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New 3.8% Net Investment Income Tax: Planning for Closely Held Companies

Navigating New Medicare Tax, Self-Employment Tax, and Capital Gains Issues
for Members and Owners of Pass-Through Entities

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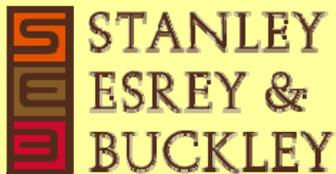
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The New Net Investment Income Tax -- Overview

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Overview

- Background
- Application to Individuals
- Income from a Trade or Business
- Computation of Net Investment Income
- Estates & Trusts
- Transfers of Partnership Interests

Background

- The medicare tax regime underwent significant changes effective 1/1/2013.

Pre-2013 Tax Landscape

- compensation income for self-employed
 - medicare tax of 2.9% on all compensation income
- compensation income for employees
 - employer pays medicare tax of 1.45% on all compensation paid to employees
 - employee pays medicare tax of 1.45% on all compensation income

Post-2012 Tax Landscape

- compensation income for self-employed
 - medicare tax of 2.9% on all compensation income up to the following thresholds:
 - \$200,000 for single filers
 - \$250,000 for joint filers
 - \$125,000 for married filing separate returns
 - medicare tax of 3.8% for compensation income above the threshold

Post-2012 Tax Landscape

- compensation income for employees:
 - employers pay medicare tax of 1.45% on all compensation income up to the following thresholds:
 - \$200,000 for single filers
 - \$250,000 for joint filers
 - \$125,000 for married filing separate returns
 - identical tax paid by employees
 - employees –but not employers – pay medicare tax of 2.35% for compensation income above the thresholds

Tax Landscape

- Concern – new payroll taxes above these thresholds will cause taxpayers to structure income so it does not qualify as compensation income
- Solution – apply new tax to capital gains, passive income and compensation

Tax on Net Investment Income

- Various referred to as:
 - the “unearned income medicare contribution tax
 - the net investment income tax (“NIIT”)
 - the additional medicare tax
 - the Obamacare tax
- Applies to individuals, estates and trusts.
- Effective 1/1/2013 -- enacted as part of the 2010 Health Care Act.

Tax on Net Investment Income

- The tax is equal to 3.8% of the tax base.
- Tax base is the lesser of:
 - the net investment income of the taxpayer or
 - the excess of the modified AGI of the taxpayer over the threshold amount.

Tax on Net Investment Income

- The tax does not apply to C corporations or to nonresident aliens.

Tax on Net Investment Income

- Modified AGI for these purposes is identical to AGI for most taxpayers.
- For taxpayers who utilize the foreign earned income exclusion under Code Section 911, there are additional adjustments that are made.

Tax on Net Investment Income

- The “threshold amount” is:
 - \$250,000 for joint returns and surviving spouses
 - \$125,000 for separate return filers
 - \$200,000 in all other cases

Tax on Net Investment Income

- Recall that one purpose of the NIIT was to “equalize” the medicare taxes on compensation income and “unearned” income.
- The NIIT and the additional medicare taxes on compensation income may apply to the same taxpayer in the same tax year, but not to the same items of income:
 - NIIT only applies only to net investment income
 - The additional medicare tax applies only to wage and self-employment income

Tax on Net Investment Income

- Estimated tax rules apply to NIIT.
- The quarterly computations that are made for estimated taxes will have to be adjusted to account for this additional tax.

Tax on Net Investment Income

- What is “net investment income”?
 - Gross income from interest, dividends, royalties and rents.
 - Net gain from the disposition of property.
 - But, does not include gross income or gain from certain types of trades or businesses

Tax on Net Investment Income

Trade or Business Exclusion

- In general, net investment income does not include gross income or net gain from a trade or business except in two cases:
 - a trade or business that is a passive activity with respect to the taxpayer, and
 - a trade or business that consists of trading in financial instruments or commodities.

Tax on Net Investment Income

Trade or Business Exclusion

- In general, pass through income from a partnership or S corporation is treated as net investment income unless it is derived in a trade or business (other than a trade or business that is a passive activity with respect to the taxpayer, or a trade or business that consists of trading in financial instruments or commodities).

Tax on Net Investment Income

Trade or Business Exclusion – Financial Instruments

- Determining whether a trade or business consists of trading in financial instruments is made at the entity level if carried on by a pass-through.
- Financial instruments are broadly defined to include stock, non-stock equity interests, debt, options, forward contracts, futures contracts, notional principal contracts, all other derivatives and any similar interests.

Tax on Net Investment Income

- The timing, exclusion and deferral rules for the “regular” income tax also govern net investment income.
- So, gains deferred under the installment method are also deferred for NIIT purposes.
- Other examples:
 - sale of principal residence
 - like-kind exchanges

Tax on Net Investment Income

- NIIT also does not include any distribution from a plan or arrangement described in:
 - §401(a) (qualified plans)
 - §403(a) (qualified annuities)
 - §403(b) (tax-sheltered annuities)
 - §408 and §408A (regular and Roth IRAs)
 - §457(b) (state/local/tax-exempt org plans)

Tax on Net Investment Income

- To prevent double taxation, NIIT also does not apply to any item that is also subject to the medicare self-employment tax.

Tax on Net Investment Income

- Gross income and gains otherwise including in net investment income can be reduced by properly allocable deductions.
- Examples are investment interest, state income taxes, investment expenses and fees, etc.

Net Investment Income

- “net investment income” (NII) generally refers to passive types of income, and also includes the net taxable gain attributable to the disposition of property held in a covered NIIT trade or business
- **IMPORTANT** – to prevent avoidance, the NIIT rules also apply to sales of interests in a trade or business that generates net investment income.

NIIT – Deemed Asset Sale

- NIIT attempts to treat the sale of a partnership interest the same as the sale of a partnership's assets.
- Proposed regulations: Prop. Reg. §1.1411-7
- Proposed regulations contain numerous caveats, details.

NIIT – Deemed Asset Sale

- Methodology:
 - Treat partnership as selling all its assets immediately prior to the sale of the partnership interest.
 - Determine the gain or loss from the deemed sale that would be allocated to the selling partner.
 - Net gain from deemed sale of assets of a NIIT trade or business is included in the definition of net investment income and subject to 3.8% tax (even if would otherwise be CG under regular income tax rules).

Net Investment Income - Timing

- Recall -- because income tax principles apply to NIIT, gain that is deferred for income tax purposes is also deferred for NIIT purposes.
- Conversely, disallowance provisions applicable in determining adjusted gross income (AGI) (e.g., the limitations on investment income or the passive activity loss limitations) also apply to the computation of NII.

Tax on Net Investment Income

- Estates/Trusts – NIIT applies to estates and trusts.
- However, the threshold amount is different.
- NIIT applies to a trust with undistributed net income equal to the amount at which the estate/trust would pay tax at the highest “regular” rate – in 2013 this is \$11,950.

Tax on Net Investment Income

- If an estate or trusts pays out all income, then NIIT cannot apply.
- Instead, NIIT may apply to the beneficiaries.
- However, because the NIIT applies at a much lower threshold, it may make sense to distribute out assets and let the beneficiaries trigger built-in income.

Tax on Net Investment Income

- Trusts may have to determine whether the interests they own in trades or businesses qualify as passive or active.
- Very little guidance under the participation regulations on this.
- Because the burden of a passive activity was generally not significant for most trusts, the issue has not been advanced. Under the NIIT the issue may become much more significant.

Tax on Net Investment Income

- In applying the material participation tests, do we focus on the activities of the trustee or the beneficiaries? What weight is given the activities of a trust's employees, if any?
- The only court case that addressed this required the activities of all three groups should be aggregated to determine whether the trust was a material participant.
- In some cases, structuring to come within the material participation rules may be critical.

Tax on Net Investment Income

- NIIT does not apply to the following trusts/estates:
 - Charitable trusts (regardless of whether the trust has UBTI)
 - Grantor trusts
 - Foreign trusts/estates (unless income is accumulated for the benefit of a U.S. beneficiary)

The Interaction of Employment Taxes and the New Code Section 1411 Tax

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SECA, FICA and Code Section 1411

- Federal health care reform increased the Medicare portion of FICA and SECA by 0.9% on wages or net earnings from self employment in excess of \$250,000 for joint filers/\$200,000 for single filers (Sections 3101(b)(2), 1401(b)(2))
- Recent CBO report suggests that approximately 40% of the Medicare portion of SECA is derived from income attributable to capital rather than labor (CBO Report 4168)

Net Earnings from Self-Employment

- Excludes :
 - › Rental income
 - › Interest and dividends
 - › Capital gains
 - › Distributive share of income of a limited partner, other than guaranteed payments for services
- Includes
 - › Distributive share of partnership income
 - › Income earned as a sole-proprietor

Net Earnings from Self-Employment

- S corporations
 - FICA applies to wages paid to S corporation shareholder (must pay reasonable compensation)
 - SECA does not apply to the distributive share of business income from an S corporation (Rev. Rul. 59-221)
- Congress intended the limited partner exception “to exclude for coverage purposes certain earnings which are basically of an investment nature” (H.R. Rep. No. 95-702, pt. 1, at 11 (1977))

Limited Partner Exclusion from SECA – Functional Test

- In 1997 Treasury proposed regulations defining limited partner under SECA
 - One-year congressional moratorium on rulemaking in 1997
 - Proposed regulations never finalized
 - Three-part functional test
 - Limited partner unless:
 - 1) Have personal liability for the debts of or claims against the partnership by reason of being a partner;
 - 2) Have authority to contract on behalf of the partnership; or
 - 3) Participate in the partnership's trade or business for more than 500 hours during the partnership's taxable year
- (Prop. Treas. Reg. Section 1.1402(a)-2(h))

Limited Partner Exclusion from SECA – Service Partners

- “Service partners” of “service partnerships” are not limited partners
- Service partner – any partner providing services, unless no more than a de minimis amount of services
- Service partnerships - substantially all activities involve performance of services in fields of health, law, engineering, architecture, accounting, actuarial science, or consulting

Limited Partner Exclusion from SECA – Deemed Limited Partners

- If functional test failed solely due to being active in the business, may nevertheless be treated as a limited partner if :
 - > Another partner holds a substantial and continuing interest in the partnership;
 - > The other partner satisfies the limited partner functional tests; and
 - > The rights and obligations with respect to the partnership interest are identical to those held by the other partner
- Not applicable to service partners of service partnerships

Limited Partner Exclusion from SECA – Second Class of Interest

- Treated as a limited partner with respect to a second class of interest if the class of interest is:
 - › Also held by a partner with a substantial and continuing interest ;
 - › The other partner satisfies the limited partner functional tests; and
 - › The rights and obligations with respect to the second class of interest are identical to those held by the other partner

(Prop. Treas. Reg. Section 1.1402(a)-2(h)(3))
- Not applicable to service partners of service partnerships

Limited Partner under Section 469

- Definition of “limited partner” under proposed Section 469 regulations generally based on whether partner has the right to manage the entity (Prop. Treas. Reg. Section 1.469-5)
- Limited partners are presumed to be passive with respect to the limited partnership’s activity, unless the limited partner:
 - 1) Participates in the activity for more than 500 hours during the year;
 - 2) Materially participated in the activity (within the meaning of any of the other six material participation tests) for any five of the preceding ten years; or
 - 3) Materially participated in the activity for any three preceding taxable years (whether or not consecutive) and the activity is a “personal service activity”

Other Exclusions

- Retired Partners
 - › Retired partners are generally not subject to SECA on distributive share of business income (Section 1402(a)(10))
 - › Under Section 469, may still “materially participate” if materially participated in the activity for any five of the preceding ten years (or if the activity is personal service activity, the individual materially participated for any three prior taxable years)
- Spousal Attribution
 - › No spousal attribution under proposed SECA regulations
 - › Services performed by a partner’s spouse will be attributed to the partner for purposes of Section 469

Capital Gains Tax Planning

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Sale of S Corp Stock Combined with 338(h)(10) Election

- Use in succession plan
- Review of IRC Section 338(h)(10)
 - qualified seller and qualified purchaser
 - deemed asset sale
 - deemed liquidation/distribution of installment note
 - allocation of purchase price
 - IRC Section 197-amortization of intangibles
 - Q Sub election by Purchaser

Use of Captive Insurance Company

- what is a captive insurance company
- review IRC Section 831(b)
- review overall transaction
- insurance premium for tax purposes
- tax deferral and conversion of ordinary income to capital gain

Use of ESOP Combined with S Corp

- What is an ESOP?
- capital gain/tax deduction symmetry
- use in succession plan
- review overall strategy