CORDASCO
& COMPANY P.C.
Certified Public Accountants

2013

NEW DEVELOPMENT

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2013 NEW DEVELOPMENTS LETTER

INTRODUCTION

We have witnessed more tax changes and developments in 2013 than in any year in recent memory, and these changes impact virtually every individual and business taxpayer. For example, 2013 ushered in: **1)** the ***"American Tax Relief Act"*** (passed on January 1, 2013) that includes massive changes to income, estate, and gift taxes; **2)** the comprehensive ***"Affordable Care Act"*** (ACA) regulations explaining the rapidly-approaching health care mandates; **3)** extensive IRS guidance on the new ***3.8% Tax On "Net Investment Income"*** (3.8% NIIT) and the ***.9% "Additional Medicare Tax"*** on W-2 wages and self-employment income of higher-income individuals; and **4)** recently-released ***Final Capitalization Regulations*** 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.

In addition, the IRS and the Courts have issued several landmark rulings and cases that could have a significant impact on both individual and business taxpayers. For example, in response to last summer's Supreme Court decision, the IRS has ruled that same-sex couples who were married in a state that authorizes same-sex marriages generally must be treated as "married" for all federal tax purposes.

Keeping up with these rapidly-changing tax provisions is extremely 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.

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.

Caution! 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.**

TABLE OF CONTENTS

We have included a Table of Contents with this letter that will help you locate items of interest. The Table of Contents begins on the next page.

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TABLE OF CONTENTS

DEVELOPMENTS IMPACTING PRIMARILY INDIVIDUALS 1

AMERICAN TAX RELIEF ACT ("ATRA") OF 2012 1

INCOME TAX RATES INCREASED FOR
CERTAIN HIGHER-INCOME TAXPAYERS..1

PERSONAL EXEMPTION AND ITEMIZED DEDUCTION
PHASE-OUTS REINSTATED...3

ALTERNATIVE MINIMUM TAX (AMT) "FIX" MADE PERMANENT.........................3

CERTAIN TEMPORARY CHANGES TO THE ESTATE
AND GIFT TAX RULES MADE PERMANENT 4

SELECTED TAX BREAKS SCHEDULED TO EXPIRE AFTER 2013 5

EXPANDED "AMERICAN OPPORTUNITY TAX CREDIT" EXTENDED
FOR INDIVIDUALS THROUGH 2017 6

**IRS PROVIDES GUIDANCE ON THE NEW .9% ADDITIONAL MEDICARE
TAX AND THE 3.8% NET INVESTMENT INCOME TAX...6**

.9% ADDITIONAL MEDICARE TAX ON "EARNED INCOME"
OF HIGHER-INCOME INDIVIDUALS 6

3.8% TAX ON "NET INVESTMENT INCOME" OF
HIGHER-INCOME TAXPAYERS 7

**NEW EXCISE TAXES AND TAX CREDITS UNDER
THE AFFORDABLE CARE ACT 9**

STATE INSURANCE EXCHANGES/MARKETPLACES 9

EXCISE TAX ON UNINSURED INDIVIDUALS
(THE "INDIVIDUAL MANDATE") 10

THE REFUNDABLE "PREMIUM ASSISTANCE CREDIT"..12

NON-LEGISLATIVE DEVELOPMENTS 14

IRS ISSUES SIMPLIFIED SAFE HARBOR FOR COMPUTING HOME OFFICE DEDUCTION 14

TAX COURT SHOOTS DOWN SELF-DIRECTED IRA WHERE IRA OWNER GUARANTEED CORPORATE DEBT 15

IRS BECOMING MORE AGGRESSIVE WITH TAXPAYERS CLASSIFYING THEMSELVES AS "QUALIFIED REAL ESTATE PROFESSIONALS" 15

IRS CONTINUES ATTACKS ON CHARITABLE CONTRIBUTION DEDUCTIONS 16

IRS ISSUES RULING ADDRESSING "SAME-SEX" MARRIAGES FOR TAX PURPOSES 17

DEVELOPMENTS IMPACTING PRIMARILY BUSINESSES 18

AMERICAN TAX RELIEF ACT ("ATRA") OF 2012 18

SELECTED "BUSINESS" TAX BREAKS EXTENDED THROUGH 2013 18

WORK OPPORTUNITY TAX CREDIT EXTENDED RETROACTIVELY THROUGH 2013 18

50% FIRST-YEAR 168 (K) DEPRECIATION DEDUCTIONS EXTENDED THROUGH 2013 19

EXPANDED SECTION 179 DEDUCTION EXTENDED THROUGH 2013 20

MISCELLANEOUS TAX CHANGES UNDER ATRA 20

AFFORDABLE CARE ACT (ACA) DEVELOPMENTS 21

IRS DELAYS EFFECTIVE DATE OF EMPLOYER MANDATE EXCISE TAX AND CERTAIN HEALTH INSURANCE INFORMATION REPORTING 21

OTHER SELECTED NON-LEGISLATIVE DEVELOPMENTS 21

CORDASCO
& COMPANY P.C.
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IRS ISSUES FINAL REPAIR VS. CAPITALIZATION REGULATIONS....................... 21

IRS RELEASES NEW EXPANDED PROCEDURE FOR OBTAINING AUTOMATIC RELIEF (WITHOUT IRS USER FEE) FOR CERTAIN "LATE" ELECTIONS APPLICABLE TO "S" CORPORATIONS 23

TAX COURT ANALYZES WHETHER LIMITED LIABILITY COMPANY (LLC) OWNER IS SUBJECT TO S/E TAX... 23

IRS CONFIRMS THAT EACH S CORPORATION MEMBER OF A CONTROLLED GROUP OF CORPORATIONS IS ENTITLED TO THE MAXIMUM ALLOWABLE SECTION 179 DEDUCTION 24

FINAL COMMENTS.. 25

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DEVELOPMENTS IMPACTING PRIMARILY INDIVIDUALS

AMERICAN TAX RELIEF ACT ("ATRA") OF 2012

On January 1, 2013, Congress passed the ***"American Tax Relief Act ("ATRA") Of 2012."*** This major tax legislation permanently retains the Bush-era tax rates for lower and moderate income individuals, while also permanently raising the highest tax rates on regular income, dividends, and capital gains for individuals with higher incomes; establishes a permanent lifetime gift and estate tax exemption amount of $5 million as adjusted for inflation ($5.25 million for 2013) and sets a top estate and gift tax rate of 40%; and locks in alternative minimum tax (AMT) relief with no sunset dates. In addition, the legislation retroactively extended (or made permanent) ***a long list of tax breaks*** for both individuals and businesses that had recently expired.

> Planning Alert! Our reference to ***"permanent"*** means that the provision ***has no sunset date*** after *ATRA* (Congress could always change these provisions with future legislation).

Income Tax Rates Increased For Certain Higher-Income Taxpayers. ***Beginning in 2013,*** *ATRA* permanently increases the highest ***"income tax"*** rates on individuals, estates, and trusts.

> Planning Alert! The tax increases discussed below ***do not include*** the new ***.9% Additional Medicare Tax*** or the new ***3.8% Net Investment Income Tax*** under the ***Affordable Care Act*** (discussed in more detail later in this letter), which also apply to higher-income taxpayers beginning in 2013.

- **Highest "Ordinary" Income Tax Rate For Individuals Increased To 39.6%.** Although ATRA permanently continues the Bush-era 10% to 35% income tax brackets, it added an additional 39.6% tax bracket for higher income individuals. ***Beginning in 2013,*** the new 39.6% tax rate applies to ***taxable income*** of an individual that ***exceeds*** the following thresholds: ***$450,000*** for married couples ***filing joint returns*** ($225,000 if married filing separate returns); ***$400,000*** for ***single filers;*** and ***$425,000*** for ***heads of households.*** These thresholds are adjusted for inflation after 2013.

> Planning Alert! The income thresholds for the new 39.6% bracket have created a new marriage tax penalty. For example, if a married couple files a 2013 joint return and each spouse has taxable income of $400,000, their joint taxable income of $800,000 will generally be taxed at 39.6% to the extent it exceeds the $450,000 income threshold for married individuals filing joint returns (i.e., $350,000 will be taxed at 39.6%). By contrast, if the individuals were not married and each filed as single, neither would be subject to the 39.6% tax rate because neither would have exceeded the $400,000 income threshold that triggers the 39.6% rate for single individuals.

- **Highest "Income Tax" Rate For Estates And Trusts Increased To 39.6%.** ***Beginning in 2013,*** *ATRA* permanently increases the highest income tax rate for income taxed to a trust or estate from 35% to 39.6%. For 2013, the 39.6% rate applies to trust or estate taxable income that ***exceeds $11,950.***

  Tax Tip! The income threshold for taxing an individual at 39.6% (e.g., $400,000 if single) is substantially higher than the income level for taxing a trust or estate at 39.6% (i.e., $11,950 for 2013). Consequently, *ATRA* has created an additional tax incentive for distributing trust or estate income to an individual beneficiary where the beneficiary's income is taxed in a lower tax bracket.

- **Highest Long-Term Capital Gain And Qualified Dividend Rates Increased To 20%.** *ATRA* permanently retains the maximum long-term capital gain and qualified dividend rates at 15% for lower and moderate income individuals. *ATRA* also permanently retains the zero percent tax rate for long-term capital gains and qualified dividends where the capital gain or dividend income would otherwise (if ordinary income) be taxed in the 15% or 10% tax brackets (for 2013, taxable income up to $36,250 for single individuals and $72,500 for joint filers is taxed in the 15% bracket or below). However, ***beginning in 2013,*** for long-term capital gains or qualified dividends that would otherwise be taxed in the 39.6% bracket, *ATRA* increases the rate to 20%. For example, to the extent ordinary income plus long-term capital gains and dividends of a single individual cause his or her taxable income to exceed $400,000 in 2013 (i.e., the income threshold for the 39.6% bracket), the capital gains and dividends will be taxed at 20%.

  Caution! The current maximum rates of 28% on the gain from the sale of collectibles (e.g., works of art, antiques, etc.) and 25% on the gain attributable to straight-line depreciation taken on depreciable realty were not changed and continue to apply for 2013 and subsequent years. **Trust and Estates.** For long-term capital gains and/or qualified dividends that would otherwise be taxed in the 39.6% bracket of a trust or estate (i.e., for 2013, where taxable income exceeds $11,950), *ATRA* permanently increases the rate to 20%.

- **Tax Tips!** The retention of the zero percent rates for long-term capital gains and qualified dividends is particularly important to lower-income retirees who rely largely on investment portfolios that generate dividends and long-term capital gains. Furthermore, gifts of appreciated securities to lower-income donees who then sell the securities could reduce the tax on all or part of the gain from 15% or 20% to zero percent.

Caution! If the donee is subject to the so-called *kiddie tax*, this planning technique will generally not work). Moreover, if you sell capital gain property using seller financing, you generally recognize the gain in the years you receive payments on the installment note. Spreading the capital gain over multiple years by taking an installment note upon the sale, may allow you to keep your taxable income below the 39.6% threshold, causing your capital gain to be taxed at a maximum rate of 15% (or possibly 0%), rather than 20%

Caution! The *entire gain* from the sale of ***marketable securities*** must be reported in the year of sale even if the seller finances the sale by taking an installment note from the buyer).

Personal Exemption And Itemized Deduction Phase-Outs Reinstated. During most of the past two decades, higher-income individuals were subject to an income phase-out provision that reduced their ***personal exemptions*** and ***itemized deductions*** as their income exceeded certain thresholds. All individuals were given a three-year reprieve from these phase-outs ***from 2010 through 2012.*** Under *ATRA*, ***beginning in 2013,*** these phase-out provisions are permanently reinstated for individuals with ***adjusted gross incomes*** exceeding the following threshold amounts: ***$300,000*** for married couples ***filing joint returns*** ($150,000 if married filing separately); ***$250,000*** for ***single filers;*** and ***$275,000*** for ***heads of households.*** These thresholds will be adjusted for inflation after 2013.

Tax Tip. The phase-out provisions ***do not apply*** to the following itemized deductions: medical expenses, investment interest, gambling losses, casualty losses, and theft losses.

Planning Alert! Individuals whose itemized deductions and/or personal exemptions are reduced by these phase-out provisions will have higher "effective" tax rates than listed in the published statutory-rate schedules discussed above.

Alternative Minimum Tax (AMT) "Fix" Made Permanent. For the past several years, Congress has routinely enacted a series of so-called AMT "patches" that temporarily increased the alternative minimum tax (AMT) exemption amounts by indexing these amounts for inflation. These AMT patches temporarily ensured that most lower and middle income taxpayers were not subject to AMT. ***ATRA provides for the permanent indexing*** of the AMT exemption amounts. *ATRA* also allows non-refundable personal income tax credits to offset the AMT permanently. Moreover, the 0%, 15%, and 20% tax rates on long-term capital gains and qualified dividends for regular income tax purposes also ***apply permanently*** in calculating the AMT.

Planning Alert! Although these permanent AMT "fixes" do not eliminate AMT, they ensure that most middle and low income taxpayers will likely not incur the AMT. The changes will also provide more certainty in planning to reduce the AMT.

Certain Temporary Changes To The Estate And Gift Tax Rules Made Permanent. 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"). Previous tax legislation temporarily set the lifetime estate and gift tax *exclusion amount* at $5 million (as indexed for inflation) for 2010 through 2012, and also temporarily set the maximum estate and gift tax rate at 35%. ATRA extends the inflation-adjusted $5 million *exclusion amount* ***permanently*** to years beginning ***after 2012*** (e.g., ***$5.25 million for 2013***), and *permanently* increases the *maximum estate and gift tax rate* from ***35% to 40%.***

- ***ATRA* Permanently Unifies The Gift And Estate Tax "Exclusion Amounts."** For several years before 2011, the gift tax *exclusion amount* for aggregate lifetime gifts was set at $1 million, while the estate tax *exclusion amount* was higher (e.g., $5 million for decedents dying in 2010). Previous tax legislation *temporarily* unified the "gift" and "estate" *exclusion amounts* by providing a single unified *exclusion amount* of $5 million (as adjusted for inflation) for 2011 and 2012. *ATRA* makes the single ***unified gift and estate exclusion amount permanent.*** For example, for an individual dying in 2013, there would generally be no estate tax unless the net value of the individual's estate plus the value of all taxable gifts made during the deceased individual's lifetime exceeds $5.25 million in the aggregate.

- **"Portability" Of Deceased Spouse's Unused Exclusion Amount Made Permanent.** Historically, each spouse's estate has been entitled to a full estate tax *exclusion amount*. Therefore, technical estate tax planning structures and strategies (e.g. credit shelter trusts) were often necessary to ensure that the estate tax *exclusion amount* of the first spouse to die was not partially or completely wasted. For individuals dying in ***2011 or 2012,*** the personal representative of the estate of the first spouse to die could "elect" (by timely filing a completed estate tax return) to transfer the deceased spouse's unused portion of the estate tax *exclusion amount* to the surviving spouse. ***ATRA* makes this so-called *"portability" provision permanent.***

  ••**Example.** Assume that Husband dies in 2013 when the maximum *exclusion amount* is $5.25 million, but Husband's taxable estate is only $3.25 million. Under this *portability rule*, the personal representative for Husband's estate is allowed to elect to have Husband's unused $2 million *exclusion amount* added to the surviving Wife's unused $5.25 million *exclusion amount*. Wife could then use her $7.25 million *exclusion amount* to shelter her lifetime gifts from gift taxes. And, to the extent Wife did not use her $7.25 million *exclusion amount* (after certain inflation adjustments) to shelter her lifetime gifts from the gift tax, any remaining *exclusion amount* could be used to shelter amounts in Wife's estate from estate taxes.

  Planning Alert! To make the "portability" election, IRS says that the deceased spouse's estate ***must timely file a properly-completed 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.

Caution! The IRS says that an estate must file a timely estate tax return to make the portability election ***even if the estate is not otherwise required to file an estate tax return.*** Generally, an estate is required to file an estate tax return only if the value of the gross estate is at least equal to the *applicable exclusion amount* (i.e., $5.25 million for 2013). If you need additional information regarding the technical requirements for making this *portability election,* the advisability of making this election, or the filing of an estate tax return, please call our firm.

Selected* Tax Breaks Scheduled To Expire After 2013!** In addition to making permanent changes to income tax rates, the alternative minimum tax, and the estate and gift tax provisions, *ATRA* temporarily extended a host of targeted tax breaks for both businesses and individuals that expired either at the close of 2011 or 2012. *ATRA* ***retroactively extended ***through 2013*** the following popular tax breaks for ***individual*** **taxpayers: 1)** school teachers' deduction (up to $250) for certain school supplies; **2)** election to deduct state and local sales taxes; **3)** deduction (up to $4,000) of qualified higher education expenses; **4)** expanded deduction and carryover limits for charitable contributions of qualified conservation easements; and **5)** deduction for mortgage insurance premiums as qualified residence interest. ***In addition,*** the following individual tax breaks were extended ***through 2013:***

- **Qualifying IRA Transfers To Charities.** For the past several years, we have had a popular (but temporary) rule that allowed an individual, who is at least age 70½, to make a qualifying transfer of up to $100,000 from his or her IRA ***directly to a qualified charity,*** and exclude the IRA transfer from income. The IRA transfer to the charity also counts toward the owner's "required minimum distributions" (RMDs) for the year. Properly utilized, this provision can result in obtaining a for AGI deduction for charitable contributions made by the IRA trustee. Although this provision originally expired after 2011, *ATRA* retroactively extended it ***through 2013.***

- **Income Exclusion For Discharge Of Qualified Principal Residence Indebtedness.** The provision allowing you to exclude the income from the discharge of all or a portion of a mortgage (not exceeding $2 million) that you incurred to purchase, construct, or substantially improve your principal residence, expired after 2012. *ATRA* extended this exclusion to qualifying discharges that occur ***by the end of 2013.***

  Tax Tip. This exclusion could potentially apply to debt forgiveness involving the "short sale" or foreclosure of your principal residence.

- **Credit For Energy-Efficient Improvements To Principal Residence.** The temporary 10% credit (with a life-time cap of $500) for qualified energy-efficient home improvements originally expired after 2011. *ATRA* retroactively extended this credit for qualifying installations ***made through December 31, 2013.***

Planning Alert! The current 30% credit for installing a qualifying solar water heater, solar electric generating property, a geothermal heat pump, or small wind energy property in or on your residential property is not ***currently scheduled to expire until after 2016.***

Expanded "American Opportunity Tax Credit" Extended For Individuals Through 2017. Before 2009, individuals were allowed a HOPE tuition tax credit (HOPE Credit) for qualifying tuition costs generally for the first two years of college (e.g., freshman and sophomore years). For 2009 through 2012, Congress changed the name of the HOPE credit to the ***"American Opportunity Tax Credit,"*** and enhanced and expanded it by: **1)** increasing the maximum credit from $1,800 to $2,500 (100% of the 1st $2,000 of qualifying education expenses plus 25% of the next $2,000 of qualifying expenses); **2)** increasing the total number of years that a student may qualify from two years to four years (i.e., generally, freshman through senior years); **3)** increasing the income phase-out levels (the credit is phased out as your modified adjusted gross income increases from $160,000 to $180,000 for those filing joint returns, and from $80,000 to $90,000 for single filers); **4)** making 40% of the credit refundable (unless the person claiming the credit is subject to the so-called kiddie tax rules); and **5)** adding course materials to the expenses (in addition to tuition and fees) that qualify for the credit. *ATRA* retroactively extended these expanded provisions of the American Opportunity Tax Credit ***through 2017.***

IRS PROVIDES GUIDANCE ON THE NEW .9% ADDITIONAL MEDICARE TAX AND THE 3.8% NET INVESTMENT INCOME TAX

Starting in 2013, the ***Affordable Care Act*** (*ACA*) imposes a ***new .9% Additional Medicare Tax*** on the wages and self-employment income of higher-income individuals, as well as a *new* ***3.8% Net Investment Income Tax (3.8% NIIT)*** on their *net investment income*. These taxes are ***in addition to*** the tax rate increases under *ATRA* (discussed above). The IRS has recently released extensive guidance on these new taxes, as summarized below:

.9% Additional Medicare Tax On "Earned Income" Of Higher-Income Individuals. Payroll taxes imposed on your W-2 earnings include both a Social Security tax and a separate Medicare tax. Prior to 2013, the overall Medicare tax rate was 2.9% (1.45% imposed on the employee and an additional 1.45% imposed on the employer). If you are self-employed, you must pay the entire 2.9% Medicare tax on your income from self-employment. The *Affordable Care Act* imposes a new ***.9% Additional Medicare Tax on W-2 wages and self-employment earnings received by individuals after 2012*** that exceed certain thresholds. This .9% Medicare tax is calculated on your individual income tax return and generally applies to the amount by which the ***sum of*** your ***W-2 wages*** and your ***self-employment earnings*** exceeds the following thresholds: ***$250,000*** if you are ***married filing jointly; $200,000*** if you are ***single;*** or ***$125,000*** if you are ***married filing separately.*** For married individuals filing a joint return, the .9% Additional Medicare Tax applies to the extent *the sum of* both spouses' W-2 earnings and self-employment earnings exceeds the $250,000 threshold.

Planning Alert! These income thresholds are fixed and are ***not indexed*** for future inflation. Also, you are not allowed an "income" tax deduction for any portion of the .9% tax, whether or not you are self-employed.

- **Recent IRS Guidance.** The IRS released regulations in late 2012 clarifying that: **1)** An employer is required to withhold the .9% Additional Medicare Tax once the employer pays an employee more than $200,000 whether the employee is single or married and without regard to the employee's spouse's earnings; **2)** Wages are subject to the .9% Additional Medicare Tax if the wages are otherwise subject to Medicare taxes generally (e.g., elective deferrals under a 401(k) plan are generally subject to Medicare tax and, therefore, are subject to the .9% Additional Medicare Tax – provided the employee's wages and self-employment income exceed the applicable threshold); **3)** Amounts deferred in a non-qualified deferred compensation arrangement are subject to the .9% Additional Medicare Tax when taken into account as wages for FICA purposes; and **6)** Individuals are required to report their .9% Additional Medicare Tax on Form 1040 (starting in 2013), and must also pay the .9% tax with their Form 1040 to the extent it was not paid through employer withholding or estimated tax payments.

3.8% Tax On "Net Investment Income" Of Higher-Income Taxpayers. ***Beginning in 2013***, the *Affordable Care Act* imposes a new 3.8% tax on the ***net investment income*** (*3.8% NIIT*) of ***higher-income*** *taxpayers*. With limited exceptions, ***"net Investment Income"*** generally includes the following types of income (less applicable expenses): interest, dividends, annuities, royalties, rents, "passive" income (as defined under the traditional "passive activity" loss rules), long-term and short-term capital gains, and income from the business of trading in financial securities and commodities.

Planning Alert! Income, including "passive" income, ***is not*** *"net investment income"* (and is therefore exempt from this new 3.8% NIIT), ***if the income is "self-employment income"*** subject to the 2.9% Medicare tax. The 3.8% NIIT applies to individuals with modified adjusted gross income (MAGI) exceeding the following ***"thresholds"*** (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.

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

- **Trusts And Estates Are Subject To The 3.8% NIIT.** In 2013, ***trusts and estates*** are subject to the 3.8% NIIT on the **lesser of: 1)** the adjusted gross income of the trust or estate in excess of $11,950 or **2)** the undistributed net investment income of the trust or estate.

  Planning Alert! Timely distributions of *net investment income* from an estate or trust could reduce or eliminate the 3.8% NIIT at the trust or estate level. However, the distributed NII would be NII to the beneficiary. But, the beneficiary would avoid the 3.8% tax on the distributed income if the beneficiary's MAGI is below the NIIT threshold (e.g., below $200,000 for a single individual beneficiary) after considering the income from the distribution.

- **Certain Income Exempt From 3.8% NIIT.** Any income that is otherwise exempt from taxable income is likewise exempt from the 3.8% NIIT. For example, the following types of income are generally tax exempt, and are therefore exempt from the 3.8% NIIT: municipal bond interest; gain on the sale of a principal residence *otherwise excluded* under the ***home-sale exclusion*** rules (i.e., up to $250,000 on a single return, up to $500,000 on a joint return); and life insurance proceeds. Also, the 3.8% NIIT ***does not apply*** to distributions from qualified plans (e.g., 401(k) plans, IRAs, §403(b) annuities, etc.), whether or not the distributions are otherwise taxable. Moreover as mentioned above, any income that constitutes *self-employment income* subject to the 2.9% Medicare tax is excluded from the 3.8% NIIT.

  Planning Alert! Any income that is taxable (i.e., IRA or qualified plan distributions) increases MAGI and could push an individual over the NIIT threshold and cause the individual's NII to be subject to the NIIT.

- **Recent IRS Guidance.** In late 2012, the IRS released proposed regulations on the 3.8% NIIT clarifying: **1)** ***Deductions allowed*** in computing *"net investment income"* ***include the following expenses to the extent allowed as a deduction on an individual's return:*** investment interest expense; investment expenses directly connected to the production of investment income (e.g., deductible investment advisor fees); state and local income taxes allocable to investment income; capital losses and capital loss carry forwards (including capital loss carry forwards from pre-2013 tax years) to the extent of capital gains; passive losses and passive loss carry forwards (including passive loss carry forwards from pre-2013 tax years) to the extent of passive income; **2)** Net operating loss (NOLs) carryovers/carrybacks ***do not*** reduce *net investment income;* **3)** Payments from non-qualified deferred compensation plans ***are not included*** in *net investment income;* **4)** The 3.8% NIIT does not apply to tax-exempt trusts (e.g., charitable remainder trusts, health savings accounts, section 529 plans); however, a charitable remainder trust's "distributions" of *net investment income* to the grantor may trigger the 3.8% NIIT to the grantor unless the investment income distributed is income accumulated prior to 2013; **5)** Although *net investment income* generally includes taxable distributions from commercial annuity contracts, it ***does not include*** Social Security benefits or alimony payments; and **6)** A child's *net investment income* will not be included in the parents' *net investment income* for purposes of the 3.8% NIIT unless the parents qualify to

file (and do file) Form 8814 ("Parents' Election To Report Child's Interest and Dividends").

- **"Passive" Income.** *Net investment income* also includes net income that you report from a business activity if you are a "passive" owner (unless the income constitutes *self-employment* income that is subject to the 2.9% Medicare tax). You will be deemed a "passive" owner if you do not "materially participate" in the business as determined under the traditional "passive activity loss" rules or if the income is otherwise deemed not to be passive. For example, under the *passive activity loss* rules, you may be deemed to be a *"passive"* owner unless you spend more than 500 hours working in the business during the year. Furthermore, subject to limited exceptions (e.g., qualified real estate professionals, rentals to a business in which you are not passive), *rental income* is generally deemed to be "passive" income under the *passive activity loss* rules, regardless of how many hours you spend working in the rental activity. If you believe that you may have income that could be classified as "passive" under these rules, please contact our firm. We will be glad to evaluate your situation to determine whether there are steps you could take to avoid "passive" income classification, and thus, minimize your exposure to the 3.8% NIIT.

NEW EXCISE TAXES AND TAX CREDITS UNDER THE AFFORDABLE CARE ACT

Last summer, the United States Supreme Court upheld the constitutionality of the ***"Affordable Care Act" (ACA)*** removing most of the ***"constitutional"*** issues surrounding health care reform. In addition to changing the rules for the health care industry, *ACA* contains several critically-important ***"tax provisions"*** that are designed to serve as the ***"enforcement mechanisms"*** for *ACA's* health insurance mandates. More specifically, **beginning in 2014,** these *ACA "tax provisions"* generally: **1)** require individuals to maintain qualified health insurance coverage, or pay an excise tax with their individual income tax returns (the ***"Individual Mandate"***); **2)** allow certain low-and-middle income individuals a refundable income tax credit that will also be reported on an individual's income tax return (the ***"Premium Assistance Credit"***) to help pay for health insurance premiums; and **3)** require employers that employ at least 50 employees to offer qualified health care coverage to employees or pay an excise tax ***if at least one full-time employee receives*** the premium assistance credit (the ***"Employer Mandate"***).

> **Planning Alert!** The *"Affordable Care Act"* states that these three *"tax provisions"* are to become effective in 2014. However, last July, the IRS announced that it is **postponing** its enforcement of the ***"excise tax"*** under the ***"Employer Mandate"*** provisions of ACA **until *2015.*** As we complete this letter, although subject to much controversy, the IRS says that it does not intend to postpone the effective date of the ***"Individual Mandate"*** excise tax or the availability of the ***"Premium Assistance Credit"*** beyond 2014.

State Insurance Exchanges/Marketplaces. A major component of *ACA's* expansion of health care coverage is the creation of the health insurance "exchanges" (also referred to as "marketplaces"). These insurance exchanges are critically important to the effective administration and enforcement of the tax provisions discussed in this letter. For example, the

refundable *"premium assistance credit"* (discussed below) is only available for insurance coverage purchased through the Federal exchange or a state exchange. However, as we go to press, the Federal website ***(www.healthcare.gov)*** used to apply for insurance through the Federal exchange has experienced a series of malfunctions. Federal officials have stated that the federal website will be fully operational by the end of November.

> **Planning Alert!** Once an individual applies for insurance through an exchange, coverage will not begin prior to January 1, 2014.

Excise Tax On Uninsured Individuals (The "Individual Mandate"). ***Starting in 2014,*** you may have to pay an excise tax with your individual income tax return (Form 1040) if you or your dependents are not covered by a ***"qualified health plan,"*** unless you or your dependents qualify for a ***specific exemption.*** Also, unless an exemption applies, if you are married and file a joint return, you could owe an excise tax if you**, your spouse,** or **your dependents** are not covered by a *"qualified health plan."* For example, if you and your spouse file a joint return and you each have qualified employer-provided health insurance, but your dependent child is not covered by either employer's plan, you could be liable for an excise tax because your child does not have health insurance coverage. Furthermore, the IRS says that you cannot avoid the excise tax simply by failing to claim the child as a dependent on your tax return. Consequently, to avoid this excise tax, an individual generally must either: **1)** have ***"qualified health plan"*** coverage, or **2)** qualify for a specific ***"exemption"*** from the tax.

- **"Qualified Health Plan" Coverage.** The excise tax ***does not apply*** for the period during which an individual has any of the following types of **"*qualified health plan"*** coverage: **1) Government Plans -** Includes *Medicare Part A, Medicaid, CHIP* (Children's Health Insurance Program), *TRICARE* for life, a program established by the Secretary of *Veterans Affairs*, a Non-appropriated Fund Health Benefits Program of the *Department of Defense*, and the government health plan for *Peace Corps* volunteers; **2) Eligible Employer Health Plans -** Includes any health insurance coverage under your employer's group health plan or group health insurance program (including COBRA coverage) that is either a governmental plan, any other plan or coverage offered in the small or large group market within a state, or *a "grandfathered employer health plan"* (as described below) offered in a group market; **3) Insurance Obtained From State Health Insurance Exchange -** Includes individual health insurance policies purchased from any of the state health insurance exchanges; **4) "Grandfathered Health Plans" -** Generally includes a group health plan that existed ***as of March 23, 2010*****,** that has not been modified since that date as to cause it to lose its "grandfathered" status; and **5) Other HHS-Approved Plans -** Includes ***state high risk pools*** and ***self-funded health coverage offered to students by colleges or universities*** for plan or policy years ***beginning before January 1, 2015*** (**Please note** that HHS may add other programs to this list in the future).

- **<u>Individuals "Exempt" From Excise Tax.</u>** Individuals who are ***not covered*** under a ***"qualified health plan"*** will generally be ***exempt*** from the excise tax if included in any of the following groups: **1)** Individuals in the U.S. illegally; **2)** Members of certain religious sects; **3)** Members of Federally-recognized Indian tribes; **4)** Incarcerated individuals; **5)** Certain U.S. Citizens living abroad; **6)** Individuals with household **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 for whom health insurance is "unaffordable" based on the individual's household income; and **9)** Individuals who obtain an economic *"hardship exemption certificate"* from a state exchange.

  <u>Planning Alert!</u> Item 7 above (the exemption from penalty for individuals without coverage for less than three months) should enable individuals to obtain qualified insurance coverage on or before March 31, 2014 and avoid the penalty for 2014, if the coverage is maintained for the remainder of the year.

- **<u>Amount Of Excise Tax.</u>** ***Beginning in 2014,*** an excise tax will apply for ***each month*** that you, your spouse, or your dependents do not have *"qualified health insurance"* coverage (and do not otherwise meet an exemption). Although the excise tax is determined on a monthly basis, the ***maximum excise tax*** for the ***entire 2014 tax year*** is the ***<u>greater of:</u>*** **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 **penalty cannot exceed the national average premium for "bronze" level health insurance** offered through the state insurance exchanges. Your *"household income"* for purposes of computing this excise 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.

  ••**Example.** Assume that for the ***entire 2014 year,*** Mary is an uninsured, single 30-year old professional who earned ***$71,000*** (also assume that this represents Mary's "*household income*"). Assume that the ***income filing threshold*** for a single taxpayer in 2014 ***is $11,000.*** If Mary does not have *"qualified health plan"* coverage 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., $71,000 less $11,000]). Therefore, Mary's ***penalty for the entire year of 2014 would be $600,*** provided the national average premium for "bronze" level health insurance for a single individual offered through the state insurance exchanges was at least $600.

  <u>Planning Alert!</u> The excise tax increases for ***2015,*** and increases again in ***2016.***

- **Reporting The Excise Tax.** Beginning with the 2014 tax year, the excise tax is reported on your income tax return (Form 1040).

  Planning Alert! Spouses filing a joint return are jointly liable for any excise tax on the joint return even if the penalty applies to only one spouse. You are also liable for the excise tax attributable to any person you are eligible to claim as a dependent. Interestingly, the IRS generally ***will not be allowed*** to collect the ***unpaid excise tax*** by using IRS ***liens or seizures.*** However, the IRS may offset any unpaid excise tax against an individual's tax refund.

- **Planning Observations.** ***Starting in 2014,*** you may be exposed to this excise tax if you, your spouse, or any individual who is eligible to be claimed as your dependent fails to have *"qualified health plan"* coverage. When exploring ways to avoid this excise tax, it's important that you consider the new ***"premium assistance credit"*** (discussed in the immediately following segment) when evaluating the ***"affordability"*** of *"qualified health plan"* coverage for 2014.

The Refundable "Premium Assistance Credit." As discussed above, a *"qualified health plan"* (for purposes of avoiding the excise tax) includes individual health insurance coverage purchased through the new ***state health insurance exchanges.*** To make health insurance more affordable and to encourage individuals to utilize the state health insurance exchanges, ***beginning in 2014,*** *ACA* provides for a tax credit (the ***"premium assistance credit"*** or ***"PAC"***) for eligible low-and-middle income individuals. The PAC is ***only available to individuals*** who purchase individual and family health insurance ***through a state exchange.*** The *PAC* 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 *PAC* will generally be paid ***in advance directly to the insurer.***

- **Who Qualifies For The "Premium Assistance Credit" (PAC)?** An individual *generally* qualifies for the *"premium assistance credit"* (PAC) ***only if*** the individual's ***"household income"*** is ***at least 100%*** and ***not more than 400%*** of the Federal Poverty Line (FPL) for the individual's family size. ***For example,*** using the 2013 FPL, a family of four could qualify for some *PAC* ***up to $94,200 of household income!*** For purposes of the ***"premium assistance credit,"*** 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. For example, tax-free social security benefits, tax-exempt interest, and the foreign earned income exclusion are ***added back*** to your ***adjusted gross income in determining "household income."***

Tax Tip. If you otherwise qualify, you are allowed the *PAC* for health insurance purchased through a state exchange for yourself or your *"family"* (i.e., your spouse and anyone you properly claim as a dependent).

••**PAC Not Allowed To Certain Individuals.** An otherwise qualifying individual will ***not qualify for the PAC*** if the person is married and files a separate return (i.e., married individuals must file a joint return to qualify for the *PAC*). Also, a person who is "eligible" to be claimed as a dependent of another individual will not qualify. In addition, the *PAC* is ***generally not available*** to the extent it is attributable to health insurance purchased through a state exchange for a person who is ***"eligible"*** for qualifying health care coverage available through programs other than the state exchanges. For example, a person who is ***"eligible"*** to enroll in Medicare or Medicaid ***will not qualify*** for the *PAC*, even if the person purchases health insurance through the state exchange. Moreover, an individual who is ***"eligible"*** for coverage in his or her employer's *"eligible employer health plan"* generally does not qualify for the *PAC*.

Tax Tip. If an employee is ***"eligible"*** to enroll in his or her employer's *"eligible employer health plan,"* but enrolls instead in the state health insurance exchange, the employee may still qualify for the *PAC* if the employer's health plan fails to satisfy certain technical ***"affordability"*** requirements or ***"minimum value"*** tests. The insurance exchanges are supposed to determine whether a person qualifies for the *PAC* as part of the health insurance application process.

- **How The Premium Assistance Credit (PAC) Is Computed And Paid.** The *PAC* is computed based on a qualifying individual's ***"household income"*** in relation to the ***"Federal poverty line"*** **(FPL).** The amount of the *PAC* is ***reduced*** on a sliding scale as an individual's *"household income"* ***increases*** from 100% to 400% of the FPL. If you otherwise qualify, the IRS will generally pay your *PAC* (as an ***"advance payment"***) *directly to* your health insurance company as a partial premium payment, and you will personally pay the remaining portion of your premium. Your eligibility for the *PAC* and the amount of your PAC *advance payment* are to be determined as part of the evaluation process when you apply for health insurance coverage through your state's exchange.

Tax Tip. Several health care providers have developed on-line interactive calculators for estimating the amount (if any) of your *PAC* based on your ***projected "household income" for 2014.*** For example, the Kaiser Family Foundation has an interactive online calculator at www.kff.org which you can use to estimate your *PAC*.

- **How The PAC Is Reported On Your Income Tax Return.** If you qualify for ***"advance payments"*** of the *PAC,* you ***must file*** an income tax return for the year the *"advance payments"* were paid to the health insurance carrier. On the return, you will be required to reconcile: **1)** the amount of the ***"actual"*** *PAC* based on your ***actual*** *"household income"* from the current tax year's information, with **2)** the amount of your ***"advance payments"*** (which

were determined based upon your *"household income"* as ***"projected"*** by the state exchange). The reconciliation will be reflected on your income tax return for the taxable year of the *PAC* (presumably the IRS will develop a new form for this reconciliation). If your ***"actual"*** PAC for the current taxable year ***exceeds*** the *"advance payments"* made to the insurance company, the excess is treated as a "refundable" credit (i.e., to the extent the credit exceeds the taxes that you would otherwise owe without the credit, the IRS will actually send you a check for the excess). On the other hand, if your *"advance payments*" for the taxable year exceed your ***"actual"*** *PAC* (based on your current year *"household income"*), you will generally owe the excess as an ***"additional income tax liability."*** In this latter situation, there may be a dollar cap on the "additional income tax liability," depending on your *"household income"* for the current year.

> **Planning Alert!** An individual, who otherwise qualifies, ***may elect out*** of the ***"advance payments,"*** and personally pay the ***entire premium*** to the health insurance company. If this election is made, the individual computes and receives benefit for the *PAC* when the individual files his or her income tax return for the year.

NON-LEGISLATIVE DEVELOPMENTS

IRS Issues Simplified Safe Harbor For Computing Home Office Deduction. Qualifying for home office deductions (e.g., depreciation, insurance, utilities, repairs and maintenance) is often tricky. To qualify, your home office must be used ***"regularly and exclusively"*** as your ***"principal place of business."*** For example, your home office will be deemed your ***principal place of business*** if you use the office to perform ***management or administrative duties*** for your business ***and*** there is ***no other fixed location*** where you perform substantial management or administrative duties for your business. If you are an "employee" (as opposed to being self employed), in addition to meeting these requirements, you must also establish that your home office is ***"for the convenience of your employer"*** (this generally means you're not provided an office at work). Moreover, assuming you qualify for the home office deduction, you must reasonably allocate costs related to your entire home (e.g., interest, property tax, utilities, insurance, and depreciation) to the home office portion. In some situations, this allocation involves time-consuming record-keeping.

- **IRS Releases Computational Safe Harbor.** Starting in 2013, the IRS will allow a person who has a qualifying home office to elect to compute certain home office expenses using the following formula: $5.00 times the home office's actual square footage (not to exceed 300 square feet). Thus, the maximum deduction under this formula is $1,500 (300 square feet x $5.00). If you elect to use this safe harbor, you must forgo the following "actual" expenses otherwise allocable to your home office: depreciation, maintenance, home insurance, and utilities.

> **Tax Tip.** To determine whether this computational safe harbor will save you overall taxes, in most cases we will need to compute your home office deductions under both the regular "actual cost" method and the new "safe-harbor" method, and choose the method producing the greatest tax benefit.

Tax Court Shoots Down Self-Directed IRA Where IRA Owner Guaranteed Corporate Debt. 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 any IRA engages in a prohibited transaction, the entire IRA loses its tax-deferred status and the entire IRA balance is taxed to the holder as a taxable distribution, which may also trigger a 10% early distribution penalty. A "prohibited transaction" includes any direct or indirect lending of money between the IRA and the IRA owner.

- **Tax Court Finds "Indirect" Loan Disqualifies IRA.** In this case, the owner of a self-directed IRA personally guaranteed a loan to a corporation owned by the IRA. The Tax Court concluded that the owner's loan guarantee was a "prohibited transaction" because it represented an "indirect" lending of money between the IRA owner and the IRA. As a result, the self-directed IRA ceased to be tax exempt, and the owner was fully taxed on the sale of a business owned by the IRA.

  Practice Alert! This case illustrates that it is critically important for owners of self-directed IRAs to seek independent consultation from reputable tax advisors before the IRA engages in any investment that might violate the "prohibited transaction" rules. This is particularly important if the IRA plans to fund any portion of the investment with debt financing.

IRS Becoming More Aggressive With Taxpayers Classifying Themselves As "Qualified Real Estate Professionals." Generally, any losses from renting real estate, where the average period rented is more than seven days, are deemed for tax purposes to be "passive" losses. Passive activity losses (PALs) are generally suspended, and are not allowed unless and until you have qualifying "passive" income to offset the losses. 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). 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 property 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 have multiple rental properties, this election is often necessary for you to qualify as a *QREP* and also to meet the required "material participation" tests.

- **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 he or she 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 did not allow "after-the-fact ballpark estimates." To minimize exposure to IRS attacks, individuals who must qualify as a QREP in order to deduct their rental real estate losses should contemporaneously document their hours spent on real estate activities (e.g., by recording their hours in a daily or weekly calendar).

> **Planning Alert!** As discussed previously in this letter, rental income is generally subject to the new 3.8% tax on "net investment income." It is possible, however, that an individual who is properly classified as a QREP may be able to avoid the 3.8% tax on certain real estate rental income. Please contact our firm if you would like more information.

IRS Continues Attacks On Charitable Contribution Deductions. Over the past two years, there has been an increase in the number of court cases dealing with charitable contribution deductions. In 2013 alone, there have been over a dozen court cases on charitable contributions, and it has been reported that the IRS has over 200 cases currently docketed with the courts on this issue. The IRS is litigating various aspects of the charitable contribution deduction, including: **1)** ***conservation easements*** (e.g., valuation and documentation issues); **2)** requisite ***donative intent*** of the contributor (e.g., did the taxpayer receive a disqualifying benefit from the charity?); and, **3)** strict compliance with the ***substantiation requirements*** (i.e., the receipt rules).

> **Planning Alert!** Whether you are contributing property or cash, the easiest and most effective way for the IRS to disallow your charitable contribution deduction is to discover that you failed to strictly comply with the technical documentation rules for the contribution. For example, regardless of the size or type of your charitable contribution, your deduction will be denied if it is $250 or more and you fail to receive a ***qualifying written receipt*** from the charity ***by the time*** you file your return (provided that you received the receipt no later than the due date of your return). 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. Furthermore, 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 non-publicly trade stock valued at $10,000 or less. Moreover, if you are claiming a deduction of more than $500 for a vehicle, a boat, or an airplane 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.

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.

IRS Issues Ruling Addressing "Same-Sex" Marriages For Tax Purposes. Last June, in a landmark decision (Windsor), the U.S. Supreme Court held that ***Section 3 of the Defense of Marriage Act (DOMA),*** which ***required same-sex spouses to be treated as unmarried*** for purposes of federal law, was ***unconstitutional.*** The Court applied its ruling to "lawful marriages," essentially leaving it to the IRS to define "lawful marriages" for same-sex couples for Federal tax purposes. In response to the *Windsor* decision, the IRS recently ruled that: **1)** it will ***recognize as married for Federal tax purposes*** same-sex couples who were married in a state, the District of Columbia, a U.S. territory, or a foreign country that authorizes "same-sex" marriages, **regardless of the couple's current domicile** (i.e., "state of celebration" rule), but **2)** it will ***not recognize as married for Federal tax purposes*** same-sex or opposite-sex couples who have entered into a *registered domestic partnership*, *civil union*, or other *similar formal relationship* recognized under state law ***"that is not denominated as a marriage under the laws of that state."***

Practice Alert! Under this ruling, legally-married same-sex couples will be treated as married for all Federal tax purposes**, including for income, gift and estate tax purposes.**

- **Filing Current Or Amended Returns.** The IRS says that legally-married, same-sex couples who file an ***"original"*** income tax return ***after September 15, 2013*** must file as married filing jointly or married filing separately. If a legally-married, same-sex couple filed an ***"original"*** income tax return ***before September 16, 2013,*** the couple may choose (but is not required) to amend the return (generally by filing Form 1040X) and use married filing jointly or married filing separately status, assuming the statute of limitations for amending the return has not expired. The IRS also says that a same-sex spouse may file a **refund claim** for **gift or estate taxes** by filing **Form 843** ("Claim for Refund and Request for Abatement"). A taxpayer generally may file an amended return or other claim for refund within three years from the date the return was filed or two years from the date the tax was paid, whichever is later.

- **Other Tax-Related Matters.** This IRS ruling applies to all Federal tax provisions where marriage is a factor – not just filing status. For example, legally-married, same-sex couples will be treated as married for purposes of claiming personal and dependency exemptions, taking the standard deduction, tax-free employee fringe benefits applicable to spouses, contributions to an IRA, distributions from an IRA (e.g., spousal rollovers), and claiming the earned income tax credit or child tax credit.

Planning Alert! Several of these tax provisions could entitle a same-sex spouse to a tax refund for previous "open" years. The IRS is currently in the process of developing and releasing guidance regarding steps we should take to seek such a refund.

DEVELOPMENTS IMPACTING PRIMARILY BUSINESSES

AMERICAN TAX RELIEF ACT ("ATRA") OF 2012

As mentioned previously in this letter, the ***American Tax Relief Act (ATRA) of 2012*** increased the highest income tax rate for individuals, trusts, and estates. However, ATRA did not change the general tax rates on regular "C" corporations. The top statutory "regular" corporate income tax rate remains at 35%. However, for ***tax years beginning after 2012,*** *ATRA* did permanently increase the *accumulated earnings* and *personal holding company* tax rates ***from 15% to 20%***.

> **Planning Alert!** Probably the most significant tax impact *of ATRA* on businesses is its temporary extension of a series of popular business tax breaks some of which are discussed below.

Selected* "Business" Tax Breaks Extended Through 2013.** *ATRA* ***retroactively extended ***through 2013*** the following tax breaks for ***businesses*** that had expired or had been reduced after 2011 or 2012: **1)** 15-year (instead of 39-year) depreciation period for "qualified" leasehold improvements, restaurant property, and retail improvement property; **2)** 7-year depreciation period for certain motor sports racetrack property; **3)** research and development credit; **4)** employer differential wage credit for payments to military personnel; **5)** favorable S corporation charitable contribution provisions involving capital gain property; **6)** temporary exclusion of 100% of gain on the sale of certain small business stock for both regular tax and AMT purposes; **7)** a host of tax benefits for qualified energy-efficient expenditures, and for qualifying investments in empowerment zones; **8)** 5-year (instead of 10-year) *recognition period* for S corporation built-in gains tax; **9)** election for C corporations to exchange bonus depreciation for refundable AMT credits; **10)** parity between employer-provided parking and employee transportation fringe benefits; and **11)** enhanced charitable contribution rules for qualifying business entities contributing food inventory

> **Caution!** Enhanced contribution rules for businesses contributing computer equipment and books ***expired after 2011 and were not extended). In addition,*** the following business tax breaks were extended ***through 2013:***

Work Opportunity Tax Credit Extended Retroactively Through 2013. Over the last two decades, many employers have taken advantage of the Work Opportunity Tax Credit (WOTC) for hiring workers from certain disadvantaged groups. The WOTC expired for certain qualifying employees hired after 2011. In addition, the WOTC for qualifying veterans expired after 2012. *ATRA* reinstated the WOTC retroactively for all qualifying individuals ***hired through 2013.***

- **Tax Tip.** To encourage employers to hire more military veterans, in late 2011, Congress added an expanded ***"qualified veteran"*** category to the types of employees that qualify for WOTC. Depending on the "tax" classification of the *"qualified veteran,"* the maximum credit runs from $2,400 to $9,600, provided the *qualified veteran* is hired ***before 2014.*** In addition, unlike

previous WOTC credits, tax-exempt employers (other than government agencies) that hire *"qualified veterans"* ***before 2014,*** may receive a *"refundable"* credit of 65% of the credit allowed for taxable employers.

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

50% First-Year 168(k) Depreciation Deduction Extended Through 2013. The 50% first-year 168(k) depreciation deduction for *qualifying* "new" business property previously expired for property placed-in-service after 2012 (after 2013 for certain long-production-period property and qualifying noncommercial aircraft). *ATRA* extended the 50% 168 (k) deductions for qualifying property placed-in-service ***through December 31, 2013*** (through 2014 for certain long-production-period property and qualifying noncommercial aircraft).

- **Qualifying 50% 168(k) Bonus Depreciation Property.** Generally, property qualifies for the 50% 168(k) bonus depreciation deduction if it is purchased *new* and it is either a "qualified leasehold improvement," or it has a depreciable life for tax purposes of *20 years or less* (e.g., machinery and equipment, furniture and fixtures, cars and light general purpose trucks, sidewalks, roads, landscaping, depreciable computer software, farm buildings, and qualified motor fuels facilities).

  Planning Alert! These are only examples of qualifying property. If you have a question about property not listed, call us and we will help you determine if it qualifies.

  Caution! "Qualified restaurant property" and "qualified retail improvement property" (described in the section 179 discussion below) do not qualify for the §168(k) deduction unless the property also constitutes a "qualified leasehold improvement."

- **168(k) Bonus Depreciation for Passenger Automobiles, Trucks, And SUVs.** The maximum annual depreciation deduction (including the section 179 deduction) for most *business automobiles* is capped at certain dollar amounts. For a business auto first placed-in-service in **calendar year 2013 and used 100% for business purposes,** the maximum first-year depreciation deduction is generally capped at $3,160 ($3,360 for trucks and vans not weighing over 6,000 lbs.) However, Congress previously increased the first-year depreciation cap by $8,000 for 2008 through 2012 for new vehicles otherwise qualifying for the 168(k) depreciation deduction. *ATRA* extended this $8,000 increase in the first-year depreciation deduction limitation to qualifying new vehicles placed-in-service ***through December 31, 2013.***

Expanded Section 179 Deduction Extended Through 2013. For the last several years, Congress has increased the maximum section 179 up-front deduction for the cost of qualifying new or used depreciable business property (e.g., business equipment, computers, etc.). For property placed-in-service in tax years beginning in 2010 and 2011, the section 179 cap was increased from $250,000 to $500,000, and the phase-out threshold for the section 179 deduction was also increased from $800,000 to $2,000,000. In addition, for tax years beginning in 2010 and 2011, a taxpayer could elect for up to $250,000 of "qualified real property" (discussed below) to be section 179 property. ***ATRA retroactively extended all of these enhanced section 179 provisions*** (i.e., $500,000 section 179 cap; up to $250,000 section 179 deduction for "qualified real property;" and the $2,000,000 phase-out threshold) for qualifying property placed-in-service in ***tax years beginning in 2012 or 2013.***

- **"Electing" To Treat Up To $250,000 Of *"Qualified Real Property"* As Section 179 Property.** Traditionally, the up-front section 179 deduction was only allowed for depreciable, tangible, "personal" property, such as equipment, computers, vehicles, etc. However, taxpayers may "elect" to treat up to $250,000 of "qualified *real* property" as §179 property, provided the property is **placed-in-service in tax years beginning in 2010 through 2013.** "Qualified Real Property" includes property within any of the following three categories: **1) Qualified Leasehold Improvement Property** (generally capital improvements to the interior portion of certain leased buildings more than 3 years old that are used for nonresidential commercial purposes); **2) Qualified Retail Improvement Property** (generally capital improvements made to certain buildings more than 3 years old which are open to the general public for the sale of tangible personal property); and **3) Qualified Restaurant Property** (generally capital expenditures for the improvement, purchase, or construction of a building, if more than 50% of the building's square footage is devoted to the preparation of, and seating for, the on-premises consumption of prepared meals).

  Planning Alert! The $500,000 overall section 179 deduction limitation is reduced by any section 179 deduction taken for *qualified real property.*

Miscellaneous Tax Changes Under ATRA. *ATRA* contains several other miscellaneous tax changes including:

- **Expanded In-Plan Roth Conversions.** Effective for ***transfers after 2012,*** *ATRA* provides that an employer-sponsored qualified retirement plan (e.g., 401(k) plan, 403(b) annuity plan, or 457 plan) that includes a qualified Roth contribution program may allow a participant to transfer an amount to a designated Roth account maintained under the same plan, ***even though the transferred amount is not otherwise distributable under the plan.*** The conversion of the otherwise taxable amounts into a Roth account is fully taxable.

- **Special Rule for Long-Term Contractors.** Generally, taxpayers that report taxable income on long-term contracts using the "percentage of completion method" of accounting must recognize (on an annual basis) a percentage of the estimated revenue from the contract based

on a completion percentage. The *completion percentage* is determined by comparing the costs allocated to the contract through the end of the current tax year, as a percentage of the estimated total costs under the contract. Thus, a taxpayer who deducts 168(k) depreciation on property used in long-term contract projects that are reporting income using the *percentage of completion* method, would normally be required to report more income from the contract for the year the 168(k) depreciation deduction is taken. *ATRA* provides that, ***for property placed-in-service in 2013 that has a depreciable life of 7 years or less,*** income reported under the "percentage of completion" method is determined ***without taking into account the 168(k) depreciation deduction.***

AFFORDABLE CARE ACT (ACA) DEVELOPMENTS

IRS Delays Effective Date of Employer Mandate Excise Tax And Certain Health Insurance Information Reporting. ***ACA*** generally provides that ***"applicable large employers"*** (using a 50-employee threshold test) must offer an ***"eligible employer health plan"*** to its full-time employees, or face a ***nondeductible excise tax*** (the so-called *play-or-pay* penalty) **if at least one of its full-time employees** obtains insurance on the exchange and **receives a premium assistance credit.** Although *ACA* states that this provision becomes effective in 2014, last summer the ***IRS announced that it will not impose this excise tax on employers until 2015.*** The IRS also says that it will delay, ***from 2014 to 2015,*** the *ACA* requirement that employers must provide certain annual health insurance information to the IRS and to their employees.

> **Note!** This delay essentially gives employers an additional year to prepare for the health care mandate imposed by *ACA*.
>
> **Planning Alert!** The employer ***"excise tax"*** for failure to offer an *"eligible employer health plan"* to employees applies only to *"applicable large employers*." An ***"applicable large employer"*** is generally an employer that employed **on average** 50 or more employees (determined by adding together the number of "full-time employees" and the "full-time equivalent employees") during each month of the entire ***preceding calendar year***. Under this rule, an employer would be classified as an "*applicable large employer"* for ***2015*** (i.e., the first year the IRS will enforce the employer mandate excise tax) if it employed a **monthly average** of at least 50 employees *("full-time employees"* plus *"full-time equivalent employees"*) during the ***entire 2014 calendar year.*** The IRS has released extensive technical guidance on how to determine whether an employer meets this 50-employee threshold. Please call our firm if you need additional details.

OTHER SELECTED NON-LEGISLATIVE DEVELOPMENTS

IRS Issues Final Repair vs. Capitalization Regulations. One of the most significant "tax" issues confronting business taxpayers is whether they must capitalize or deduct (as a current "expense") expenditures for acquiring, maintaining, or repairing "tangible" business property (e.g., equipment, vehicles, buildings, supplies, etc.). For example, let's assume that a storm damaged the

roof of your commercial building costing you $50,000 to bring the roof back to its pre-damaged condition. If you are allowed to treat the expenditure as a *repair*, you could deduct the entire $50,000 immediately. By contrast, if you are required to *capitalize* the expenditure as an "improvement" to the building, you would be required to deduct the $50,000 over the depreciable life provided for a commercial building (i.e., over 39 years). Virtually every business, large and small, eventually confronts this "repair" vs. "capitalization" issue.

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

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

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

In the meantime, if you need more information, feel free to call us.

IRS Releases New Expanded Procedure For Obtaining Automatic Relief (Without IRS User Fee) For Certain "Late" Elections Applicable To "S" Corporations. Generally, if owners of a qualifying business entity decide they want the business to be taxed as an "S" corporation, they must file a properly-completed "S" election (IRS Form 2553) with the IRS, no later than the 15th day of the third month following the desired effective date of the "S" election. In addition, there are additional "time-sensitive" elections that certain "S" corporations must make in order to maintain their "S" status. For example, trusts generally may not own stock of an "S" corporation. However, certain types of trusts that make a timely election are allowed to own "S" corporation stock.

> **Planning Alert!** Subject to certain exceptions, a qualifying business entity that cannot or did not comply with the filing deadline for an "S" corporation election must file a formal request with the IRS (by means of a private letter request or PLR) asking for an extension of the filing deadline. Unfortunately, the IRS generally requires the taxpayer to pay a significant "user fee" in order to apply for a PLR. Furthermore, there is no guarantee that the IRS will approve the extension.

- **IRS Provides Safe Harbors For Requesting Certain Late "S" Corporation Elections Without A User Fee.** The IRS recently released a comprehensive procedure for taxpayers to seek expedited relief from the IRS for late S corporation elections. If a taxpayer satisfies the requirements of this new procedure, the IRS will ***automatically grant*** relief ***without charging a user fee.*** For example, if a business entity has satisfied certain conditions required by the new IRS procedure, the IRS will allow the entity to make an election to be an "S" corporation up to 3 years and 75 days after the desired effective date of the "S" election, without having to pay an IRS user fee.

> **Planning Alert!** Very specific conditions must be satisfied to qualify for relief under this procedure. For example, the corporation must represent that it intended to be an S corporation as of the requested effective date of the S election and the shareholders of the S corporation must have reported their income from the corporation consistent with S corporation status for the year the S Corporation election should have been made and for every subsequent taxable year. If you think that your business entity might benefit from this new IRS procedure and you need more details, feel free to contact this firm.

Tax Court Analyzes Whether Limited Liability Company (LLC) Owner Is Subject To S/E Tax. "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" they 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 a case reported in early 2011, the Tax

Court held that owners of a law firm operating as a "limited liability partnership" (LLP) should be treated as "general" (not "limited") partners and, therefore, should be subject to S/E tax on all pass-through business income from the LLP (whether or not distributed). The Court generally concluded that an owner of an LLP qualifies for the "limited partner" exception to S/E taxes only if the LLP owner is a ***"mere investor"*** who does not ***"actively participate"*** in the business operations of the LLP. Since the lawyers in that case were not *mere investors* and *actively participated* in the firm's law practice, the Court imposed S/E tax on their business income from the LLP.

- **Recent Case Suggests Tax Court Will Apply Same Test To LLCs.** In a case released in late 2012, the Tax Court analyzed whether an owner of a Limited Liability Company (LLC) was subject to S/E tax. In its analysis, the Court seemed to apply to the LLC owner the same standard it applied to the LLP owner in the earlier case. That is, in this latter case, the Tax Court suggested that an LLC owner would qualify for the "limited partner" exception to S/E tax only if the owner is a ***"mere investor"*** who does not ***"actively participate"*** in the business operations of the LLC.

  Observation! Despite these two cases, 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. However, it appears that the Tax Court will generally use the same analysis for owners of LLPs and LLCs.

IRS Confirms That Each S Corporation Member Of A Controlled Group Of Corporations Is Entitled To The Maximum Allowable Section 179 Deduction. Subject to certain maximum dollar caps, a taxpayer is allowed an up-front section 179 deduction for the cost of qualifying new or used depreciable business property (e.g., business equipment, computers, etc.). As discussed previously in this letter, for qualifying property placed-in-service in tax years beginning in ***2010 through 2013,*** the maximum section 179 deduction is $500,000, and this $500,000 cap begins phasing out once the taxpayer's total purchases of section 179 property for the year exceed $2 million. Therefore, ***each*** corporation generally applies the $500,000/$2,000,000 limitations to its own return in determining how much section 179 deduction it can take. However, if shareholders of multiple corporations have certain levels of overlapping ownership in a group of corporations (referred to as a "controlled group" of corporations), the entire "controlled group" of corporations is limited to a ***single*** $500,000 cap and ***single*** $2 million phase-out threshold.

> **Good News!** The IRS has recently confirmed that this "controlled group" rule ***does not apply*** to S corporations. Therefore, ***each S corporation*** is ***entitled to a full $500,000 limitation amount and $2 million phase out threshold*** **amount** under section 179 even where the S corporation is a member of a "controlled group" of corporations.

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 these items discussed may apply to a specific situation.

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