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Accrued Bonus Deduction: Not Just a 2½ Month Test

For taxpayers using the cash basis accounting method, determining when to deduct accrued bonuses is typically a straightforward matter - the compensation deduction occurs when the bonus is paid.

Similarly, accrual basis taxpayers also believed that decision was simply determined by answering one question: was the amount earned by year-end and was it paid within 2½ months of year-end? If so, then the deduction was allowed in the year of accrual. If the employee later forfeited the bonus, it was considered a condition subsequent that did not prevent the deduction in the earlier year. Unfortunately, IRS, in recent guidance, has made clear that

the necessary inquiry is far more granular. This guidance, discussed below, has forced many taxpayers to revise their bonus plans and file accounting method changes for back-year audit protection. Without a change to their bonus plans, taxpayers may suffer a significant deferral of their year-end bonus deductions.

The General Rule

The Internal Revenue Code (Sec. 461) allows accrual-basis taxpayers to deduct accrued bonuses (excluding related party transactions) if the following four conditions are met:

1. All events must have occurred to establish the fact of the liability by year-end;
2. The amount of the liability must be determinable with reasonable accuracy by year-end;
3. Economic performance must occur by year-end; and
4. Payment must be made within 2 ½ months of year-end.

Many companies have applied these provisions by treating forfeiture provisions that might cause an employee to forfeit the bonus as a condition subsequent that would not prevent the bonus from accruing at year-end. Others have simply focused on whether the bonus payments were made within 2 ½ months of year-end while ignoring the other three requirements.

In recent years, IRS has made clear in examinations that it considers the elimination of any risk of forfeiture of the bonus to be a condition precedent to establishing the fact of the liability. IRS has also made clear that taxpayers must satisfy each of the four requirements cited above, not just the requirement of payment within 2 ½ months. IRS has had a long-held position that a taxpayer must know the identity of the recipient of a bonus at year-end for that bonus to be deductible. Notwithstanding having lost on that position in court, IRS created uncertainty for taxpayers by publishing guidance announcing that it would not acquiesce in that decision. Even though IRS in recent years has not enforced this position, the outstanding published guidance has created uncertainty for taxpayers and the potential for unnecessary controversy during examinations.

Since most bonus plans require that the employee be employed by the company on the date the bonus is paid and permit eligible employees to be determined after year-end subject to a set formula, IRS' position as stated above would defer the bonus deduction for most taxpayers until the date of payment.

IRS has issued two items of guidance that clarify its current position with respect to both of these issues. This guidance provides a roadmap for taxpayers to modify their bonus plans and secure a year-end bonus accrual.

Revenue Ruling 2011-29

In Rev. Rul. 2011-29, IRS considered a situation in which the terms of the employer's bonus plan required that an aggregate minimum bonus amount be determined by year-end with the allocation to individual employees to be determined after year-end. The plan also provided that any bonus allocable to an employee who had left the company before the bonus had been paid would be reallocated to other eligible employees. On these facts, IRS

concluded that the minimum bonus amount determined under the plan could be accrued at year-end if paid by the 15th day of the third month following year-end. This ruling reverses a previous ruling which reached a contrary conclusion, requiring that amounts to be paid to individual employees be determined by year-end.

IRS makes clear in the ruling that taxpayers must follow the accounting method change procedures in Rev. Proc. 2011-14 to change to the method described in Rev. Rul. 2011-29. Such filings provide taxpayers with back-year audit protection and a four year spread of any unfavorable catch-up adjustment that results from the method change. A favorable catch-up adjustment can be taken into account in full in the year of change. Companies that do not currently have a bonus plan with provisions similar to those in Rev. Rul. 2011-29 may modify their plans after filing the method change to secure back-year audit protection for the old plan.

While Rev. Rul. 2011-29 did much to increase the focus on the requirements and to provide some clarity on IRS' position, some uncertainty still remained. More recent guidance at the end of last year provided guidance related to "pooled" bonus arrangements.

CCA 201246029

In November, 2012, IRS issued Chief Counsel Advice (CCA) 201246029 examining how Rev. Rul. 2011-29 would apply to a company that pays bonuses only to employees who are employed by the company at the time of payment. IRS considered a situation in which the company established a bonus pool to be paid out in the subsequent year. However, the company stipulated that employees must be employed at the time of the payment to be eligible. Further, the plan required that amounts not paid to an employee (because they were not employed at the time of payment) revert back to the company.

IRS determined that the company was not obligated to pay the bonus amount because the "fact of the liability" was not established until the payment date, as some portion may never be paid. Since the payment date came after year-end, IRS ruled that the company could not take a deduction for accrued bonuses until after year-end.

While the CCA is unfavorable for the taxpayer, it provides more clarity on how a bonus pool might be structured to secure a tax deduction. Specifically, the CCA identified that the critical element of the analysis was that the bonus amounts actually be paid to employees and not revert to the taxpayer. Therefore, elimination of the reversion of unpaid bonuses back to the company and reallocation of those bonuses to other employees would enable the bonus pool to qualify as a fixed obligation (if created prior to year-end).

Many companies feel very uncomfortable with the unjust and unintended benefit that might result from a provision that bonuses intended for one employee be paid to other employees. That said, those same companies know that turnover before bonuses are paid tends to be relatively low. As a consequence, it may be possible to authorize a minimum bonus pool before year-end in an amount that is reasonably expected to be paid to qualifying employees.

Conclusion

Taxpayers that are not properly accounting for their accrued bonuses under the guidance discussed above may have significant tax liability exposure that could result in financial statement disclosures. This exposure can be addressed

by filing accounting method changes that provide back-year audit protection. Bonus plans may also be restructured to maximize the amount of qualifying year-end bonus accruals.

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Conservation Easements – Extension of Tax Incentives

The American Taxpayer Relief Act of 2012 (The Act) renews the enhanced charitable income tax deduction for qualified conservation easements through 2013.

The law contains expanded tax incentives that increase financial benefits for landowners who wish to preserve their farms, forests, or natural areas by donating a voluntary conservation easement, or agreement, on their land.

Prior to The Act, the rules for 2012 and subsequent years generally allowed an individual donor to take a charitable

deduction for the donation of qualified real property of up to 30% of adjusted gross income (AGI). Any amounts not utilized in the year of contribution as a result of the charitable contribution limitation were allowed to be carried forward for up to five years. The renewed law raises the charitable deduction a landowner can take for donating a qualified conservation easement for 2012 and 2013 from 30% of AGI to 50%. Qualifying farmers and ranchers can take a charitable deduction of up to 100% of their AGI for 2012 and 2013. The law also increases the number of years over which a landowner can carryover amounts that were not deductible in the year of contribution due to the charitable deduction limitation from 5 to 15 years.

What is a qualified conservation easement? A conservation easement is an interest in real property restricting the future use of the land for preservation, conservation, wildlife habitat, or some combination of those uses. A conservation easement may permit farming, timber, harvesting or other uses of a rural nature to continue, subject to the easement. The restrictions on use of the land must generally be perpetual.

The creation of a conservation easement typically requires the participation of an entity like a qualified land trust. According to U.S. Treasury Regulations, if a conservation easement is donated, the easement holder that accepts the easement must have a commitment to protect the conservation purpose of the conservation easement, the resources to enforce the restrictions for the duration of the conservation easement, and be a qualified organization such as a government unit or a 501(c)(3) organization. As highlighted earlier, the easement, or agreement, between a land owner and a conservancy organization suppresses development upon the real property for an indefinite term. In exchange for the lost development rights, the land owner receives a benefit in the form of a tax deduction for a charitable contribution of the easement value.

To obtain a deduction requires the donor to submit a Qualified Appraisal prepared by a Qualified Appraiser as part of his/her tax filing; both terms are defined in the U.S. Treasury Regulations. A Qualified Appraiser is, among other things, an individual that holds himself out as one appraising the type of property being valued. A Qualified Appraisal is prepared in line with U.S. Treasury Regulations in terms of format, timing and information contained.

To quantify the value of a conservation easement, most appraisers employ a “before and after” valuation methodology. This is essentially two appraisals: 1) the appraisal of the property (and other contiguous family-owned parcels) assuming the easement is in place; and 2) the appraisal of the property assuming the property is not encumbered by the easement. The difference between the two values is the value of the conservation easement.

It is critical that the appraisal report meet U.S. Treasury Regulation guidelines. In the past, IRS has challenged a number of positions and disallowed the deduction in many cases. Criticisms have included:

- The appraisal report does not properly address the highest and best use. For example, the analysis may assume a land use change (such as a significant re-development) without proper analysis and support;
- The appraisal does not meet the requirements of a Qualified Appraisal and/or the appraiser is not a Qualified Appraiser;
- The appraisal did not consider the contiguous, family-owned parcel. Treasury guidelines dictate that the appraisal report consider the value impact on all contiguous family owned property – not just the parcel on which the easement is being placed. This would include enhancement value to other parcels owned by the

donor or donor's family; and

- The easement does not serve a qualified conservation purpose.

The process of land conservation may take many months or longer to complete. As of now, these enhanced tax incentives are only secured until December 31, 2013. Although only three months into the New Year, now is the time to begin planning for land preservation in 2013. A qualified advisor will need a fair amount of time to ensure that a conservation easement can be finalized by year-end so that landowners can take advantage of the renewed tax incentives.

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An Introduction to MLPs

With interest rates still at historic lows, the current economic environment presents obstacles for investors seeking an attractive risk-adjusted yield. As an alternative solution, investors should consider an allocation to master limited partnerships (MLPs).

In addition to offering attractive yield opportunities, MLPs have intriguing tax advantages, contain a degree of inflation protection, and can provide diversification benefits to a portfolio.

An MLP is an infrastructure company organized as a partnership (rather than a corporation) that trades on a public exchange or market. It combines the tax benefits of a partnership with the liquidity of publicly traded securities. Congress recognized MLPs in the 1980s to encourage investment in energy and natural resources companies. In order to qualify for MLP status, a partnership must generate at least 90% of its income from what IRS deems "qualifying" sources, which generally includes all manner of activities related to the production, processing, or transportation of oil, natural gas and coal. Due to these stringent provisions, energy related businesses compose 75% of the MLP universe, with financial, consumer discretionary, utility, materials, and industrial companies rounding out the balance. To provide an example of a MLP company, think of a business that transports natural gas through a pipeline network.

Contrary to corporate shareholders, investors in MLPs are known as unit holders, or limited partners (LPs) and the managers of MLPs are known as general partners (GPs). Shares are referred to as units and payouts are made as distributions as opposed to dividends. The GP has full management responsibility of the business and typically holds a minority stake. The LPs own the remaining interest in the partnership but play no role in daily operations and typically have no voting rights.

The yield opportunities of an MLP make it very attractive in a low interest rate environment. Partnership agreements typically require MLPs to pay out all of their available cash flow in the form of quarterly distributions, which provide a steady yield stream for the investor. Currently, the average MLP yields more than 6%, which is greater than high-yield corporate bonds. The yields are not only attractive today, but their growth prospects remain compelling. Demand for energy and MLP-related services is relatively stable, meaning future distributions should not be adversely affected by market conditions. Since the asset class is still relatively young (about 90 MLPs in total) and investments in energy should continue to keep pace with rising energy demand, MLP distributions may continue to increase for the foreseeable future.

In addition to the yield opportunities, MLP investments can offer significant tax advantages for taxable investors.[1] To illustrate, in the case of a corporation, income is first taxed at the entity level (i.e., the corporate rate), and then taxed again when distributed via a dividend to shareholders at the dividend rate. In the case of an MLP, because it is structured as a partnership, there is no entity level tax. This results in larger cash distributions to its owners, all else equal, because the entirety of the MLP's income is available for distributions rather than just the remaining portion after the entity tax. Additionally, the majority of the distribution portions are tax-deferred. As MLPs tend to be capital intensive businesses, the LP unit holders can benefit from their proportionate share of depreciation and/or depletion deductions. Since these deductions reduce taxable income without impacting the cash available to the unit holders, distributions tend to be very tax-efficient, with a significant portion of each distribution treated as a tax-free return of capital. Commonly, only about 10% to 25% of the investor's distributions are recognized as taxable income (typically at the investor's ordinary income tax rate). Any tax on the balance of the distributions is deferred until the sale of the LP unit. The benefits of entity tax pass-through treatment and tax-deferral characteristics are some of the most attractive features of MLPs for investors, especially in the current environment where taxes on investments have increased for most wealthy investors. [2]

MLPs can also help mitigate concerns that certain S corporations may have regarding the generation of passive

investment income. Generally, S corporations with accumulated earnings and profits earned before electing S corporation status are subject to an entity level tax on the net passive investment income (i.e., royalties, rent, dividends, interest, and annuities) generated in excess of 25% of the corporation's total gross receipts. Further, the S corporation election will be automatically terminated if the corporation is subject to this tax for three consecutive years. Since the distributive share of gross receipts from a partnership, rather than its share of the venture's net income or loss, is used in applying the passive investment income tests, MLP gross receipts passed through to an S corporation are not considered passive investment income. Accordingly, holding investments in MLPs should be beneficial since they will generate an additional source of gross receipts that are not included in passive investment income.

Many MLPs also have inflation protection built into their revenue flows. The Federal Energy Regulatory Commission allows certain tariff-based MLPs to increase their pipeline fees according to the Producer Price Index (PPI), and many storage contracts adjust to the Consumer Price Index (CPI), so any rise in inflation is at least partially offset by these pricing abilities.

Aside from the above advantages, MLPs are suitable in a portfolio context due to the diversification benefits. As can be seen in the table below, MLPs have historically demonstrated a low correlation to other asset classes. Therefore, including MLPs in a portfolio may decrease the portfolio's overall risk.[3]

Asset Class Correlations

November 2003 to April 2012

Asset Class	**U.S. Long Term Treasuries**	**U.S. TIPs**	**High Yield Bonds**	**S&P 500**	**Gold**
Alerian MLP Index	-0.44	0.12	0.63	0.49	0.03

As with all types of investments, there are important risks to consider before investing in MLPs. Regulatory risk poses the most significant threat, as an elimination of the entity tax exemption or the pricing abilities stated above would have a tremendous impact on MLP valuations. Other considerable risks are interest rate risk and credit risk. MLPs rely on the capital markets to finance growth, so a decreased credit rating and/or rise in interest rates would increase their cost of capital.

In addition to the investment risks, there are several important tax reporting and compliance considerations specific to MLP investments. As MLPs generate taxable income, investors may be required to file tax returns in the numerous states in which an MLP operates. This can create a large burden, as in the case of the pipeline MLP example above, which typically runs through many states. Additionally, MLPs that generate losses can be even more onerous from a tax compliance standpoint due to the strict limitations on losses that flow through to investors. Consequently, the investment community has responded to the tax compliance concerns by creating ways to gain exposure to the asset class through vehicles such as mutual funds, ETFs, ETNs and total return swaps. These

solutions, however, generally sacrifice a few of the potential tax benefits associated with direct ownership of MLP units in exchange for simpler tax compliance. Accordingly, it is very important to coordinate a decision to invest in MLPs with both sophisticated investment and tax advisors to determine if MLPs are an appropriate fit for your portfolio.

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[1] Due to the partnership status, tax-exempt investors are subject to unrelated business income tax (UBIT), which might not be desirable.

[2] The depreciation and depletion deductions mentioned above can also mitigate the impact of the new Unearned Income Medicare Contributions Tax of 3.8% for investors subject to that tax.

[3] A low correlation between assets indicates that there is a weak relationship between their returns; as a result, risk is mitigated since there is less likelihood that both assets will decrease to the same extent.

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Participation in a Foreign Pension Plan

Form 8938 (Statement of Foreign Financial Assets), introduced in 2011 as part of the Foreign Account Tax Compliance Act (FATCA), requires taxpayers to report their foreign assets, subject to minimum values, and indicate where the related income is picked up on their tax return.

One asset often misunderstood and likely overlooked in many cases is a taxpayer's interest in a foreign pension plan. Foreign nationals who move to the United States or U.S. citizens who have spent significant time overseas are likely to have some form of foreign pension arrangement.

In many cases, there is uncertainty as to the reporting requirements and the application of U.S. tax rules and/or tax treaties to such plans but, in general, for senior level participants it is likely that employer contributions will be taxable as compensation and the growth in the value of the pension will create taxable income annually. Furthermore, the plan will generally need to be reported by the taxpayer on Form 8938, Foreign Bank Account Report (FBAR), and possibly Form 3520 relating to U.S. owners of foreign trusts.

Foreign pension plans will almost certainly not qualify under IRC Sec. 401, which defines '*Qualified Plans*' for U.S. tax purposes and includes a requirement that the plan has to be created or organized in the United States. To understand the tax treatment of these plans, it is necessary to first understand the type of plan being addressed. Generally, there are four main types of plans: 1) defined contribution plans funded by the employer and possibly employee; 2) defined benefit plans, typically funded by employer contributions only; 3) personal pension plans, funded by individuals; and 4) unfunded plans which are maintained on the company's books.

A common misconception is that most foreign pension plans would be considered tax-exempt under a tax treaty. While this may be true in some cases, the exemption is generally limited to only those plans that would be correspondingly approved by both governments and any tax benefits are limited to those available to a U.S. qualified plan (e.g., a 401(k) plan).

It is possible that a foreign plan is considered a trust arrangement and, consequently, treated as a foreign grantor trust requiring U.S. participants to report their interest in the trust on a Form 3520. To enable this reporting, the pension trustee must issue a Form 3520-A to the U.S. participant by March 15 following the tax year-end proving specific details of the participant’s interest. However, for senior executives, the form of pension is likely to be a funded employee benefit trust governed by IRC Sec. 402(b), which specifically exempts the trust from being treated as a foreign grantor trust and, consequently, the above filing requirements.

The tax treatment of the pension (or deferred compensation plan) under IRC Sec. 402(b) depends on whether the trust is discriminatory towards highly compensated employees. A highly compensated employee is defined broadly as a 5% owner of a company, one who meets a compensation limit ($115,000 in 2013), or an employee whose pay is in the top 20% of compensation for that company. If the IRC Sec. 402(b) trust is discriminatory, highly compensated employees who participate in the underlying plan are taxed each year on the employee’s “vested accrued benefit,” less the employee’s investment in the contract or the value of the previously taxed portion of that benefit. In other words, if the plan is discriminatory, the employee would effectively be taxed on the increase in the pension value each year.

Within these rules lies a potentially disastrous scenario. A foreign national who moves to the U.S. could find herself fully taxed on any distribution, even if the contributions were made to the foreign plan long before she set foot in the U.S. For distribution purposes, IRC Sec. 72(w) provides that a U.S. resident receiving a distribution will not have any ‘basis’ for any foreign source contributions made during a period as a non-resident alien if those contributions were not previously subject to income tax and would have been subject to income tax if paid as cash compensation. This generally should be creditable against the U.S. tax to the extent any distributions are subject to foreign withholding tax.

With the recent passing of FATCA, the increased focus on reporting foreign trusts and foreign assets makes the disclosure and treatment of such foreign deferred compensation plans more transparent to IRS. Given the potential tax exposure and onerous penalties, it is important to plan ahead to understand the tax treatment of these plans and to understand how to correctly report them.

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Help I'm Being Audited! The Many Ways to Pay

As part of our ongoing series covering the audit process, this article focuses on the payment stage of the exam and the courses of action available to taxpayers. Whether an audit is big or small, the fundamental procedures are the same.

IRS will request information from the taxpayer and based on the responses provided, IRS will:

1. Claim that additional tax is owed by the taxpayer;
2. Determine that a refund is due to the taxpayer; or

3. Issue a "no change" letter.

In the case where a refund is due or there is no change, the taxpayer will exit the audit process. However, when the audit concludes and additional tax is owed, the taxpayer can choose to appeal the determination or pay the tax. Even if a taxpayer disagrees with IRS' determination, there may be reasons why a taxpayer would choose to pay the balance owed versus appealing. The amount owed may be immaterial relative to the cost of an appeal. Also, a high-profile taxpayer, who continues on to Appeals but without success, might choose to pay the tax rather than moving to the next level where the dispute will become part of the public record. As mentioned in our previous article, once the dispute reaches the Tax Court, the taxpayer's identity will become part of the public record and many high-profile taxpayers may wish to retain anonymity with respect to their private tax matters. A taxpayer has a number of options to consider when paying a balance due. This article will focus on those options.

Option #1 – Write a Check

The most obvious and easiest method to pay a balance due is simply to write a check. An audit determination will usually contain a remittance advice with instructions on how to pay IRS. The taxpayer merely needs to attach a check made payable to the "United States Treasury" and mail it to the address indicated. IRS will credit the taxpayers account for the year, or years, in question and this will complete the audit. However, not all taxpayers have the funds to pay a balance due resulting from an audit. In this situation, IRS does provide alternative payment methods.

Option #2 – Request an "Installment Agreement"

The Installment Agreement is the method of choice for a taxpayer who has the assets to pay the audit assessment, but due to illiquidity, they cannot be easily converted into cash. This agreement allows the taxpayer to pay the balance due over time. IRS generally has 10 years to collect a liability and will not enter into an agreement that lasts beyond this limit. When requesting an installment payment plan, the taxpayer must file form 9465-FS, "Installment Agreement Request," with IRS.

For tax liabilities greater than $50,000, IRS will also require the taxpayer to complete and file Form 433-F, "Collection Information Statement." This is a personal financial statement that will help IRS determine the installment payment amount. IRS will not require the taxpayer to make installment payments so large that the taxpayer would not be able to provide the necessities of life for his or her family. However, the rules are complex and a qualified tax advisor should be consulted when considering this option.

In order to be considered for an Installment Agreement, the taxpayer must be current on all other federal tax liabilities, including estimated tax payments for the current year. IRS will not allow a taxpayer to pay down one tax liability over time, while accruing another for another tax year. It is also important to note that interest and penalties do not stop accruing simply because an installment agreement is reached. These items will still add to the balance owed although their impact will dissipate over time as the liability is paid off.

Option #3 – The "Offer-In-Compromise"

For taxpayers in very poor financial conditions where payment of the tax liability will create a severe financial hardship, IRS will consider an "Offer-In-Compromise." This option allows the taxpayer to settle his or her liability for less than the full amount owed. This can be in the form of a one-time payment or a series of payments.

In order to be considered for this option, the taxpayer must file Form 656 "Offer-In-Compromise" and Form 433-A (OIC) "Collection Information Statement" or Form 433-B (OIC) for businesses. Like Form 433-F, the 433-A or B will provide IRS with a full financial picture of the taxpayer. IRS can then determine the taxpayer's ability to pay the tax balance due. Like the Installment Agreement, the taxpayer must be current on all other tax liabilities to qualify for this option. Also, the taxpayer must not be party to a bankruptcy proceeding. Generally, a taxpayer will not be considered for an "Offer-In-Compromise" if their total assets exceed the amount owed. It is not easy to qualify for this option, but if approved, the taxpayer must comply with the agreed upon arrangement.

Conclusion

This article discussed the methods to pay a federal tax liability that resulted from an audit. Option #1 is to simply write a check to IRS. This might be painful but it will resolve the matter quickly. Option #2, "The Installment Agreement," allows the taxpayer to pay the total liability and penalties over time but interest on the unpaid balance will continue to accrue until paid in full. Option #3, The "Offer-In-Compromise," can yield a settlement for an amount less than the actual tax liability. However, this option is available only to those who can prove severe financial hardship or insolvency. A taxpayer should consider each option carefully with the assistance of a qualified tax advisor in order to choose the most appropriate method.

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Certainty in Tax Planning...For Now: The American Taxpayer Relief Act of 2012

Less than 12 hours into the new year, the House of Representatives passed The American Taxpayer Relief Act of 2012 (the Act).

President Obama signed the Act on January 2, 2013, mitigating the tax aspects of the so-called "fiscal cliff." Although technically a tax reduction bill, the Act results in an increase in income and transfer tax rates relative to those applicable in 2012. Further, two new taxes that were part of the Health Care and Education Reconciliation Act of 2010 (commonly known as Obamacare) took effect on January 1, 2013.

We expect that many are trying to understand the impact of these changes to their individual situations. Those with taxable income (TI) less than $250,000 per year will experience very little change relative to the last few years. However, those with TI in excess of $250,000 will experience increases, and those increases will become very significant for those with TI greater than $450,000. The magnitude of the potential increases varies based on the type of income one earns, making it difficult to provide a simple answer to the question, "how much will my tax rate increase in 2013?"

To help clarify the potential impact of the changes, Table 1 summarizes the increase from 2012 to 2013 in the highest marginal rates of tax on different classes of income for a married couple filing jointly. It also reflects the threshold amounts at which the incremental effect of the changes will begin to apply. The threshold amounts are stated as either TI or adjusted gross income (AGI), which simply stated is taxable income before subtracting itemized deductions and personal exemptions. The last column in Table 1 reflects the maximum increase in the marginal tax rate for different classes of income. The table is not intended to provide precise answers for every situation, but rather to give a general idea of the magnitude of the increase in tax rate for a married couple filing a joint return with income in excess of the threshold amounts.

(Click below to see larger table:)

TABLE 1: Increase in Marginal Income Tax Rates for Different Income Categories (2012 - 2013)
(For Married Filing Joint Return)

Income Category	2012 Regular Income Tax Rate		2013 Regular Income Tax Rate		2013 Incremental "Obamacare" Taxes *		Impact of "Pease" Phaseout of Itemized Deductions		Aggregate Rate Increase Above Highest Threshold
	Max. Rate	TI Threshold	Max. Rate	TI Threshold	Rate	AGI Threshold	Net Impact**	AGI Threshold	
Wages	35%	388,350	39.6%	450,000	0.9%	250,000	1.2%	300,000	**6.7%**
Self-Employment Income	35%	388,350	39.6%	450,000	0.9%	250,000	1.2%	300,000	**6.7%**
Capital Gains	15%	N/A	20%	450,000	3.8%	250,000	0.6%	300,000	**9.4%**
Qualifed Dividends	15%	N/A	20%	450,000	3.8%	250,000	0.6%	300,000	**9.4%**
Other Investment Income (rents, royalties, etc.)	35%	388,350	39.6%	450,000	3.8%	250,000	1.2%	300,000	**9.6%**
Active Business Income not Subject to Self-Employment Tax	35%	388,350	39.6%	450,000	-	-	1.2%	300,000	**5.8%**
Passive Income from Businesses	35%	388,350	39.6%	450,000	3.8%	250,000	1.2%	300,000	**9.6%**

* NOTE: Effective in 2013 are two new taxes enacted in 2010 as part of the healthcare reform legislation. One is a new .9% Medicare tax applicable to wages and other earned income of higher income individuals. The other is a new 3.8% tax on investment income of higher income individuals.

** NOTE: For capital gains and dividends, assumes all of individual's income is from these sources.

By way of example, assume a married couple has taxable income in 2013 of $1 million that is comprised primarily of salary and wages, and that the couple itemizes deductions. The aggregate increase in their tax rate that applied in 2012 (35%) on taxable income in excess of $450,000 is approximately 6.7% or $36,850 ($550,000 x 6.7%). For a couple with a similar amount of income derived primarily from qualified dividends and capital gains, the increase in rate would be approximately 9.4%. Estimating the increase becomes more complicated when income includes multiple categories, but one can approximate the rate increase by interpolating among the amounts reflected on the chart. A more thorough analysis of the changes resulting from the Act follows.

The Act permanently extends the 2012 “ordinary” income tax rates for the 10%, 15%, 25%, 28%, 33% and 35% brackets, as well as the 0%, 10%, and 15% rates on qualified dividends and long-term capital gains. New income tax rates were added that apply to TI exceeding thresholds of $400,000 (single filers), $425,000 (heads of households), $450,000 (married, filing jointly) and $225,000 (married, filing separately). The new rates on TI in

excess of these thresholds are 39.6% for ordinary income and 20% for qualified dividends and long-term capital gains. The threshold amounts are indexed for inflation beginning after 2013.

The highest rate for alternative minimum tax (AMT) purposes will continue to be 28% for ordinary income. The highest AMT rate for capital gains and qualified dividends will be 20%. In addition, a taxpayer friendly, permanent "AMT patch" was passed, which increases the AMT exemption to $50,600 for individual filers (previously $33,750) and $78,750 for married filing jointly filers (previously $45,000), while also allowing nonrefundable personal credits against AMT. The Act allows the exemption and phaseout amounts to be indexed for inflation. This permanent patch will prevent the annual rush to pass a temporary solution to prevent millions of middle-class taxpayers from being subject to AMT.

There are two other features of the pre-Bush tax era that will effectively increase the marginal tax rate above 39.6% for many higher income individuals. The Personal Exemption Phaseout (PEP) is reinstated for those with AGI above $250,000 (single filers), $275,000 (heads of households), $300,000 (married filing jointly) and $150,000 (married filing separately). Taxpayers above the applicable thresholds must reduce the amount of their exemption by 2% for each $2,500 by which their AGI exceeds the threshold. The exemptions are completely eliminated when AGI exceeds the threshold by $125,000.

The "Pease" limitation, named for its original sponsor, Congressman Donald Pease, also returns. It limits certain itemized deductions for taxpayers whose AGI is above the same thresholds as applied for PEP. It also reduces the itemized deductions a taxpayer is eligible to take by 3% of the amount by which the taxpayer's AGI exceeds the threshold. The total reduction cannot exceed 80% of itemized deductions otherwise permitted.

Despite the debates and various proposals regarding the gift, estate, and generation-skipping transfer tax (GST) regimes—and to the surprise of many—very little was actually changed relative to 2012. The estate, gift and generation-skipping transfer tax exemptions remain at $5 million plus inflation adjustments (indexed for inflation, the 2012 amount was $5.12 million). The tax rate permanently increased from 35% to 40%. Since the Act avoids the return to pre-Bush law (with the adjustment of the highest rate), provisions such as portability of any unused exemption to a surviving spouse and deductibility of state estate taxes paid are also permanently extended.

It is also worth noting that, despite much talk about closing "loopholes," the Act did not include any of the following proposals:

1. Grantor retained annuity trusts (GRATs) - eliminating zeroed out GRATs and requiring a 10-year minimum term;
2. Valuation discounts - eliminating discounts for interests in family-owned entities;
3. GST exempt trusts - limiting their term to 90 years;
4. Defective grantor trusts - requiring that a trust be a non-grantor trust if a completed gift is made to that trust; and
5. Carried interests - eliminating capital gains treatment for income generated from carried interests.

It is entirely possible that these proposals will be revisited at some point in the future when/if tax reform is considered.

Action Should be Considered Now for Some Changes

Along with these more publicized provisions, the Act also allows for additional planning opportunities related to individual retirement accounts (IRAs) and 401(k) accounts. The Act extends the ability of individuals to convert traditional IRAs to Roth IRAs regardless of income laws, as well as revoke this election before the filing due date of the individual's tax return for that year. Factors to consider in making the election include age, current and expected future income tax rates, and intended use of IRA funds.

The Act also extends for 2012 and 2013 the ability of an individual age 70 ½ or older to arrange for a direct distribution to charity from his/her IRA, up to $100,000 each year, and exclude it from income. A taxpayer who received an IRA distribution in December 2012 can contribute some or all of that amount, again up to $100,000, to charity this month and exclude it from 2012 income. A taxpayer also has the option to make a distribution this month from an IRA directly to charity and have it treated as made in 2012 and excluded from income. This might be advantageous, for example, for a taxpayer who wants to maximize over two years the IRA funds used for charitable purposes — up to $200,000 could be distributed from an IRA in 2013 directly to charity with some excluded in 2012 and the rest excluded in 2013.

The ability to convert an IRA or 401(k) account to a Roth IRA and pay the tax today still exists under the Act. Individuals should consider the benefit of paying the tax on conversion today and having the appreciation grow tax free. The company 401(k) plan may have to be amended to allow such a conversion.

Owners of qualified small business stock (QSBS) also received an extension of beneficial treatment that applied to QSBS acquired from September 27, 2010 through December 31, 2011. They can continue to exclude 100% of the gain from the sale of such stock that is held for five or more years provided that it is acquired before January 1, 2014, up to the greater of $10 million or 10 times the taxpayer's basis in the stock.

Whether viewed as a taxpayer friendly bill or not, the Act did remove the uncertainty that has existed since 2010 and earlier. While more sweeping tax legislation is always possible, at least for now, taxpayers and their advisors know what they face in 2013 and beyond.

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Cutler v. Franchise Tax Board and FTB Notice 2012-03 – What it Means for Taxpayers

The Franchise Tax Board (FTB) issued FTB Notice 2012-03 (Notice) on December 21, 2012 outlining the procedures the FTB will use to apply the California Court of Appeal's decision in Cutler v. Franchise Tax Board (2012) 208 Cal.App.4th 1247.

In Cutler, the Court of Appeals held that Revenue and Taxation Code (RTC) Sections 18038.5 and 18152.5, which allowed taxpayers to defer gain on certain qualified small business stock (QSBS) dispositions as applied to

California-based businesses, violated the Commerce Clause of the U.S. Constitution. In response to the Court of Appeal's decision, the FTB issued the Notice stating that since RTC Sections 18038.5 and 18152.5 were deemed unconstitutional, the statutes are invalidated and no taxpayer may defer gains from the disposition of QSBS.

QSBS

The Internal Revenue Code (IRC) allows taxpayers to exclude or defer gain from the sale or exchange of certain QSBS. California generally adopted the federal language for QSBS treatment; however, it requires that at least 80% of the taxpayer's payroll at the time the stock was purchased must be within California and 80% of assets and payroll must be within California during the taxpayer's holding period for the stock in order to qualify for a QSBS gain exclusion or deferral.

Cutler

In *Cutler*, the taxpayer argued that California's QSBS statutes violated the U.S. Constitution because it favored California-based taxpayers over out-of-state taxpayers. The taxpayer in *Cutler* sold stock from a start-up company and used a portion of the proceeds to acquire interests in several small businesses. Pursuant to RTC Sections 18038.5 and 18152.5[1], the taxpayer deferred the gain on the sale of the QSBS on his 1998 California return. Upon audit by the FTB in 2004, the taxpayer's gain deferral was denied because the FTB argued that the taxpayer failed to meet the requirements under RTC Sections 18038.5 and 18152.5. The taxpayer sued the FTB in 2009 asserting that the sale did meet the applicable requirements. Alternatively, the taxpayer argued that the QSBS provisions violated the U.S. Constitution's Commerce and Due Process Clauses. The trial court, agreeing with the FTB's motion for summary judgment, held that the QSBS deferral provisions did not violate the U.S. Constitution and that the taxpayer failed to meet the requirements of RTC Sections 18038.5 and 18152.5.

On appeal, the Court of Appeals reversed the lower court's decision and held that RTC Sections 18038.5 and 18152.5 violate the Commerce Clause of the U.S. Constitution because the provisions favored California corporations over out-of-state corporations. The Court of Appeals remanded the case to the trial court to determine the appropriate remedy.

FTB Notice 2012-03

In response to the Court of Appeal's determination that RTC Sections 18038.5 and 18152.5 violate the U.S. Constitution, the FTB issued Notice 2012-03 that invalidated RTC Sections 18038.5 and 18152.5 for all taxpayers. The FTB, relying on the remedy provided in *River Garden Retirement Home v. Franchise Tax Board* (2010) 186 Cal.App.4th 922 and *McKesson Corp. v. Florida Alcohol & Tobacco Div.* (1990) 496 U.S. 18, stated that similarly situated taxpayers should all be treated alike and therefore, the deferral provision is invalid for taxable years beginning on or after January 1, 2008 (within the four-year statute of limitations). The QSBS position taken by taxpayers on returns for taxable years before January 1, 2008 is unaffected as are any existing closing agreements and settlement agreements with the FTB.

Procedurally, the Notice states that accepted returns and returns that are currently in audit, protest, claim for

refunds, or pending appeals in front of the Board of Equalization will have the above-mentioned remedy applied by FTB staff. Furthermore, taxpayers may proactively self-assess any additional tax and remit the amounts to the FTB.

Commentary

While the FTB has taken a hardline position on the appropriate remedy as a result of *Cutler*, taxpayers should keep in mind that the Court of Appeals remanded the case to the trial court to determine the appropriate remedy. While the FTB has invalidated statutes in the past after they were deemed unconstitutional by a court, the FTB has also been compelled to remedy a Constitutional defect by applying the statute in an unoffending manner.[2] The court in *Cutler* may recommend that the FTB revise RTC Sections 18038.5 and 18152.5 by excising only the language that violates the U.S. Constitution leaving the benefit intact. Due to the uncertainty surrounding the appropriate remedy, taxpayers should consider whether to claim the QSBS benefit based upon their particular facts and circumstances. Additionally, taxpayers may consider filing amended returns in the event they did not take the benefit on their originally filed return in order to preserve a possible claim for refund.

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[1] RTC Sections 18038.5 and 18152.5 provide an elective deferral of gain for individuals on the disposition of QSBS (1) held for more than six months; (2) amount realized was used to purchase QSBS within a 60-day period beginning on the date of the sale; and (3) the QSBS sold and purchased was issued by "domestic corporations" (i.e., corporations that use 80% of their assets in the conduct of business in California and maintain 80% of their payrolls in California).

[2] See Ventas Finance I, LLC v. Franchise Tax Board (2008) 165 Cal.App.4th 1207 and FTB Notice 2009-04.