,*** while others ***are not effective until 2016.*** The **"effective date"** of each new tax provision discussed below is highlighted.

Revised Due Dates For Various Tax Returns For Tax Years Beginning After 2015. For ***tax years beginning after 2015***, *Recent Tax Legislation* revises the initial due dates and/or the extended due dates for a series of tax returns including: ***Form 1065*** (partnership return); ***Form 1120*** ("C" corporation tax return); and ***Form 1041*** (trust and estate income tax returns). The following are just a few examples of the new due dates and extended due dates provided by the new legislation.

For tax years beginning after 2015, the ***"Initial"*** due date for a ***Partnership Return*** (Form 1065) will be the15th day of the ***"third"*** month following year end (i.e., March 15 of the following year for a calendar-year partnership). Partnership returns are currently due the 15th day of the ***"fourth"*** month (i.e., April 15 of the following year). However, the ***"Extended"*** due date for partnership returns will not change (i.e., it is the 15th day of ninth month of the following year under both current law and the new law).

For calendar-year *"C" Corporation Returns* (Form 1120), the ***"Initial"*** due date of the return for tax years beginning after 2015 will be April 15 of the following year instead of the current due date which is March 15 of the following year. However, the **"Extended"** due date for calendar-year "C" corporation returns will be September 15 of the following year which is the same as the current extended due date for calendar-year "C" corporation returns.

For an "*income tax return*" for an *Estate or Trust* (Form 1041), under the new law the ***"Initial"*** due date ***will not change*** (i.e., the 15th day of the fourth month of the following year). However, under the new law, the ***"Extended"*** due date of Form 1041 will be the ***"last"*** day of the ninth month following year end, instead of the current ***"15th" day***"of the ninth month following year end. **Observation.** The *New Tax Legislation* does not change the initial due date or the extended due date for an "S" corporation tax return (Form 1120S).

- **Planning Alert!** Since these new due date provisions are effective for ***tax years beginning after 2015,*** the initial and extended due dates for the ***current 2015 tax year*** for all of the returns described above will remain the same as in the past. The new deadlines ***will first apply*** to returns ***for the 2016 tax year*** – which are filed ***in 2017.***

Failure To File Certain Information Returns Timely Has Become More Costly. The *Recent Tax Legislation* significantly increased the monetary penalties for failing to file certain information returns (e.g., the Form 1099 series, Form 1095-B, Form 1095-C), ***effective for returns required to be filed after 2015.*** For example, the penalty for failing to file a Form 1099 with the payee is increased from $100 to $250 for each Form 1099 and, in addition, the failure to file a Form 1099 with the IRS is also increased from $100 to $250. Therefore, under the new law, failure to file a single Form 1099 with both the payee and the IRS would generally trigger a total penalty of $500 ($250 for failing to file with the payee, plus $250 for failing to file with the IRS). **Planning Alert!** These increased penalties are ***effective*** for information returns ***required to be filed after 2015.*** So the increased penalties will apply to Forms 1099 reflecting payments made during 2015, that are generally required to be furnished to the payee by February 1, 2016, and to the IRS by February 29, 2016 if filed by paper (by March 31, 2016 if filed electronically). **Tax Tip.** If your business is required to file Forms 1099 for the 2015 tax year, it is more important than ever that you begin gathering the information that is necessary to complete the forms as soon as possible. The February 1, 2016 deadline for furnishing a Form 1099 to the payee is rapidly approaching.

- **Planning Alert!** Generally, any taxpayer that makes payments in the course of its trade or business for ***interest, rents, compensations, remuneration for services, annuities, etc. aggregating $600 or more*** for the year to a single payee is required to report the payments to the IRS and to the recipient of the payments by filing Form 1099**.** This reporting requirement generally *does not apply to payments to corporations*. However, the 1099 reporting requirements do apply to payments made to corporations for attorneys' fees, and to amounts paid to corporations providing medical or health care services. In addition, if a business makes a payment otherwise required to be reported on Form 1099, the payment is generally ***not required to be reported if the payment is made using a credit card, a debit card, or a qualified third party payment network.***

FINAL "CAPITALIZATION" REGULATIONS

IRS Provides "Implementation" Relief For "Qualifying Small Businesses" Applying The Capitalization Regulations. Most businesses, regardless of size, commonly 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. On September 13, 2013, the IRS released the long-awaited "final" capitalization regulations (filling more than 200 pages) addressing expenditures relating to the acquisition, production, or maintenance of tangible business property (e.g., machinery, equipment, vehicles, buildings, etc.).

The IRS says that all taxpayers (large and small alike) are required to apply these new regulations ***beginning with the 2014 tax year***. Although the final regulations are not effective until the first tax year ***beginning after 2013,*** in many situations implementing these regulations would require filing an automatic accounting method change request (i.e., Form 3115) with the taxpayer's 2014 tax return and, in some cases, require adjustments to the taxpayer's 2014 taxable income based on

transactions that occurred before 2014.

In response to concerns voiced by the small business community and various professional groups, last February the IRS provided "optional" relief for qualifying small businesses to implement these regulations. More specifically, the IRS has provided special rules allowing a trade or business with under $10 million of assets ***or*** $10 million or less of gross receipts for the past three years, to more easily adopt these final tangible property regulations. If a taxpayer qualifies and chooses to utilize these simplified rules, the taxpayer applies the new capitalization regulations to ***amounts paid or incurred in tax years beginning after 2013*** *rather than applying the capitalization regulations retroactively.*

- **Planning Alert!** Qualifying small businesses are not required to adopt these simplified rules for implementing the capitalization regulations. However, those that qualify and choose to utilize the simplified rules by properly following the capitalization regulations for amounts paid or incurred in tax years beginning after 2013, are not required to file an accounting method change request with the IRS. In addition, they are generally not required to make adjustments to their taxable income for transactions that occurred before 2014 when adopting the capitalization regulations. ***Please call our firm*** if you need additional details.

YEAR-END PLANNING WITH PURCHASES OF DEPRECIABLE EQUIPMENT, ETC.

The 50% 168(k) Bonus Depreciation. For most of the last decade, businesses have been entitled to a ***168(k) first-year bonus depreciation*** deduction for qualifying property (generally ***"new"*** property with a MACRS recovery period of 20 years or less). Over the last several years, the deduction percentage has fluctuated between 30% and 100% of the asset's cost. However, for qualifying property placed-in-service ***after 2011*** and ***before 2015,*** the deduction was 50% of the cost of the property. This deduction generally ***expired*** for qualifying property ***placed-in-service after December 31, 2014.*** **Planning Alert!** A narrow group of property that includes certain long-production-period property and qualifying noncommercial aircraft still qualifies for the 50% bonus depreciation if placed-in-service ***on or before December 31, 2015.*** **Observation!** As mentioned previously in this letter, proposed legislation is currently being considered by the House and the Senate to extend this deduction at least through 2015. In fact, one proposal Congress is considering would make this 50% deduction permanent. However, as we complete this letter, this legislation is still up in the air.

- **Planning Alert!** As we approach year-end, our firm will closely monitor any extenders legislation that would, if passed, extend this deduction through 2015. If the legislation is ultimately passed and retroactively reinstates and extends this provision through 2015, the 50% bonus depreciation will serve as a windfall tax savings for 2015 for taxpayers that have already bought qualifying ***new*** assets (generally, those with a MACRS recovery period of 20 years or less) and ***placed them in service by December 31, 2015.*** Retroactively reinstating this deduction could also create opportunities for substantial tax savings for *"late-in-the-year"* purchases of qualifying property. **Tax Tip.** This 50% first-year bonus depreciation ***does not require*** any proration based on the length of time that an asset is in service during the tax year.

Therefore, if the deduction is reinstated, a business would get the benefit of the ***entire 50% deduction*** for 2015 purchases, even if the qualifying property ***were placed-in-service as late as December 31, 2015!*** Please call our firm if you need a status report on this pending legislation.

The "Expanded" Section 179 Deduction. Another extremely popular business tax break ***that expired for tax years beginning after 2014*** is the *"expanded"* Section 179 deduction. The Section 179 up-front deduction generally applies to the cost of qualifying "new" or "used" depreciable business property (e.g., business equipment, computers, etc.). For property placed-in-service in ***tax years beginning in 2010 through 2014,*** the overall Section 179 cap was increased to ***$500,000,*** and this $500,000 deduction limit was reduced only if the aggregate Section 179 property *placed-in-service* during the year exceeded ***$2 million.*** In addition, for ***property placed-in-service in tax years beginning in 2010 through 2014,*** a business could elect to deduct ***up to $250,000*** of ***"qualified real property"*** under Section 179. Unfortunately, these "expanded" Section 179 deduction provisions were temporary. Consequently, under current law, for ***tax years beginning after 2014:*** **1)** The maximum Section 179 deduction has dropped ***to $25,000*** (down from $500,000), **2)** The phase-out threshold has ***dropped to $200,000*** (down from $2 million), and **3)** ***"Qualified real property"*** and ***computer software*** no longer qualify for the ***Section 179 deduction*** at all. **Observation!** Proposed legislation mentioned previously, would (if passed) re-instate each of these "expanded" Section 179 provisions at least through 2015.

Equipment Purchases May Still Save Taxes Even If The 50% Section 168(k) Bonus Depreciation And The Expanded 179 Deductions Are Not Re-Instated For 2015! As we noted above, our firm will closely monitor congressional activity concerning the reinstatement of the Section 168(k) bonus depreciation and the expanded Section 179 deduction. If the legislation is enacted for 2015, it could be a substantial after-the-fact tax savings for those who have already purchased Section 168(k) property and/or significant Section 179 property. However, regardless of future congressional action, current law allows a Section 179 deduction ***of up to $25,000,*** which begins phasing out once aggregate purchases of Section 179 property ***exceeds $200,000*** (and is phased out completely once aggregate purchases equal $225,000). There are traditional tax-saving strategies for the Section 179 deduction even if the "expanded" Section 179 deduction is not extended through 2015, including the following:

- **Purchase Of "Heavy" Truck Or SUV For Use In Business.** The maximum annual depreciation deduction (including the Section 179 deduction) for most *business automobiles* is capped at certain dollar amounts. For a business auto first placed-in-service in ***calendar year 2015,*** the maximum first-year depreciation deduction is generally capped at $3,160 ($3,460 for trucks and vans not weighing over 6,000 lbs). However, trucks and SUVs with loaded rated vehicle weights over 6,000 lbs are generally exempt from the annual depreciation caps. These *"heavy vehicles,"* ***if used more than 50% in business,*** will also qualify for the Section179 deduction (limited to $25,000). For example, let's assume that in 2015 you purchase and place-in-service a new "over-6,000 lb" SUV ***for $40,000*** used ***entirely for business.*** If you elect to take the maximum Section 179 deduction on the vehicle, for 2015 (under current law) you could deduct: **1)** Up to $25,000 under Section 179, and **2)** up to 20% of the remaining cost (i.e., $3,000) as regular depreciation for the first year. Thus, for a $40,000 new heavy SUV

placed-in-service in 2015, you could write-off up to $28,000 in 2015 (assuming 100% business use and the half-year convention applies). **Planning Alert!** If you take the Section179 deduction on your business vehicle, and your business use percentage later ***drops to 50% or below*** in a later tax year**,** you will generally be required to bring into income a portion of the deductions taken in previous years.

- **Judicious Selection Of Section 179 Property May Avoid The Mid-Quarter Convention Rules.** Since taxpayers can select which qualifying property to deduct under Section 179, it is generally preferable to allocate the Section 179 deduction to the qualifying property that has the ***longest depreciable life.*** In addition, generally, if a business purchases more than 40% of its machinery, equipment, business vehicles, etc., in the last 3 months of its tax year, it may only take 1½ months of depreciation (instead of 6 months of depreciation) for the property acquired in the last 3 months. This is commonly referred to as the "mid-quarter convention." **Tax Tip.** If you elect the Section 179 deduction for property purchased in the last three months of the tax year, that portion of the cost of the property is ***excluded from the 40% test.*** This may allow you to avoid the onerous mid-quarter depreciation convention and use the half-year convention instead.

- **"Placed-In-Service."** Generally, if you are purchasing "depreciable property" (equipment, computers, vehicles, buildings, etc.), the property must be *placed-in-service* no later than the last day of the tax year (i.e., ***by December 31, 2015*** for a calendar-year taxpayer) for you to qualify for the Section 179 deduction or for regular depreciation for 2015. ***"Placed-in-service"*** is generally considered to have occurred if the property is ***ready and available*** for its intended use. To be safe, for calendar-year taxpayers, qualifying property should be ***set up and tested*** on or before the ***last day of 2015.*** If you are dealing with a newly-constructed building or building improvements to an existing building (e.g., qualified leasehold improvement property, non-structural components of a building), the receipt of a ***certificate of occupancy*** will generally be considered evidence that the property was placed-in-service.

    - **Tax Tip.** In a recent District Court case, the Court held that a "retail" building was "placed-in-service" when the taxpayer was issued a *certificate of occupancy* allowing the building to ***receive equipment, shelving, racks and merchandise*** as well as allowing the appropriate personnel to install and or stock those items – ***not when*** it was later ***"open for business"*** as the IRS argued.

    - **Planning Alert!** For the past several years, Congress has allowed an increased portion of the cost of qualifying commercial buildings and/or building improvements to be deducted in the year the property is placed-in-service. For example, a ***50% §168(k)*** additional first-year depreciation for ***"qualified leasehold improvements"*** has been allowed, as well as a ***$250,000 immediate deduction*** under §179 for ***"qualified real property"*** (i.e., qualified leasehold improvements, qualified restaurant property, and qualified retail property). Therefore, if your business is incurring any of these "building" costs that could qualify for these rapid write-offs, this case indicates that you could take the deductions in the tax year that the building and/or its improvements has been issued a *certificate of*

occupancy allowing the building to ***receive equipment, shelving, racks and merchandise,*** as opposed to the tax year the building is "open for business." **Caution!** As mentioned previously, this $250,000 immediate deduction under §179 for *"qualified real property"* and the 50% §168(k) additional first-year depreciation for "qualified leasehold improvements" both ***expired after 2014.*** Although Congress is currently considering "extenders" legislation that would, if passed, extend both of these tax breaks at least through 2015, as we complete this letter this legislation has not passed. Please contact our firm if you need a status report on this legislation.

- **Don't Overlook The "De Minimis" Safe Harbor For Deducting Lower-Cost Items Under The Capitalization Regulations.** The recently-finalized capitalization regulations (discussed above) offer a ***"de minimis safe harbor"*** election which generally allows qualifying businesses to deduct immediately purchases of individual items of tangible business property (including materials and supplies) not exceeding $500 each (not exceeding $5,000 each for certain businesses that have a qualifying financial statement). Deductions under this safe harbor are not impacted by the Section 179 deduction or its dollar limits. That is, the Section 179 deduction is allowed ***in addition to*** the purchases deducted under this *de minimis safe harbor*, and there is no overall aggregate dollar limit on the total amount of deductions taken under this safe harbor. Therefore, the amount your business may deduct under the *de minimis safe harbor* will be the same regardless of whether Congress extends the "expanded" Section 179 deduction beyond 2014.

  •• **De Minimis Safe Harbor Election.** This election is made annually (by attaching a statement to a timely filed—including extensions—original Federal income tax return). To qualify, the taxpayer generally must have an ***accounting procedure*** (as of the beginning of the year) treating as an expense for non-tax purposes amounts paid for property costing less than a specified dollar amount.

  If the taxpayer has an *"Applicable Financial Statement"* (i.e., financial statement filed with the SEC; a certified audited financial statement; or, a financial statement (other than a tax return) required to be provided to the Federal or a state government), the accounting procedure ***must be in writing,*** and the safe harbor amount is ***$5,000 per item.*** For taxpayers that do not have an *"Applicable Financial Statement"* (most small and mid-sized business), the safe harbor amount is ***$500 per item,*** and it appears that the *"beginning of the year"* accounting procedure referred to above is not "required" to be in writing. However, we recommend that ***all business*** wishing to make the *de minimis safe harbor* election have a "written" accounting procedure to be safe.

Potential Trap For Fiscal Year Pass-Through Entities Qualifying For Last Year's "Expanded" Section 179 Deduction. If you have a pass-through business entity (e.g., S Corporation, LLC, Partnership), you must apply the Section 179 dollar limitations twice–once at the entity level and again to the owners (i.e., to the S Corporation Shareholders, LLC Members, and Partners). This rule can present a trap for the owners of a fiscal-year entity. For example, let's assume that Bob owns 100% of his S corporation, and the S corporation's "tax year" ***ends***

September 30. The "expanded" Section 179 deduction (i.e., $500,000) expired ***"for tax years beginning after 2014."*** Therefore, the S corporation for its tax year that began on October 1, 2014 and ended on September 30, 2015, would still qualify for the $500,000 deduction for qualifying Section 179 property purchased and placed-in-service ***as late as September 30, 2015.*** However, the Section 179 deduction taken by the S corporation for its fiscal tax year ***ending September 30, 2015,*** would flow through and be reported on Bob's individual "calendar-year" tax return for 2015. For 2015, under current law, Bob's Section 179 deduction on his individual return is capped at $25,000. In this situation, the IRS says that even though the S corporation could pass through the 179 deduction of $500,000 (for its fiscal year ending September 30, 2015), Bob can only deduct $25,000 of the pass through on his 2015 individual return and the remaining $475,000 could not be carried forward to future years. **Planning Alert!** If Congress re-instates the "expanded" Section 179 deduction to 2015, this potential trap should be eliminated. If Congress does not extend the $500,000 Section 179 deduction to 2015, Bob should amend his S corporation return to elect a Section 179 deduction of no more than $25,000.

GENERAL YEAR-END BUSINESS PLANNING

Salaries For S Corporation Shareholder/Employees. For 2015, an employer must pay FICA taxes of 7.65% of an employee's wages up to $118,500 and FICA taxes of 1.45% on wages in excess of $118,500 (**Note** – this $118,500 threshold will apply to 2016 as well). In addition, an employer must withhold FICA taxes from an employee's wages of 7.65% on wages up to $118,500 and 1.45% of wages in excess of $118,500. If you are a stockholder/employee of an S corporation, this FICA tax is generally applied only to your W-2 income from your S corporation. Other income that passes through to you or is distributed with respect to your stock is generally not subject to FICA taxes or to self-employment taxes.

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

- **Planning Alert!** Keeping wages low and minimizing your FICA tax could also reduce your

Social Security benefits when you retire. Furthermore, if your S corporation has a qualified retirement plan, reducing your wages may reduce the amount of contributions that can be made to the plan on your behalf since contributions to the plan are based upon your "wages."

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

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

Deductions For Business Expenses Paid By Partners And Shareholders May Be Limited. Historically, the IRS has ruled that a partner may deduct business expenses ***paid on behalf*** of the partnership ***only if*** there is an agreement (preferably in writing) between the partner and the partnership providing that those expenses are to be paid by the partner, and that the expenses will not be reimbursed by the partnership. **Tax Tip.** If you are a partner paying unreimbursed expenses on behalf of your partnership, to be safe, you should have a written agreement with the partnership

providing that those expenses are to be paid by you, and that the expenses will not be reimbursed by the partnership. **Planning Alert!** The Courts continue to hold that a corporate shareholder may not deduct expenses the shareholder pays on behalf of the corporation ***unless*** the shareholder is employed by the corporation, the shareholder is required to incur the expenses as a part of his or her duties as an employee, and there is an agreement or understanding that the corporation will not reimburse the expenses. Even if the expenses are deductible by the shareholder-employee, they are classified as *miscellaneous itemized deductions* which are subject to the 2% reduction rule, and are not deductible at all for *alternative minimum tax* purposes.

- **Please note** that these rules ***apply to both S corporation and C corporation*** shareholders. **Tax Tip.** If business expenses paid by a shareholder for an S corporation or C corporation are reimbursed to the shareholder under a qualified *"accountable plan*," the corporation can take a full deduction and the shareholder will exclude the reimbursement from taxable income.

Establishing A New Retirement Plan For 2015. Calendar-year taxpayers wishing to establish a qualified retirement plan for 2015 (e.g. profit-sharing, 401(k), or defined benefit plan) *generally* must adopt the plan ***no later than December 31, 2015.*** However, a SEP may be established by the due date of the tax return (including extensions), but a ***SIMPLE plan*** must have been established ***no later than October 1, 2015.***

Self-Employed Business Income. If you are self-employed, it continues to be a good idea to defer income ***into 2016,*** if you believe that your marginal tax rate for 2016 (including the new .9% Additional Medicare Tax and the new 3.8% tax on Net Investment Income) will be equal to or less than your 2015 marginal tax rate. If deferring 2015 income to 2016 will save you overall taxes, and you use the cash method of accounting, consider delaying year-end billings until 2016. **Planning Alert!** If you have already received the check in 2015, deferring the deposit does not defer the income. Also, you may not want to defer billing if you believe this will increase your risk of not getting paid.

Deferring Cancellation Of Debt Income. If you or your business negotiates or arranges a reduction or cancellation in your debt to others, unless you meet certain exceptions (e.g., bankruptcy, insolvency), you will trigger ***"Cancellation Of Debt"*** (COD) income. For example, COD income could occur where: your creditor agrees to accept as full payment an amount which is less than the balance due on an obligation; you own real estate subject to a mortgage and the lender forecloses on the property (or, you enter into a short sale of the mortgaged property); or, you own an interest in a partnership (or LLC) or "S" corporation that is anticipating a transaction that could trigger COD income that will "pass through" to the owner. **Planning Alert!** If you (or your business) are in the process of negotiating an agreement with your creditors that involves a debt reduction that could trigger COD income, consider postponing the action until ***after December 31, 2015*** in order to defer any debt cancellation income into 2016. **Caution!** The rules for determining whether a transaction may trigger COD income, or whether you qualify for an exception, are complicated. If you are currently working with a lender to potentially reduce the outstanding balance on a debt, please call our firm if you need assistance in evaluating the potential tax consequences before finalizing your negotiations with the lender.

Work Opportunity Tax Credit. Over the last two decades, many employers have taken advantage of the Work Opportunity Tax Credit (WOTC) by hiring workers from certain disadvantaged groups. For example, hiring a worker who receives certain government benefits (e.g., SNAP or food stamps; SSI; long-term family assistance), or resides in an "empowerment zone," may qualify a business for this credit. Also, to encourage employers to hire more military veterans, several years ago Congress added an expanded ***"qualified veteran"*** category to the types of employees that qualify for the WOTC. Depending on the "tax" classification of the *"qualified veteran,"* the maximum credit runs from $1,500 to $9,600 per qualifying employee. In addition, unlike the WOTC allowed for hiring an employee from one of the other qualifying groups, tax-exempt employers (other than government agencies) that hire *"qualified veterans"* may receive a *"refundable"* credit of 65% of the credit allowed for taxable employers. As we complete this letter, the WOTC ***for all groups*** (including "qualified veterans") ***expired for workers who began work after December 31, 2014.*** However, Congress is considering extending this credit for workers who begin work during 2015.

- **Planning Alert!** To qualify for the WOTC, all employers (including tax-exempt employers who hire "qualified veterans") must have the new worker complete IRS **Form 8850** ("Pre-Screening Notice and Certification Request for the Work Opportunity Credit"), and submit that form to the state employment security agency ***no later than 28 days*** after the employee begins work. Even though the WOTC has expired, we suggest that if your business hires a worker who would otherwise qualify for the WOTC, you should complete Form 8850 and submit it to the appropriate agency within 28 days of the employee's starting date. That way, if the WOTC is re-instated for 2015 (which many predict), you will have ensured that the 28-day filing requirement has been satisfied. **Tax Tip.** You can locate Form 8850 at www.irs.gov. The instructions to the form provide a detailed explanation of the categories of workers who qualify for the WOTC (including the definition of a *"qualified veteran"*).

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

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

- **Regular "C" Corporations.** If a C corporation accrues an expense (e.g., compensation, interest, etc.) to a cash basis stockholder owning ***more than 50%*** (directly or indirectly) of the company's stock, the accrual is not deductible by the corporation until the **"day"** it is includable in the stockholder's income. **Tax Tip.** If the corporation's tax rate for 2015 is significantly greater than the more-than-50% stockholder's individual rate for 2015, the

accrued amount should be paid by the ***end of 2015.***

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

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

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

THE 3.8% "NET INVESTMENT INCOME TAX" – STRATEGIES FOR BUSINESS OWNERS

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

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

- **Planning Alert!** Because of this potential double benefit afforded owners that *materially participate* in the business activities (i.e., the owner's net business *"losses"* are deductible and the net business *"income"* is generally exempt from the 3.8% NIIT), the ***"material participation"*** test is attracting much more scrutiny from the IRS and the Courts. We have recently seen a significant uptick in the number of cases the IRS is taking to Court contesting

whether an owner has *materially participated* in the activities of his or her business operation. In these cases, IRS commonly argues that the owner's activities were passive because the owner could not properly document that he or she met one of the *"material participation"* tests. These cases typically involve an owner who is not working for the business full-time (e.g., retired owners, a side business, remote owners). Although the Courts generally did not strictly require these individuals to produce daily logs of time spent on the activity, the Courts rarely accepted *"after-the-fact ballpark estimates"* of the time spent. To minimize exposure to IRS attacks, where "*material participation"* could be an issue, owners should contemporaneously document their hours worked in their business activities (e.g., by recording their hours in a daily or weekly calendar).

- **"Passive" S Corporation Shareholders And Limited Partners Should Take Steps To "Materially Participate."** If you are an ***S corporation shareholder*** or ***limited partner,*** and you ***materially participate*** in the business, your pass-through business income will generally be ***exempt*** from the 3.8% NIIT. **Note!** The pass-through income is also generally exempt from Social Security and Medicare taxes on earned income. However, if you are currently a ***"passive"*** limited partner or S corporation shareholder and your MAGI exceeds the thresholds for the 3.8% NIIT (e.g., exceeds $250,000 if married filing jointly; $200,000 if single), you should begin now taking steps to establish that you *"materially participate"* in the business. For example, one way to *materially participate* in the business would be to devote *over 500 hours* during the year working in the business. **Tax Tip.** Depending on your specific facts and circumstances and the type of ownership interest you have in a business (e.g., S corporation shareholder vs. limited partner), there may be other ways you can *show that you "materially participate"* in the business without working more than 500 hours. **Planning Alert!** If you have other *"passive"* activities generating losses, you may prefer to remain *passive as to an activity producing income* so that the activity's income may be used to absorb the *passive* losses. **Caution!** These rules are complicated and require a thorough review of your particular situation to develop the most tax-wise strategy.

Rental Income Is Generally Subject To The 3.8% NIIT. Generally, 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. 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 you are a *QREP* and you *materially participate* in your rental real estate activities and those activities produce net income, that net rental income generally would not be subject to the 3.8% NIIT.

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 must be 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 is taking an increasing number of individuals to Court contesting their "QREP" classification. The IRS has prevailed where the individual could not provide adequate documentation that the individual spent more than 750 hours and over 50% of their work time working in qualifying real estate activities. 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 does not involve real estate activities, but who argue that they are QREPs with regard to the rental real estate properties they own. ***Caution*!** As illustrated by this discussion, the rules for determining whether the rental income of a ***Qualified Real Estate Professional*** is exempt from the 3.8% NIIT are tricky and complicated. If you think that this exception to the 3.8% NIIT might apply to you, we will be glad to review your specific situation.

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.

Disclaimer: Any tax advice contained in the body of this material was not intended or written to be used, and cannot be used, by the recipient for the purpose of promoting, marketing, or recommending to another party any transaction or matter addressed herein. The preceding information is intended as a general discussion of the subject addressed and is not intended as a formal tax opinion. The recipient should not rely on any information contained herein without performing his or her own research verifying the conclusions reached. The conclusions reached should not be relied upon without an independent, professional analysis of the facts and law applicable to the situation.