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Tax Talk

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Inside this issue:

Dear Clients and Friends,

I am often asked for my predictions as to future tax legislation. My crystal ball is far from perfect (and attempting to predict tax legislation is a fool's errand), but, with that caveat, here are my quick thoughts on the subject.

Reduction in the corporate rate appears to be the top priority, as the current top Federal corporate rate (35%) is generally viewed as being uncompetitive globally. As a result of various deductions and credits, the actual effective rate (as a percentage of GAAP earnings) is generally much lower (average probably closer to 20%), but clearly the high marginal rate does encourage companies to attempt to relocate outside the U.S. or leave earnings parked offshore. There has been talk of reducing the corporate rate to as low as 15%; but 25% - 30% seems more realistic.

Most privately held companies in the U.S. are structured as flow-through entities. So if you cut the corporate rate, what do you do for flow-throughs (where tax is paid at the already higher individual rate)? And if you reduce the rate on pass-through business income, how do you avoid individuals attempting to structure all of their income as K-1 income in order to take advantage of the lower rate? All of this begs the question as to why can't we have a single rate on all types of income (as was the case following the Tax Reform Act of 1986).

If you cut the corporate rate (or rate on business income in general), how do you pay for it? The "border adjustment tax" is dead (and really was dead on arrival), and an increase in individual marginal rates seems out of the question at this time. That really leaves only two options: (1) you make the assumption that the economic growth that results from a tax rate cut will be sufficient to pay for the tax cut itself (due to higher incomes); or (2) you reduce deductions, exclusions or credits. The big "tax expenditures" (as deductions and exclusions are often referred to) are the exclusions for employer-provided health insurance and retirement plan contributions and deductions for mortgage interest, state and local taxes, and charitable donations. The exclusions for employer-provided health insurance and retirement plan contributions appear safe (although there has been some talk of "Rothification"), as does the deduction for charitable contributions. Complete repeal of the mortgage interest deduction appears highly unlikely, but conceivably it could be limited to primary residence only and the maximum mortgage amount reduced from the current $1,100,000 to maybe $500,000. Repeal of the deduction for state and local taxes is frequently talked about. This is a deduction that largely benefits residents of "blue states", which tend to elect Democrats, and with an elimination of this deduction repeal of the very unpopular alternative minimum tax would be much less costly. But there will undoubtedly be much pushback against any attempt to eliminate the deduction.

Kent Bridges, Managing Partner

Republicans have long pledged to repeal the estate tax; but with a current exemption of roughly $5.5 million per person (and portability between spouses which can effectively double this amount), repeal would only benefit (at least directly) the wealthy (while costing the government revenue), so there may not be enough support for this.

A lower tax rate on corporate earnings repatriated from abroad could be a revenue raiser, so it might have a chance. Taxation of "carried interest" as ordinary income is frequently talked about, and the question there may be whether to apply broadly or target narrowly at hedge fund managers.

Major tax reform is difficult. Ultimately, my guess is that we will see some slight temporary reduction in marginal rates, with no real revenue offsets, and that we will continue to kick the can down the road with respect to the deficit.

In this issue we will discuss the IRC 1202 qualifying small business stock exclusion, the importance of disclosing cost basis for noncash donations, LLCs and self-employment tax, multi-state taxation, the risks of an LLC making a check-the-box S election, and income tax planning as part of estate planning.

We hope that you will enjoy this issue and gain from it some useful information.

Sincerely,

Kent Bridges

A 0% Tax Rate on Gain from Sale of Qualified Small Business Stock?

Throughout the history of our income tax system, long-term capital gains have almost always enjoyed preferential treatment over ordinary income. But can you have a 0% tax on a significant gain?

IRC 1202 provides a special exclusion for income tax purposes for gain from certain sales of qualifying stock. The rules under IRC 1202 have varied over the years, but, in their current form, provide for a 100% exclusion (and no addback for alternative minimum tax purposes, as was required under an earlier version of the rules) if qualifying stock is held for more than 5 years before being sold (with the exclusion being limited to the greater of $10,000,000 or 10 times the amount invested in the stock). In order to qualify for the 100% exclusion, the stock must have been issued after September 27, 2010, and the issuing corporation must have been a domestic C-corp with total assets of $50 million or less and at least 80% of the corporation's assets must have been used in the active conduct of a "qualified business."

Many states (e.g. Georgia), but not all (e.g. Alabama) also recognize the exclusion, so you may avoid not only Federal tax, but also state tax. Further, the exclusion applies for purposes of the 3.8% Medicare tax on net investment income.

So, in light of the incredible potential tax savings from this exclusion, should all businesses be structured as C-corps (a requirement under IRC 1202)? The short answer is no. For many (perhaps most) businesses, the correct choice will still be a flow-through entity (LLC or S-corp). The choice requires a fact-specific analysis; and a bit of a crystal ball.

Be Sure to Include Cost Basis on Form 8283

Form 8283 (form for reporting noncash charitable donations) provides a space for the cost of property you are donating to charity. Since your deduction is generally based on the property's fair market value, and not your cost basis, does it really matter whether you provide the cost basis amount? According to a recent Tax Court decision (*RERI Holdings I*), failure to provide this information constitutes a failure to comply with the substantiation requirements and means forfeiture of the deduction.

It appears that the IRS plans to use the case as a basis for disallowance of conservation easement deductions in situations where the cost basis was not provided. Whether the IRS will take this position more broadly to apply to all noncash donations where the substantiation rules apply is yet to be seen. It should be noted that in the *RERI Holdings I* case the taxpayers were claiming a deduction of over $33,000,000 for property acquired less than two years earlier for less than $3,000,000.

LLC Members' K-1 Income and Self-Employment Tax

Tax rules which were enacted long before the LLC format came into existence provide that a general partner's K-1 ordinary business income is subject to self-employment tax, while a limited partner's K-1 income is not (except for "guaranteed payments"). So what about an LLC member? Should an LLC member be treated as a "general partner" or a "limited partner" for purposes of self-employment tax?

IRS regulations which were proposed in 1997, but which have never been finalized, provide that an LLC member will be subject to self-employment tax if:

1) He or she has personal liability for the debts of or claims against the LLC because he or she is a member of the LLC;
2) He or she has authority to contract on behalf of the LLC;
3) He or she participates in the LLC's business for more than 500 hours per year; or
4) Substantially all of the activities of the LLC involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.

As noted above, these proposed regulations have never been finalized, leaving this as an unresolved issue with taxpayers taking varying positions.

Over the past few years, we have had a number of court cases and IRS rulings (mostly unfavorable for the taxpayers) addressing this issue. Thus far in 2017, we have had at least two Tax Court cases addressing this; one favorable and one unfavorable.

In the *Hardy* case, the Tax Court found that a doctor who performed surgery at a surgery center owned by an LLC in which he was a member was not subject to self-employment tax on his share of the LLC's profit. Dr. Hardy had no management or day-to-day responsibilities at the surgery center, and his share of the income from the LLC was not tied to the surgeries he performed there.

In the *Castigliola* case, however, the Tax Court ruled that attorneys who were members of a Mississippi PLLC were subject to self-employment tax on not only their guaranteed payments (which were commensurate with local legal salaries), but also on their share of the net profit. It should be noted that Mississippi law (unlike Georgia law) does not permit a limited partner to materially participate in the business of a limited partnership without the risk of losing limited liability status, and also the attorneys in this case exercised management control over the LLC.

The quick takeaways from these recent cases are that if you do not materially participate in an LLC or have management control, then you probably have a good basis for avoiding self-employment tax, but if you are active in the business or have management control, then the IRS may successfully assert that you are subject to self-employment tax. Also, being in a state like Georgia (where limited partners are permitted to be active in a limited partnership) may help you distinguish your facts from those in the unfavorable cases.

Multi-State Taxation

Jacquelyn J. Brown, CPA

Our business clients often conduct business in multiple states, and our individual clients often work in more than one state, own real estate in multiple states, or have ownership in flow-through entities with income from other states. This article provides a brief overview of the general rules of multi-state taxation.

Individuals – Most states tax their residents on their worldwide income, while permitting them a credit for taxes paid to other states, so long as the effective rate paid to the other state does not exceed the effective rate paid to the state of residence on that same income. To the extent that you work in another state or have income from real estate in another state (e.g. rental income or gain from the sale of property) you may be subjected to that other state's income tax. Additionally, if you own an interest in an S-corp, LLC or partnership with income from other states, your income from that entity may be subject to other states' income tax.

Corporations – In addition to being subject to the income tax of their state of domicile, corporations are potentially subject to income tax in any other states with which they have "nexus". What constitutes taxable nexus varies by state, but companies will almost certainly have taxable nexus with any state in which they own property or maintain an office. Provision of services within a state will typically result in taxable nexus with that state, and licensing of intangibles within a state may also result in taxable nexus. Further, some states are beginning to assert "factor presence nexus", whereby a company may have nexus with a state solely by virtue of having a certain level of revenue from customers based in the state. Public Law 86-272 provides a limited safe harbor from state income taxation for companies that sell tangible personal property where the company's only physical contact with a state is in-state solicitation of orders which must be approved outside the state with shipment to occur from a point outside the state. Assuming a company has taxable nexus with a particular state, its income subject to tax in that state is generally determined by multiplying its overall taxable net income by an "apportionment" percentage. Historically, most states computed the apportionment percentage as the numerical average of three factors - property, payroll, and sales – computing the percentage of each of those factors within the state as compared to the amounts everywhere. In more recent years, many states have begun to move away from equally weighting these three factors to more heavily weighting the sales factor (in some cases using only the sales factor). This methodology tends to reward companies based in the state (who likely have a larger percentage of their property and payroll in the state compared to the percentage of their revenue derived within their home state) and punish companies based outside the state (which may have very little property or payroll within the state, but derive revenue from the state). Georgia is amongst the states to have moved in this direction.

Flow-through entities – Most states recognize the flow-through status of entities like partnerships, LLCs and S-corps. However, the individual owners of these entities are subject to the state's income tax on income from the entity, and many states require the entity to remit the income tax on behalf of its nonresident owners. Some states permit the entity to file a composite return on behalf of its nonresident owners, enabling the shareholders or partners to avoid the necessity of filing an individual return with the state. Some states also have entity level taxes that can apply.

Sales and use tax - Sales tax rules vary by state, but in general most states subject to the sales tax the sale or rental of tangible personal property. Many states, such as Georgia, exempt from the sales tax the sale of most services. While the tax is technically a tax on the buyer, the seller is generally obligated to collect and remit the tax. Since the tax is based on gross receipts, even an unprofitable company with minimal exposure to income tax can have substantial exposure for sales tax if it fails to properly collect and remit the tax. In addition to the sales tax, a business may also be liable for "use tax", to the extent that one of its vendors does not collect from it the sales tax on the sale to it of an item subject to the sales tax.

Property tax – In most states, real estate, business tangible personal property and certain personal use assets like automobiles, motorcycles and boats are subject to a tax on the value of the asset.

Payroll tax – If a company has employees providing services within a state (even though the employees may be resident of another state and providing services there only temporarily), then the company likely has an obligation to withhold that state's income tax and pay its payroll taxes.

Risks of an LLC Electing Subchapter S Status

Prior to 1997, if you wanted your business entity to be a Subchapter S corporation, you needed to first form a corporation, and then have it file an S election. Regulations issued in late 1996 provided a "check-the-box election" whereby LLCs (previously generally treated as partnerships for income tax purposes) could make a check-the-box election to be treated as a corporation for income tax purposes and simultaneously elect S status (by filing Form 2553).

We are increasingly seeing LLCs formed which immediately elect S status. While the check-the-box rules were designed to be taxpayer friendly, absent compelling reasons for doing so, if you wish to conduct business as an S-corp we generally recommend that you form a state law corporation rather than an LLC. In addition to the general confusion that results from having an LLC taxed as an S-corp, there is a very real risk of having an invalid S election due to disqualifying provisions in the LLC operating agreement.

An S-corporation can only have one class of stock, which means that all allocations of income or loss and distributions must be proportionate to ownership percentages. On the other hand, a typical LLC operating agreement permits (or in some situations may require, if the agreement defaults to IRC 704(b) regulations)

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Risks of an LLC Electing Subchapter S Status - continued

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allocations and distributions that are not proportionate to ownership, which would disqualify the LLC from S status and potentially result in the entity being treated as a C-corp; a potentially disastrous result. Unfortunately, we often find this to be the case when we review the operating agreement of an LLC which has elected S status.

If you have an LLC and are contemplating electing S status (or have already done so), you should review your operating agreement to make sure that it complies with the S-corp single class of stock requirement.

Income Tax Planning as Part of Estate Planning

With a Federal estate tax rate of up to 40%, the focus of estate planning (particularly with larger estates) is often on avoiding the estate tax by removing assets from the taxable estate. However, the potential income tax planning opportunities should not be overlooked.

The general rule is that assets included in the "taxable estate" enjoy a step-up in income tax basis to fair market value date of death. This is the case even if there is no estate tax due because of the exemption equivalent. Accordingly, for estates which are likely to be below the exemption equivalent (approximately $5.5 million per person, or up to $11 million for a married couple), the focus should generally be on taking advantage of the basis step-up; and even for larger estates consideration should be given to leaving in the taxable estate those assets for which basis step-up would be most advantageous. If a trust will be used for reasons other than estate tax minimization, then consideration should be given to using a testamentary power of appointment or qualified terminal interest property election in order to achieve basis step-up. In the case of appreciated property which is likely to be sold after the death of one of the spouses, consideration should be given to having that property owned by the spouse most likely to pass first.

Not all assets qualify for basis step-up. Items which are considered "income in respect of a decedent" (e.g. IRAs and installment notes) do not enjoy the basis step-up, and so may be a good choice for fulfilling charitable intentions.

Quick Notes

The IRS (Notice 2017-29) has extended to October 2, 2017 the due date for filing Form 8886 to disclose participation in a syndicated conservation easement for years prior to 2016.

The IRS (Rev. Proc. 2017-34) has extended to the later of January 2, 2018 or two years from date of death the due date for executors to make a "portability election" (election for surviving spouse to use deceased spouse's unused estate tax exemption) for persons dying after 2010.

Effective January 1, 2018, the Georgia net worth tax no longer applies to corporations with book net worth of $100,000 or less. Not much of a tax savings here ($100 or less), but this will enable small S-corps to avoid the hassle factor of making a Georgia tax payment.

Seattle has joined the short list of cities with an income tax by enacting a 2.25% tax on individual income over $240,000 and couples' income over $500,000. The tax is potentially not legal under Washington law, so expect a challenge.

Effective July 1, 2017, Illinois has increased the individual rate from 3.75% to 4.95% and the corporate rate from 5.25% to 7%.

The Tax Court has ruled that a hockey team (Boston Bruins) can deduct 100% of the cost of team meals provided to players and staff on road trips.

Bridges & Dunn-Rankin has a new Client Services Administrator, Ms. Anna Thibodeaux.

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