Changing Tax Laws Affecting You and Your Business

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– TOPICS –

Individual Taxes • Business Taxes • 3.8% Medicare Tax • Alternative Minimum Tax (AMT)

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Weighing the Impact of the Individual Tax Rate Increases on Business Owners

by Sean Kelly, CPA, Tax Partner, Hein & Associates LLP

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Government figures currently estimate that 95 percent of all businesses in the U.S. are structured as flow-through entities (LLCs, Partnerships and S Corporations). In addition, over 60 percent of all businesses that make more than $1 million of profits are also structured as flow-through entities. In Orange County, where entrepreneurs and middle-market companies dominate our local economy, the percentage is likely higher.

Under federal tax law, flow-through entities don't pay income taxes. Instead, the business income is allocated among the owners and the income taxes are levied against the individual owners. As you can imagine, the increase in individual income tax rates will have an impact on U.S. businesses and therefore we feel that it is important to review the provisions of the American Taxpayer Relief Act related to the increases in the individual tax rates.

Tax Rate Increase

The American Taxpayer Relief Act permanently extends the Bush-era income tax rates for all taxpayers except for taxpayers with taxable income above certain thresholds. The Tax Act creates a new tax bracket for single individuals of $400,000 and a married couple filing a joint return of $450,000. Taxpayers that fall into the new bracket will see their marginal income tax rate increase from 35 percent to 39.6 percent on their ordinary income and from 15 percent to 20 percent on their long-term capital gains and qualified dividends. In addition, there were a number of other tax law changes that we will see in 2013; however, we will only be addressing the increase in the individual tax rates. Please talk with your tax advisor to get a complete list of the 2013 tax law changes.

Strategies

So what can business owners and high wage earners do to mitigate the impact of the rate increases? The goal is to reduce income as much as possible in the higher tax brackets. Some of the strategies you may want to discuss with your tax advisor are:

- Convert your business entity to a C corporation (not a flow-through entity)
- Max-out your retirement plan contribution
- Implement a Deferred Compensation Plan
- Accelerate losses and defer gains
- Invest in municipal bonds
- Set up a captive insurance company

Critical Planning Opportunity

There is still a planning opportunity if you sold your business in 2012. A number of business owners raced to sell their business in 2012 prior to the capital gain tax rate increase. A typical sales structure requires that the seller take back a note or accept an earn-out. A specific tax treatment allows the seller to defer gain until the payment is made in the future. This is called an installment sale. However, since the capital gain tax rates increased in 2013, it may be more advantageous to elect out of installment sale treatment and recognize the entire gain in 2012. The election is made with your 2012 tax return.

Looking Ahead

The American Taxpayer Relief Act is not the grand bargain as envisioned by the President and many lawmakers after the November elections. Instead, it's a stop-gap measure to prevent the expiration of the Bush-era tax cuts from falling on the middle income taxpayers. Congress must still address sequestration and it is likely to revisit tax policy and spending cuts as soon as next month. Unfortunately, this means that business owners may find themselves peering over the "Fiscal Cliff" again soon.

Sean Kelly

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Does Washington Want to Ruin You? Yes—But, so what?

by Don Dahl, Tax Partner, KSJG

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Fiscal Cliff Fallout — You've most certainly heard about the new fiscal cliff tax Act that has the words "taxpayer relief" in the title. You'd think this would mean the laws contained within it would be positive. Let's just be blunt — they're not. But calm your heart palpitations. There are things you can do right now. And definitely don't wait till the year is nearly gone to react to the changes. At that point, it'll be too late. Be proactive from the beginning, because by understanding all the caveats of the laws and working with a skilled advisor, there are issues that can be solved with planning and proactive, smart tactics.

Here's the scoop. On the first day of 2013, Congress rang in the year by passing the American Taxpayer Relief Act of 2012 (HR 8). Thanks, Congress (sarcasm). Without delay, Obama signed the Act the next day. The Act forces upon us some major changes. The effects already start this tax year, such as a federal income tax rate of 39.6 percent for taxable income above $400,000 ($450,000 for joint filers). Also, the 2 percent payroll "tax holiday" expires, and the Medicare contribution hikes begin, meaning a reduction in take-home pay for everyone. This Act creates important planning challenges and opportunities for you — as an individual and business. Let's cover the business side.

Top Five Changes for Business
For business, it's not all bad news. Let's get into the nitty-gritty.

1. Enhanced Expensing — The Act gave us a nice boost for 2013 tax year (and is retroactive for 2012), increasing expensing levels to $500K (previously $125K) with a new max of $2 million. Meaning, a business can deduct 100 percent of the purchase price of qualified financed or leased equipment (new or used) and software of up to $500K in each year. This means qualifying purchases you made in 2012 and make in 2013 qualify for the new, higher deduction limits. If you've been considering new items for your business, 2013 is the year to get them.

2. Bonus Depreciation — The Act added a one-time 50 percent "Bonus Depreciation" on equipment that exceeds the deduction limit for qualified depreciable property placed in service in 2013. Bonus Depreciation is useful if you're spending more than $560K on new capital equipment. Note — the Bonus Depreciation covers new equipment only and no software. Also, businesses with a net loss in 2013 qualify to carry-forward the bonus to a future year. Take advantage of this bonus this year, as it may be gone next year.

3. Retroactive Extensions — The Act extends the Research Tax Credit through 2013, which rewards those with a tax credit who do qualified research activities (to design, develop, or improve products, processes, techniques, formulas, or software). Also, the Work Opportunity Tax Credit has been extended. It rewards employers hiring individuals from certain groups with a tax credit. FYI — like the perks above, the credits are not permanent, so take advantage in this tax year.

4. Shortened S-Corp Built-in Gain Period — Normally, for a period of 10 years after a C-corporation elects to be an S-corporation (the "Recognition Period"), any "net unrealized built-in gain" (NUBIG) of the sale of the corporation's assets as of the conversion date from a C-corp to S remain subject to tax at C-corp rates. After the recognition period expires, these gains would no longer be subject to C-corp rates. But now, the recognition period for sales of assets in 2012 and 2013 has been reduced to five years. After 2013, the previous 10-year recognition period will once again apply. What does this mean? Corporations subject to NUBIG may want to consider selling assets in 2013.

5. Increased Tax Rates — We're addressing business changes here, but the new higher individual tax rates greatly affect business owners. In addition, everyone in the state needs to consider the impact of California passing Proposition 30 which created retroactive tax increases back to January 1, 2012. But there are things you can do, including decreasing your taxable income with retirement account contributions, charitable gifts, trusts and many other strategies. Talk with your tax professional.

The tax world is erratic. It will continue to change — but change is opportunity. Remember, if you take a proactive vs. reactive approach to taxes, you can actively strategize with a good tax adviser and take advantage of the new laws so that you can minimize your current and future tax liabilities.

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The New 3.8% Medicare Tax on Investment Income

by Bradford L. Hall, CPA, Managing Director, Hall & Company CPAs

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January 1 of this year, Obamacare's (Patient Protection and Affordable Care Act) 3.8 percent Medicare Tax on the unearned income of "high income" individuals above certain thresholds went into effect. The purpose of this newly created tax is to help pay for the nation's healthcare costs. The tax is imposed on passive and unearned income such as capital gains, dividends, interest, annuities, royalties, rents, and all income from passive activity on individuals earning $200,000 or above and joint filers earnings $250,000 and above ($125,000 for married taxpayers filing separate returns). A couple is subject to this surtax starting at $250,000 of income whereas if they were single they would each have a $200,000 threshold or a total of $400,000 before this new tax would kick in. This is a whopping 60 percent increase in the threshold of two single taxpayers over a married couple. This new tax stretches widely over most types of portfolio income.

The new Internal Revenue Code Section 1411 defines and applies the 3.8 percent tax on unearned income for high-income individuals (listed above); in addition to a new 0.9 percent Medicare tax on earned income. The combination of these two new taxes is estimated to raise $317.7 billion over the next 10 years.

The surtax on individuals equals 3.8 percent of the lesser of 1) net investment income or 2) the excess if any of the individual's adjusted gross income (AGI) for the tax year over the threshold income levels listed above. One of our clients, a married couple, has salaries of $225,000 and about $90,000 of investment income and rental income. The extra 3.8 percent tax in 2013 is approximately $2,500. We are suggesting moving a portion of their investments into tax-free municipal bonds versus taxable bonds, in addition to raising their 401-K contributions so they can minimize this surtax.

Types of Income Excluded

Recently the IRS and Treasury issued proposed regulations which precisely define what is subject to the 3.8 percent tax. It does not include Social Security income, tax-exempt interest, retirement income, alimony, or any item taken into account in determining self-employment income for the tax year. Also excluded are distributions from pensions, profit-sharing plans, a 403(b) tax-sheltered annuity, any other kind of qualified annuity (held inside a retirement account), IRAs, Roth IRAs and 457(b) plans. However, be aware that the distribution from retirement plans might push one's AGI over the threshold to make the investment income subject to the surtax. Also, it excludes income from a trade or business in which the taxpayer actively works in. S corporation distributions escape both the 3.8 percent Medicare tax and the 0.9 percent Medicare tax on earned income as long as the taxpayer is an active participant in the business (if ownership is passive, all partnership, LLC or S corporation income would be classified as passive investment income and subject to the surtax). For example, a client who owns and operates nursing homes in a Florida S corporation but does not materially participate in the business will be subject to the Medicare surtax. Gain on a sale of a partnership, LLC or S Corporation interest in which there was a material participation by the taxpayer at the time of sale is not subject to the surtax.

Gains that are not recognized for income tax purposes in a particular year are not subject to the surtax, including: (1) installment sales (2) tax-free exchanges; (3) involuntary conversions; and (4) excludable gain ($250,000/$500,000) on the sale of principal residence.

One concern receiving a lot of attention lately has been the application of the 3.8 percent surtax on gains from the sale of a residence. Any capital gain that is otherwise subject to income tax on the sale of a principal residence would also be subject to the surtax.

Investing in life insurance is definitely an easy way to avoid the tax. All growth in a life policy is tax deferred if designed properly. Income withdrawn is not taxable as long as it does not exceed your investment. Any withdrawals beyond your investment can be taken out in the form of loans which are non-taxable. In addition, borrowing from a life insurance policy can help prevent being subjected to any income or Medicare surtax.

Proper Planning is Key

Net capital gains from investment accounts are perhaps the most common type of income subject to the surtax. In that regard, it is important to note that short-term or long-term gains are subject to the same 3.8 percent surtax, irrespective of the ordinary income rate applied to short term gains or the lower rate applied to long-term capital gain. Year end capital gain harvesting has never been more important given the recent increase in the capital gain rate plus this Medicare surtax.

Basically, anyone in these income levels should consider planning opportunities very carefully in order to minimize the impact of this new tax along with all the other recent changes in income taxes that have gone into effect.

For more information, please contact Bradford Hall, CPA at 949.910.4255 or bh@hallcpas.com.

Fixing the Individual Alternative Minimum Tax

by Bill Carter, Marcum LLP

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Nobody likes the April tax bill surprise.

For many American taxpayers' the April surprise has come by way of the Alternative Minimum Tax (AMT). AMT is a separate tax system that operates parallel to the regular income tax. All individual taxpayers are subject to the tax. Taxpayers compute both the regular income tax and AMT. If AMT is higher the difference is added to the regular income tax.

History

In 1969 outgoing Treasury Secretary Joseph Barr told Congress that 155 individuals with 1966 gross incomes of $200,000 ($1.4 million in 2012 dollars) or more paid no income tax. These and other high-income taxpayers used tax-exempt income and special deductions to avoid paying income tax. This created what Congress believed was an unfair distribution of the tax burden. Does that sound familiar?

The fix, included as part of the 1969 Tax Reform Act, was a new minimum tax. The idea being that virtually no individual with significant amounts of income should avoid paying some tax. This purpose would be achieved by broadening (more income is taxed) the minimum tax base. A lower tax rate would be applied to this broadened tax base. This minimum tax, which became the alternative minimum tax in 1982, has existed with many changes since 1969.

Computing AMT

The starting point for AMT is the taxpayers' adjusted gross income, which is before the deduction for personal exemptions. Thus, personal exemptions provide no benefit in the AMT computation. Next, certain deductions and tax preference items are added (or possibly subtracted). An exemption amount is subtracted from this total with a tax rate of 26 percent or 28 percent (if the amount is over $175,000) applied. If AMT is more than your regular income tax the excess is added to the tax bill. Surprise!

The most common deductions and preferences included in AMT are itemized state and local taxes (63 percent), personal exemptions (22 percent) and miscellaneous itemized deductions (11 percent). Some of the other items that may trigger AMT are mortgage interest on a refinance, incentive stock options, passive income or loss, accelerated depreciation, foreign tax credits and investment expenses.

Taxpayers living in states with relatively high state taxes are much more likely to be subject to AMT. California has one of the highest percentages of taxpayers subject to AMT.

The Patches

Over the last several years the number of taxpayers affected by AMT has increased dramatically. By 2010, over 4 million taxpayers were subject to AMT. This number would have been significantly higher had it not been for a series of patches or temporary fixes designed to correct flaws in the AMT. The AMT design flaws are:

- A low exemption amount
- An exemption amount not indexed to inflation
- The starting point of the 28 percent tax

The new AMT fix is for tax years beginning after December 31, 2011 – i.e., the 2012 tax year. If the 2012 tax year was not fixed, it has been estimated that over 32 million U.S. taxpayers would have had an April AMT surprise!

The American Taxpayer Relief Act of 2012

The American Taxpayer Relief Act provides a permanent AMT fix for 2012 by lifting the exemption amounts to $50,600 for individuals; $78,750 for married taxpayers filing jointly; and $39,375 for married taxpayers filing separately. These are increases from what the 2012 exemption amounts would have been, which were $33,750, $45,000 and $22,500, respectively. The new exemption amounts will be indexed for inflation for years after 2012. The act will also allow certain nonrefundable credits to off-set AMT.

Finally, some in Congress and at the White House have expressed interest in replacing the AMT system. It is possible that comprehensive tax reform could make these permanent AMT relief provision short lived.

Stay tuned and be sure to contact your tax advisor. They feel neglected when they don't hear from you.

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