

# CUTTING EDGE TAX DEVELOPMENTS

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# Surveying the Landscape

## *I. Where we are now -- Budget Control Act of 2011*

On August 2, 2011, the President signed legislation aimed at reducing the deficit, raising the debt limit, and avoiding default.

### **A. Highlights**

The legislation:

- Extends debt limit to 2013.
- Makes a nearly \$1 trillion down payment on deficit reduction.
- Expedited process for balanced deficit reduction in a longer term process for an additional \$1.5 trillion in savings through **both tax and entitlement reform**.
- Employs a proven enforcement mechanism that will compel painful spending cuts (50 percent defense/50 percent non-defense) that should force Congress to act.

### **B. Details of the deficit reduction package (2012-2021)**

#### **1. Stage One**

The debt limit was raised by \$900 billion, \$400 billion immediately (which should last through September 2011); the remaining \$500 billion debt limit increase would take place unless both the House and Senate pass resolutions of disapproval and the President does not veto such resolutions. This increase of nearly \$1 trillion is offset by a \$10 billion spending reduction in 2012 and 2013 in **discretionary spending** (approximately 1 percent of such spending); there is no reduction of non-discretionary spending (such as Social Security benefits, etc.). The balance (nearly \$1 trillion) of the discretionary spending cuts arises in the out-years (after 2013, and after the next round of elections) of a **ten-year plan**. Discretionary spending has a hard cap (ceiling) on the total amount of discretionary spending at approximately \$1.04 trillion in 2012 and 2013. Caps continue in each of the out-years with separate caps established for security and non-security spending; for these purposes, security spending includes defense, state and foreign operations, homeland security, and military construction/veterans affairs.

#### **2. Stage Two**

A joint, bipartisan committee (the "Joint Committee"), made up of 12 members (6 from each Chamber, equally divided between Democrats and Republicans, and appointed by the Majority and Minority Leaders in each Chamber), will be tasked with developing legislation to achieve at least \$1.5 trillion in future deficit reduction (over the ten-year reduction period ending in 2021) by November 23, 2011. The committee's legislation, which can include entitlements (non-discretionary spending) and revenues (tax increases), is guaranteed an up-or-down Senate vote, without amendments, by December 23, that avoids the Senate's general 60-vote rule on closing debate.

#### **Note:**

Tax increases, if recommended and enacted, would not, in our opinion, become effective until 2013. Such changes may well follow the recommendations of the Gang of Six in the Senate and the Fiscal Commission (discussed elsewhere in these materials).

**Note:**

The process is currently in Stage Two, with November 23 the cut-off date for the deficit reduction to be drafted and introduced. The members of the Committee are (1) from the Senate, Murray (D-Washington), Kerry (D-Massachusetts), Baucus (D-Montana), Kyl (R-Arizona), Toomey (R-Pennsylvania), and Portman (R-Ohio); and (2) from the House, Becerra (D-California), Van Hollen (D-Maryland), Clyburn (D-South Carolina), Camp (R-Michigan), Hensarling (R-Texas), and Upton (R-Michigan).

**3. Outcomes**

- a. If the Committee's recommendations achieve at least \$1.5 trillion and are enacted by Congress, the debt ceiling will be raised by \$1.5 trillion.
- b. If the committee's bill is enacted and produces between \$1.2 trillion and \$1.5 trillion, the debt limit will be raised dollar-for-dollar.
- c. If the committee fails to produce a bill, its bill is not enacted, or it produces less than \$1.2 trillion, the debt limit will increase by \$1.2 trillion. This debt limit increase would be subject to a disapproval vote by the Senate and the House, which would, in turn, be subject to a Presidential veto.
- d. If the Committee fails to report legislation that achieves \$1.2 trillion in deficit reduction, or Congress fails to enact the Committee's recommendations, certain parts of appropriated funds in the budget are set apart and not spent (sequestration), on a pro rata ("across-the-board") basis. If the Joint Committee fails to come to a majority agreement on recommendations that achieve at least \$1.2 trillion, or Congress fails to enact recommendations that produce at least that amount, sequestration is triggered, forcing across-the-board spending cuts. The sequestration will, with interest savings, make up the differential between the deficit reduction achieved by the joint committee and \$1.2 trillion.

"Deficit reduction" is a slippery term, and Washington gives it several different meanings. Sometimes it means that the deficit is reduced from what it would have been had the action not been taken, i.e., merely reducing the annual deficit from, say, \$500 billion to \$400 billion, thereby reducing the aggregate national debt by \$100 billion from what it would have been without the action; it does not mean necessarily that the national debt has been reduced in absolute dollars.

**Note:**

Because spending reductions are the only recourse in the event no legislation is introduced, there will be no tax increase (revenue enhancers) if the Joint Committee cannot reach a consensus (defined as 7 of the 12 members). If both sides stay fixed on their ideological positions -- one insisting on tax increases, the other pledged not to support any such measures -- this scenario of no tax increases but automatic reduction in actual spending through sequestration is a likely outcome.

- If across-the-board cuts are triggered, 50 percent will come from defense spending, with the remaining 50 percent coming from non-defense spending. The spending cuts would apply to fiscal years 2013-2021, and apply to both discretionary and mandatory spending programs with important exemptions (below). **The amount of the defense spending cuts each year would be approximately \$50 billion if sequestration is triggered.**
- If across-the-board cuts are triggered, the following will be exempt: Social Security; Medicaid; veterans' benefits and pensions; payments to federal retirement funds; civil

and military pay; and the child nutrition, Supplement Security Income, and Women, Infants, and Children programs, among others.

- If across-the-board cuts are triggered, any cut to Medicare would be limited to no greater than 2 percent of the program's cost. Any such cut would come from payments to providers and insurance plans. There will be NO Medicare benefit cuts or increases in seniors' costs.

**Note:**

The last time an enforcement mechanism like this was used -- with 50 percent domestic and 50 percent defense cuts -- the threat of defense cuts helped drive the 1990 bipartisan agreement under President George H.W. Bush that included both revenues and spending reductions.

#### **4. Future votes on balanced budget constitutional amendment**

As part of the compromise, both the House and Senate will vote on a balanced budget constitutional amendment before the end of the year. The debt limit increase is not contingent on *passage* of the amendment. Nor does it prevent a vote on an alternative version of the balanced budget amendment.

## **II. Where we are going -- Commissions and task forces**

### **A. Fiscal commission<sup>1</sup>**

#### **1. Background**

Tax reform should lower tax rates, reduce the deficit, simplify the tax code, reduce the tax gap, and make America the best place to start a business and create jobs. The Commission proposes fundamental and comprehensive tax reform that achieves these basic goals:

- a. Lower rates, broaden the base, and cut spending in the tax code. The current tax code is riddled with \$1.1 trillion of tax expenditures: backdoor spending hidden in the tax code. Tax reform must reduce the size and number of these tax expenditures and lower marginal tax rates for individuals and corporations -- thereby simplifying the code, improving fairness, reducing the tax gap, and spurring economic growth. Simplifying the code will dramatically reduce the cost and burden of tax preparation and compliance for individuals and corporations.

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<sup>1</sup> President Obama created the bipartisan National Commission on Fiscal Responsibility and Reform to address our nation's fiscal challenges. The Commission is charged with identifying policies to improve the fiscal situation in the medium term and to achieve fiscal sustainability over the long run. Specifically, the Commission was to propose recommendations designed to balance the budget, excluding interest payments on the debt, by 2015. In addition, the Commission was to propose recommendations that meaningfully improve the long-run fiscal outlook, including changes to address the growth of entitlement spending and the gap between the projected revenues and expenditures of the Federal Government.

**Note:**

A tax expenditure is revenue a government foregoes through the provisions of tax laws that allow (1) deductions, exclusions, or exemptions from the taxpayers' taxable expenditure, income, or investment, (2) deferral of tax liability, or (3) preferential tax rates. It does so for policy reasons. For example, the earned income credit supplements certain taxpayers as if they paid their full tax but the government then spent money on their behalf; it also subsidizes home ownership by more wealthy taxpayers by allowing some portion of the economic cost of a personal residence (the mortgage interest) to not be taxed (as though the taxpayer paid the tax on such interest but the government returned it to the taxpayer). It is the economic equivalent of a collection of the forgiven tax liability and a simultaneous direct budget outlay to the benefited taxpayers. Of course it does not appear as a government expenditure on the budget; hence it is "backdoor spending."

- b. Reduce the deficit. To escape our nation's crushing debt and deficit problem, we must have shared sacrifice -- and that means a portion of the savings from cutting tax expenditures must be dedicated to deficit reduction. At the same time, revenue cannot constantly increase as a share of the economy. Deficit reduction from tax reform will be accompanied by deficit reduction from spending cuts -- which will come first. Under our plan, revenue reaches 21 percent of GDP by 2022 and is then capped at that level.
- c. Maintain or increase progressivity of the tax code. Though reducing the deficit will require shared sacrifice, those of us who are best off will need to contribute the most. Tax reform must continue to protect those who are most vulnerable, and eliminate tax loopholes favoring those who need help least.
- d. Make America the best place to start a business and create jobs. The current tax code saps the competitiveness of U.S. companies. Tax reform should make the U.S. the best place for starting and building businesses. Additionally, the tax code should help U.S.-based multinationals compete abroad in active foreign operations and in acquiring foreign businesses.

**2. Eliminate income-tax expenditures**

The Commission proposes tax reform that relies on "zero-base budgeting" by eliminating all income-tax expenditures (but maintaining the current payroll tax base (Social Security and Medicare), which should be modified only in the context of Social Security reform), and then using the revenue to lower rates and reduce deficits.

- a. A "zero plan" could reduce income-tax rates to **as low as** 8 percent, 14 percent, and **23 percent**. Even after adding back a number of larger tax expenditures, rates would still remain significantly lower than under current law (the burden of the retained tax expenditures being borne solely by the highest tax rate).
  - (i) Cut rates across the board, and reduce the top rate to between 23 and 29 percent. Real tax reform must dedicate a portion of the savings from cutting tax expenditures to lowering individual rates. The top rate, **as a matter of policy**, must not exceed 29 percent.
  - (ii) Dedicate \$80 billion to deficit reduction in 2015 and \$180 billion in 2020. In addition to reducing rates, reform must be projected to raise \$80 billion of additional revenue (relative to the alternative fiscal scenario) in 2015 and \$180 billion in 2020.
  - (iii) Simplify key provisions to promote work, homes, health, charity, and savings while increasing or maintaining progressivity. Congress and the President must decide which tax expenditures to include in the tax code in smaller and more

targeted form than under current law, recognizing that any add-backs will raise rates. The new tax code must include provisions (in some cases permanent, in others temporary) for the following:

- Support for low-income workers and families (e.g., the child credit and EITC);
- Mortgage interest only for principal residences;
- Employer-provided health insurance;
- Charitable giving; and
- Retirement savings and pensions.

		<b>Bottom Rate</b>		<b>Middle Rate</b>		<b>Top Rate</b>	<b>Corporate Rate</b>
<b>Current Rates for 2010</b>	10%	15%	25%	28%	33%	35%	35%
<b>Scheduled Rates for 2013</b>		15%	28%	31%	36%	39.6%	35%
<b>Eliminate all Tax Expenditures*</b>		8%		14%		23%	26%
<b>Keep Child Tax Credit + EITC</b>		9%		15%		24%	26%
<b>Enact Illustrative Tax Plan (Below)</b>		12%		22%		28%	28%

\*Taxes capital gains and dividends as ordinary income.

**Note:**

Additional tax expenditures could be added to the provisions above, but must be paid for with higher rates. Furthermore, the revised code must increase or maintain progressivity, across the income spectrum, relative to the alternative fiscal scenario. In enacting tax reform, Congress and the President should design appropriate transition rules that minimize economic distortions, achieve the necessary revenue targets, and allow taxpayers to adapt to the changes.

- b. The Commission has designed an illustrative set of reforms that would accomplish the necessary parameters for tax reform. Congress could choose different options. We developed this illustrative plan to demonstrate that it is possible both to reduce rates dramatically and to achieve significant deficit reduction if tax expenditures are eliminated or scaled back and better targeted.

**Current Law****Illustrative Proposal (Fully Phased In)**

<b>Tax Rates for Individuals</b>	In <b>2010</b> , six brackets: 10% 15% 25%  28% 33% 35%. In <b>2013</b> , five brackets: 15% 28% 31% 36% 39.6%.	Three brackets: 12% 22% 28%.
<b>Alternative Minimum Tax</b>	Scheduled to hit middle-income individuals but “patched” annually.	Permanently repealed.
<b>PEP and Pease</b>	Repealed for <b>2010</b> , resumes in <b>2012</b> .	Permanently repealed.
<b>EITC and Child Tax Credit</b>	Partially refundable child tax credit of \$1000 per child. Refundable EITC of between \$457 and \$5,666.	Maintain current law or an equivalent alternative.
<b>Standard Deduction and Exemptions</b>	Standard deduction of \$5,700 (\$11,400 for couple) for non-itemizers; personal and dependent exemptions of \$3,650.	Maintain current law; itemized deductions eliminated, so all individuals take standard deductions.
<b>Capital Gains and Dividends</b>	In <b>2010</b> , top rate of 15% for capital gains and dividends. In <b>2013</b> , top rate of 20% for capital gains, and dividends taxed as ordinary income.	All capital gains and dividends taxed at ordinary income rates.
<b>Mortgage Interest</b>	Deductible for itemizers; Mortgage capped at \$1 million for principal and second residences, plus an additional \$100,000 for home equity.	12% non-refundable tax credit available to all taxpayers; Mortgage capped at \$500,000; No credit for interest from second residence and equity.
<b>Employer Provided Health Care Insurance</b>	Excluded from income. 40% excise tax on high cost plans (generally \$27,500 for families) begins in 2018; threshold indexed to inflation.	Exclusion capped at 75 <sup>th</sup> percentile of premium levels in 2014, with cap frozen in nominal terms through 2018 and phased out by 2038; Excise tax reduced to 12%.
<b>Charitable Giving</b>	Deductible for itemizers.	12% non-refundable tax credit available to all taxpayers; available above 2% of Adjusted Gross Income (AGI) floor.
<b>State and Municipal Bonds</b>	Interest exempt from income.	Interest taxable as income for newly-issued bonds.
<b>Retirement</b>	Multiple retirement account options with different contribution limits; saver’s credit of up to \$1,000.	Consolidate retirement accounts; cap tax-preferred contributions to lower of \$20,000 or 20% of income, expand saver’s credit.
<b>Other Tax Expenditures</b>	Over 150 additional tax expenditures.	Nearly all other income-tax expenditures are eliminated.

### 3. Social Security

**Note:**

Social Security is the foundation of economic security for millions of Americans. More than 50 million Americans -- living in about one in four households -- receive Social Security benefits, with about 70 percent going to retired workers and families, and the rest going to disabled workers and survivors of deceased workers.

Much has changed that will impact the structure of Social Security from its origins. Average life expectancy was 64 and the earliest retirement age in Social Security was 65 then, but today, Americans on average live 14 years longer, retire three years earlier, and spend 20 years in retirement. Probably most relevant to the funding crisis the program now faces is the underlying support for the system: in 1950, there were 16 workers per beneficiary; in 1960, there were 5 workers per beneficiary. Today, the ratio is 3:1 -- and by 2025, there will be just 2.3 workers "paying in" per beneficiary. These immense demographic changes undermine the promise of Social Security benefits currently pledged. Today, the program is spending more on beneficiaries than it is collecting in revenue. Although the system's revenues and expenditures are expected to return to balance temporarily in 2012, it will begin running deficits again in 2015 if interest income from the trust fund is excluded and in 2025 including such interest "payments." After that point, the system's trust fund will be drawn down until it is fully exhausted in 2037.

The system is in need of a major facelift. Doing nothing plan would require an immediate 22-percent across-the-board benefit cut for all current and future beneficiaries in 2037. Over the next 75 years, the program faces a shortfall equal to 1.92 percent of taxable payroll. To avert this financial calamity, the Commission made the following recommendations, premised first and foremost by the necessity that the most fortunate will have to contribute the most, by taking lower benefits than scheduled and paying more in payroll taxes, the middle-income earners able to work to do so a little longer, and more engagement with the poor to provide additional help:

Its proposals are similar to those offered by the Bipartisan Policy Center, discussed below, with some relatively minor differences.

**Note:**

The plan proposed by the Commission is designed to restore actuarial balance as a stand-alone proposal. However, the tax reform process recommended by the Commission may separately result in additional payroll tax revenues into the Social Security system as a result of base broadening measures which would likely cause employers to shift some portion of non-wage compensation into wages (with resulting indirect increase in payroll tax revenues). As noted in the tax reform section, the Commission recommends that the precise details of tax reform be developed under a fast track procedure over the next two years. The impact of this reform on trust fund revenues will depend on the decisions Congress makes in the process. If Congress considers the Commission's Social Security recommendations in conjunction with or subsequent to tax reform legislation that results in additional trust fund revenue, this additional revenue will provide flexibility to moderate the changes in benefits or taxation recommended by the Commission.

Recently, the AARP modified its stance on Social Security, concluding that while it would not lobby for, it would likewise not actively oppose benefit cuts in light of the fiscal problems the nation now faces.<sup>2</sup>

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<sup>2</sup> *Wall Street Journal*, "Seniors Lobby Pivots on Benefits," June 17, 2011.

### **III. Where we are going -- Administration's budget proposals**

Just as the Administration's 2010 Budget Proposal outlined the tax policies and specific proposals for its first term, the recently issued Budget Proposal for 2012 establishes a blueprint for what it hopes will be a second term, having essentially deferred action on most areas to the post-2012 period following the enactment of the tax compromise in the Taxpayer Relief, Unemployment Compensation Reauthorization, and Job Creation Act of 2010.

#### **A. Individual changes**

##### **1. Allow the top two rates to return to 36 percent and 39.6 percent**

The Administration renews its call for the top tax rate in 2013 to increase from 35 percent to 39.6 percent as is scheduled under current law. In 2013, using currently projected COLA for 2011 and 2012, that would increase income-tax liability for all taxpayers with taxable income over \$390,050 (half that amount for married couples filing separately). Similarly, the 33-percent tax rate would increase to 36 percent for joint filers with adjusted gross income over \$250,000 (\$200,000 for single filers) in 2013. Actually, this is what is scheduled under current law but only for joint filers with adjusted gross income over \$250,000 (\$200,000 for single filers, with both values in 2009 dollars and indexed for inflation in future years). For married couples filing jointly, the 36-percent bracket would begin when **taxable income** exceeds \$250,000 minus the sum of the standard deduction for couples and the taxpayers' personal exemptions. For single filers, the threshold would start at \$200,000 minus the sum of the standard deduction for single filers and the taxpayer's personal exemption.\* These are the same numbers as in the earlier budget proposal, without adjustment for inflation, but because it is stated in 2009 dollars, the pivot point will have to be determined by COLA. For taxpayers currently in the 33-percent tax rate but with income below those thresholds income would continue to be taxed at a 33-percent tax bracket. This would require enactment of legislation to prevent such taxpayers from automatically moving into the second highest bracket.

##### **2. Reinstate personal exemption phase out and limitation on itemized deductions**

Higher-income taxpayers face reductions of their personal exemptions and itemized deductions as their income exceeds specified levels. The reductions were gradually phased out and eliminated in 2010. The 2010 legislation extended the elimination through 2012, after which, under current law, the reductions would return at their original levels. The president proposes to allow both reductions to resume in 2013 but only for high-income taxpayers -- single filers with AGI over \$200,000 and joint filers with AGI over \$250,000 (2009 values, indexed for inflation). However, it would require further legislation to ensure that taxpayers below those thresholds from being subject to phaseout.

- a. The personal exemption phase out (PEP) reduces the value of each personal exemption from its full value by 2 percent for each \$2,500 or part thereof above specified income thresholds that depend on filing status. Personal exemptions are fully phased out over a \$122,500 range.
- b. The limitation on itemized deductions -- known as Pease after the congress-man who introduced it -- cuts itemized deductions by 3 percent of adjusted gross income above specified thresholds but not by more than 80 percent. The income threshold -- projected to be \$174,450 in 2013 (\$87,225 for married couples filing separately) -- is indexed for inflation.
- c. The threshold for the phase outs would begin at 2009 levels of \$250,000 for couples\* and \$200,000 for other taxpayers, with both values indexed for inflation. TPC estimates that

2013 thresholds would be \$261,450 for couples, \$209,150 for single filers, \$235,300 for heads of household, and \$130,725 for couples filing separately. Personal exemptions would thus phase out at incomes between \$261,450 and \$383,950 for joint filers, between \$209,150 and \$331,650 for single filers, and between \$235,300 and \$357,800 for heads of household. \*\*Taxpayers would have their itemized deductions reduced in 2013 by 3 percent of their income over the same thresholds but not by more than 80 percent.

Income Ranges for Personal Exemption Phaseout (PEP) and Limitation on Itemized Deductions (Pease), 2013				
Filing Status	Budget Proposal		Current Law	
	Starting AGI, Pease and PEP	AGI, Phaseout Complete	Starting AGI, PEP*	AGI, Phaseout Complete
Married, filing jointly or surviving spouse	\$261,450	\$383,950	\$261,650	\$384,150
Heads of household	\$235,300	\$357,800	\$218,050	\$340,550
Single	\$209,150	\$331,650	\$174,450	\$296,950
Married, filing separately	\$130,725	\$191,975	\$130,825	\$192,075

\* Under current law, Pease begins at the same income for single, joint, and head of household filers —\$174,450 in 2013. For married couples filing separately, the threshold is half that amount.

- d. Phaseouts increase marginal tax rates for taxpayers in the affected income ranges. Pease would increase the marginal tax rate of affected taxpayers by 3 percent of their bracket rate: 36 percent would go to 37.08 percent, and 39.6 percent would rise to 40.79 percent. The personal exemption marginal tax increase depends on the number of personal exemptions, which will vary from taxpayer to taxpayer.




**Note:**

Because both personal exemptions and itemized deductions are taken below-the-line, the Medicare tax on unearned income, which is predicated on and limited by an adjusted gross income level, is unaffected. Nevertheless, it is additive in the sense that the additional tax rate resulting from the phase outs applies to any excess unearned income in addition to the 3.8 percent. Thus, some taxpayers in a 39.6-percent nominal bracket could see some unearned income taxed at a 44.59 percent (40.79 + 3.8) without consideration of the variable personal exemption effect.

**Planning point:**

Higher-income taxpayers face a variety of phaseouts (at different levels) that reduce or eliminate certain tax benefits with the effect of increasing the taxpayer's marginal tax rate. When taxpayers are in the phaseout zone for multiple benefits, the effective tax rate can increase substantially over the phaseout range. There is no easy formula for the effect because of the various structures the Code uses to implement them. Some merely reduce credits, which affect all taxpayers equally, while others affect deductions, which affect taxpayers in accordance with their marginal tax bracket; some phase out constantly over the range, but can differ depending on the width of the phaseout range, while others phase out a fixed amount for certain increments of income, which can produce discontinuities in effective tax rate; and some are indexed for inflation, while others are not, creating sometimes significant marginal tax changes from one year to the next. And filing status can also change the effect of a phaseout, particularly married couples that may incur more (or less) of a change in marginal tax rate than two single, co-habiting taxpayers.

**2013 Tax Rates, Standard Deduction, and Personal Exemption under Alternative Baselines and as Proposed in the 2012 Budget**

Taxable Income		Current Law (Bush-Era Tax Cuts Expire)	Administration's FY2012 Budget Proposal	Current Policy (Bush-Era Tax Cuts in Place)
Over	But not over			
<b>Marginal Tax Rates for Single Individuals</b>				
\$0	\$8,750	15%	10%	10%
\$8,750	\$35,500	15%	15%	15%
\$35,500	\$86,000	28%	25%	25%
\$86,000	\$179,400	31%	28%	28%
\$179,400	\$199,350	36%	33%	33%
\$199,350	\$390,050	36%	36%	33%
\$390,050	—	39.6%	39.6%	35%
<b>Marginal Tax Rates for Married Couples Filing Jointly</b>				
\$0	\$17,500	15%	10%	10%
\$17,500	\$59,300	15%	15%	15%
\$59,300	\$71,000	28%	15%	15%
\$71,000	\$143,350	28%	25%	25%
\$143,350	\$218,450	31%	28%	28%
\$218,450	\$241,900	36%	33%	33%
\$241,900	\$390,050	36%	36%	33%
\$390,050	—	39.6%	39.6%	35%
<b>Marginal Tax Rates for Heads of Household</b>				
\$0	\$12,500	15%	10%	10%
\$12,500	\$47,600	15%	15%	15%
\$47,600	\$122,850	28%	25%	25%
\$122,850	\$198,900	31%	28%	28%
\$198,900	\$222,750	36%	33%	33%
\$222,750	\$390,050	36%	36%	33%
\$390,050	—	39.6%	39.6%	35%
<b>Standard Deduction</b>				
Single:		\$5,950	\$5,950	\$5,950
Married Filing Jointly:		\$9,950	\$11,900	\$11,900
Head of Household:		\$8,750	\$8,750	\$8,750
<b>Personal Exemption:</b>				
		\$3,800	\$3,800	\$3,800
			Same as Current Law and Current Policy	
			Reduced relative to Current Law, same as Current Policy	
			Increased relative to Current Policy, same as Current Law	

**3. Allow resumption of 20-percent rate on long-term capital gains for high-income taxpayers**

In 2011 and 2012, long-term capital gains (gains on assets held at least a year) face a maximum tax rate of 15 percent. Taxpayers with regular tax rates of 15 percent or less pay no tax on that income. Under current law, tax rates on long-term gains are scheduled to revert in 2013 to their pre-2003 levels of 10 percent for taxpayers in the 15-percent bracket and below and 20 percent for taxpayers in higher tax

brackets. The Administration would allow the rate on gains to rise to 20 percent starting in 2013, but only for high-income taxpayers. The proposal defines high-income taxpayers as those in the top two tax brackets: couples with 2013 taxable income above \$241,900 (half as much for couples filing separately), single filers with income over \$199,250, and heads of household with income over \$222,750, with all values indexed for inflation.

A higher tax rate on capital gains would suggest two strategies for affected taxpayers. One would be to hold on to assets with accrued gains and therefore realize fewer taxable gains. The second is to realize more gains in 2011 and 2012 when the rates are low and fewer in 2013 and subsequent years when the rates are higher.

#### **4. Reduce the tax rate on qualified dividends to 20-percent rate for high-income taxpayers**

In 2011 and 2012, qualified dividends face a maximum tax rate of 15 percent. Taxpayers with regular tax rates of 15 percent or less pay no tax on that income. Under current law, qualified dividends will be taxed at regular tax rates in 2013. The Administration would reduce the tax rate in 2013 to 20 percent for taxpayers in the top two tax brackets -- couples with 2013 taxable income above \$241,900 (half as much for couple filing separately), single filers with income over \$199,250, and heads of household with income over \$222,750, with all values indexed for inflation -- and maintain the current 15-percent and 0-percent rate schedule at lower incomes.

**Note:**

Dividend payments from publicly-owned companies may be predicted to some extent, but cannot be easily varied; on the other hand, dividends from closely-held businesses are rare, but business owners can control their timing. Some corporations may elect to accelerate some dividend payments that might otherwise have been paid in 2012 to take advantage of the current lower rate.

**Note:**

Phaseouts create additional effective tax rates for capital gains and dividends above the statutory rates. For example, taxpayers in the phase out range of the AMT exemption increase the effective tax rate by 6.5 percent (for taxpayers in the 26 percent AMT bracket) or by 7 percent (for taxpayers in the 28 percent AMT bracket), since the inclusion of the income increase AMTI not just dollar-for-dollar but also by the loss of the exemption (of up to 25 percent of such income).

#### **5. Limit the value of itemized deductions to that enjoyed by a 28-percent bracket taxpayer**

Taxpayers may reduce their taxable income by subtracting either the appropriate standard deduction or their itemized deductions for medical expenditures, state and local taxes, mortgage interest, charitable contributions, and other allowed expenses. Because deductions reduce taxable income, their effect on tax liability depends on the taxpayer's tax bracket.

The Administration re-proposed a system that would limit the amount of the reduction of the tax liability itemized deductions could produce to no more than 28 percent starting in 2012, but only for taxpayers with income whose tax rate bracket exceeds 28 percent. In 2012, those affected would include all taxpayers in the 35-percent tax bracket and some of those in the 33-percent bracket. Starting in 2013, the limitation would apply to taxpayers in the 36-percent and 39.6-percent brackets.

**Note:**

There is little or no chance, given the current composition of the House of Representatives that such a proposal could be enacted in respect of 2012; application in 2013 would depend on political results from the 2012 election.

But if enacted, its effect could interact with the limitation on itemized deductions to reduce the tax benefit substantially. For example, itemized deductions cannot under the general rule be reduced by more than 80 percent, but conceivably as little as 20 percent of a taxpayer's itemized deductions could be deductible, which in conjunction with a maximum 28-percent valuation limitation could result in a tax liability reduction of only 5.6 percent of the itemized expenditures the taxpayer made. Without the general limitation or the valuation limitation, a taxpayer, assuming a tax rate increase, could enjoy a tax liability reduction of as much as 39.6 percent of those same expenditures.

The Tax Policy Center estimated that the limitation on the value of deductions would raise taxes by an average of about \$5,000 for the upper one-ninth of taxpayers in the top income quintile in 2012. Just over 80 percent of taxpayers in the top 1 percent would pay more tax, an average increase of more than \$11,000. In 2013, when the top tax rates rise, about one-eighth of taxpayers in the top quintile would pay an average of about \$9,000 more tax compared with current law and over 80 percent of those in the top 1 percent would pay an average of more than \$20,000 additional tax.

**6. *Extend the 2001 and 2003 tax cuts for non-wealthy taxpayers***

In concert with the scheduled increase in the tax rates for the wealthy (as so-defined) is a scheduled increase in the tax rates for the non-wealthy in 2013, which would affect ordinary income, long-term capital gains, and dividends; also scheduled to reappear are marriage penalties, the credits for earned income and child and dependent care credits. All of those changes were originally scheduled to sunset at the end of 2010, but the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended the sunset to the end of 2012.

Individual Income Tax Parameters in 2013 under Under Current Law and under the Budget "Adjusted Baseline"				
Income Tax Provisions		Current Law	2013 Law Assumed in the Budget "Adjusted Baseline" for Taxpayers with Incomes:	
			Below Threshold*	Above Threshold*
Tax Rates (2013 income ranges for single filers)	\$0 - \$8,750	15%	10%	10%
	\$8,750 - \$35,500	15%	15%	15%
	\$35,500 - \$86,000	28%	25%	25%
	\$86,000 - \$179,400	31%	28%	28%
	\$179,400 - \$199,350	36%	33%	33%
	\$199,350 - \$390,050	36%	N/A	36%
	\$390,050 and over	39.6%	N/A	39.6%
Standard deduction and 15% tax bracket for joint filers		167% of single filers	200% of single filers	200% of single filers
Child Tax Credit		\$500	\$1,000	Generally phased out**
Child and dependent care credit	Max. creditable amount	\$2,400/child, max \$4,800	\$3,000/child, max \$6,000	\$3,000/ child max \$6,000
	Credit rates	20% - 30%	20% - 35%	20%
Phaseout of Personal Exemptions		Over \$122,500 range	No phaseout	Over \$122,500 range
Limitation on Itemized Deductions		Up to 80%	No Limitation	Up to 80%
Top rate on long-term capital gains	15% bracket or lower	10%/8%***	0%	0%
	above 15%, below 36% bracket	20%/18%***	15%	15%
	36% bracket or above	20%/18%***	N/A	20%
Top rate on Qualified Dividends	15% bracket or lower	Regular tax rate	0%	0%
	above 15%, below 36% bracket	Regular tax rate	15%	15%
	36% bracket or above	Regular tax rate	N/A	20%

\* Threshold for single filers is \$200,000 and for joint filers is \$250,000 (2009 values, indexed for inflation).  
\*\* Very large families with income above the relevant threshold may receive some child credit.  
\*\*\* Lower rate of 8% or 18% applies to gains on capital assets held at least five years.

The "adjusted baseline" used in the president's budget in place of current law assumes permanent extension beyond 2012 of all the 2001 and 2003 tax cuts for taxpayers with incomes below certain thresholds (\$250,000 for joint filers and \$200,000 for single filers). The adjusted baseline also assumes that the 2001 and 2003 tax cuts that apply only to taxpayers with incomes above those thresholds expire in 2013 as scheduled.

## 7. Index to inflation the 2011 parameters of the individual alternative minimum tax

Under current law, individual taxpayers may be subject to an alternative minimum tax if their tentative AMT liability exceeds their regular income-tax liability. Tentative AMT liability is computed using a different rate schedule and different tax base than the regular income tax. The AMT owed is equal to the difference (if any) between tentative AMT liability and liability under the regular income tax.

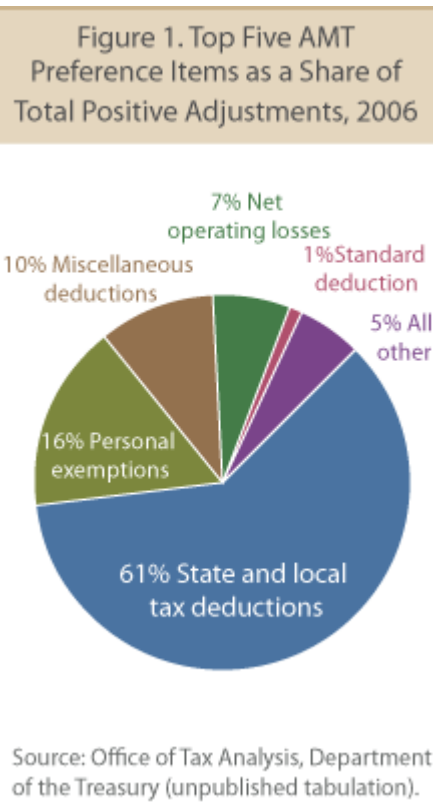
- a. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended the AMT patch through 2011, setting the AMT exemption levels in 2011 at \$48,450 for single and head-of-household filers, \$74,450 for married people filing jointly and qualifying widows or widowers, and \$37,225 for married people filing separately. The AMT has two tax rates: 26 percent on the first \$175,000 of income above the exemption and 28 percent on incomes above that amount. The AMT exemption phases out at a 25-percent rate between \$117,650 and \$311,450 for singles and heads of household, between \$156,850 and \$454,650 for married couples filing jointly, and between \$78,425 and \$227,325 for married couples filing separately. For affected taxpayers, the phase out creates effective AMT tax rates of 32.5 percent -- 125 percent of 26 percent -- and 35 percent -- 125 percent of 28 percent.
  - (i) The AMT has two tax rates: the first \$175,000 of income above the exemption is taxed at a 26-percent rate, and incomes above that amount are taxed at 28 percent. The AMT exemption phases out beginning at \$112,500 for singles and heads of household, \$150,000 for married filing joint returns, and \$75,000 for married returns filing separately. (Since the exemption phases out at a 25-percent rate, it creates effective AMT tax rates of 32.5 percent -- 125 percent of 26 percent -- and 35 percent -- 125 percent of 28 percent.)

Figure 1. Effective AMT Rates on Ordinary Income and Capital Gains by Income, 2009

Income (AMTI), dollars		Tax rate (percent)	
Single	Filing jointly	Ordinary income	Capital gains
33,750 - 112,499	45,000 - 149,999	26.0	15.0
112,500 - 189,499	150,000 - 205,999	32.5	21.5
190,000 - 247,499	206,000 - 329,999	35.0	22.0
247,500 and over	330,000 - and over	28.0	15.0

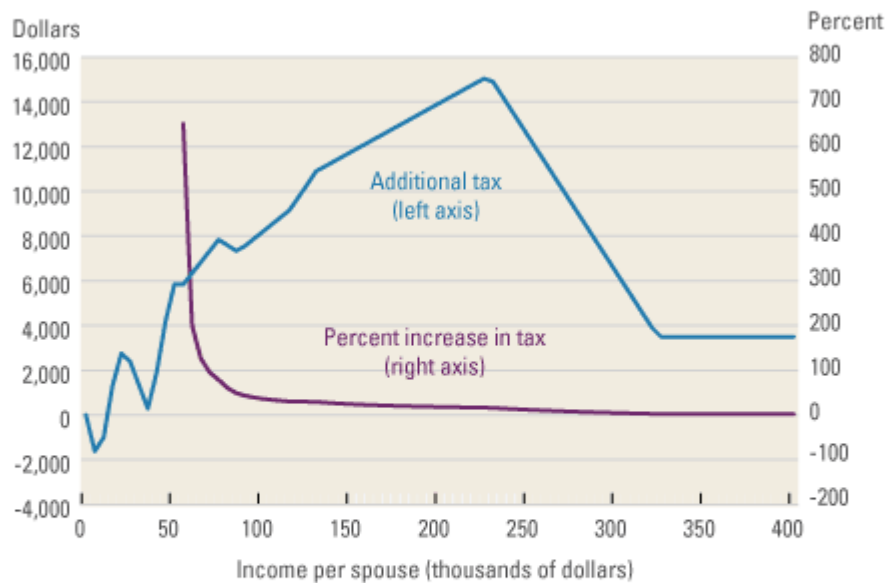
Source: Authors' calculations based on Internal Revenue code.

- (ii) The AMT disallows state and local tax deductions and dependent exemptions. Those two adjustments account for most of the difference between the AMT and the regular income tax. In consequence, middle income families with children who live in high-tax states are among those most likely to be subject to AMT.
- (iii) In addition, the relatively high AMT exemption means that the amount of income subject to tax under the AMT is often less than it is under the regular income tax. In 2009, 58 percent of AMT taxpayers will have more income subject to tax under the regular tax than they would have under the AMT. Most AMT taxpayers face a higher marginal rate applied to a narrower tax base than they would if they were in the regular income-tax system.



- b. Taxpayers effectively pay the higher of their tax calculated under regular income-tax rules and their tax calculated under AMT rules. Since the 35-percent top rate under the regular income tax is higher than the 28-percent top statutory rate under the AMT, households with very high incomes who do not shelter a substantial portion of their income typically end up in the regular tax system. Households with lower but still moderately high incomes face lower regular tax rates and are thus more likely to owe AMT.
- (i) The Tax Policy Center claims that in 2009, only 40 percent of tax filers with incomes greater than \$1 million were affected by the AMT, compared with nearly 50 percent of those with incomes between \$200,000 and \$500,000. In 2010, had the legislation not taken place, only 48.7 percent of millionaires would have paid the AMT, but 92 percent of those in the \$200,000-to-\$500,000 income class would have. Without that patch in 2010, for those making between \$100,000 and \$200,000, the percent of filers affected by the AMT would have risen from 4 percent in 2009 to 75 percent in 2010.

Figure 3. Potential Marriage Penalties in an AMT-only Tax System, 2006<sup>a</sup>



Notes:

(a) Penalty is for a family of four consisting of two parents who each earn the same income and two children under seventeen who qualify for the child credit and the earned income tax credit. The penalty equals the difference between tax paid on a joint return and the sum of taxes paid on a head-of-household return claiming two children as dependents and a single return with no children. Calculations assume that itemized deductions allowed against the AMT are 12.6 percent of adjusted gross income.

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 1006-1).

- (ii) Most married couples receive a "marriage bonus," paying less regular income tax than they would if they were single. But because AMT tax brackets are identical for married and single taxpayers and the AMT exemption is only about one-third larger for couples than for singles, there may be a penalty. In contrast, the standard deduction for couples under the regular income tax is twice that for singles and tax brackets for married couples are twice as wide as those for singles. Married couples often have children (and corresponding more personal exemptions that are disallowed by the AMT), and tend to have higher household incomes than single individuals resulted in married couples being more than 5 times as likely to owe AMT as singles in 2009.

**Note:**

Although most AMT payers are doing fairly well, the tax has increasingly affected more and more solidly middle and upper-middle class taxpayers. In 2010, 37 percent of all tax filers making between \$75,000 and \$100,000 would have paid the AMT, up from 0.5 percent in 2009, when the temporary AMT fix or "patch" was in place; avoiding this result animates the annual patching. The AMT is also more likely to strike taxpayers with large families, who are married, or who live in high-tax states (as those preferences account for 77 percent of all preferences).

**Note:**

Because the top regular income-tax rate of 35 percent is higher than the top statutory AMT rate of 28 percent, the AMT affects relatively few of the highest-income taxpayers. According to the Tax Policy Center, taxpayers with at least \$1,000,000 of income will lose only 7.6 percent of the tax cuts they would have received without the AMT.

- c. AMT incurs significant “bracket creep”: the lack of indexing for inflation means that the tax rises in real terms as prices rise, unlike the regular income tax, which is indexed. Inflation pushes more income above the unindexed exemption threshold and, for high-income taxpayers, subjects more income to the exemption phase out and the 28-percent AMT rate.
  - (i) Since 2001, Congress has repeatedly increased the individual AMT exemption level on a temporary basis to prevent too many taxpayers from being subject to the tax. Those patches have also allowed taxpayers subject to the AMT to use personal nonrefundable tax credits, including credits for child care and higher education, which the AMT disallows in the absence of temporary, enabling legislation. Without the patch, the lower AMT exemption would result in almost a third of all taxpayers being affected by the AMT.
  - (ii) The Administration proposes that the 2011 AMT parameters -- exemptions, rate brackets, and phase out thresholds -- be permanently extended and indexed after 2011 for inflation.

**8. Tax carried interest as ordinary income**

The president’s budget proposes to tax the income from “carried interest” as ordinary income rather than as capital gains as under current law.<sup>3</sup> Carried interest accrues to certain investment fund managers, including managers of hedge funds and venture capital partnerships. These managers generally receive part of their compensation in the form of an interest in the partnership, which entitles them to a share of partnership profits. If the partnership earns a capital gain, the manager reports his share -- the carried interest -- as capital gain income. Under the budget proposal, a partner’s share of income from an “investment services partnership interest” (ISPI) would be taxed as ordinary income, regardless of the character of the income at the partnership level. Partners would be required to pay self-employment taxes on income from an ISPI. If a partner sells an ISPI, the gain would be taxed as ordinary income, not as a capital gain. Income that a partner earns from capital invested in the partnership would not be recharacterized provided that the partnership reasonably allocates income across invested capital and carried interests.

**9. Expand the child and dependent care tax credit**

- a. The child and dependent care tax credit (CDCTC) provides a credit of between 20 and 35 percent of up to \$3,000 (\$6,000 for two or more children) in child care expenses for children under age 13 whose parents work or go to school. Families with income below \$15,000 qualify for the 35-percent credit. That rate falls by 1 percentage point for each additional \$2,000 of income (or part thereof) until it reaches 20 percent for families with income of \$43,000 or more. The credit is nonrefundable—that is, it can only reduce a

<sup>3</sup> Carried interest is a right that entitles the general partner (GP) of a private investment fund to a share of the fund’s profits (see Figure 1). Typically, the GP contributes 1 to 5 percent of the fund’s initial capital and commits to managing the fund’s assets. In exchange, the GP receives an annual management fee of 2 percent of the fund’s assets plus a “carried interest” of 20 percent of the fund’s profits that exceed a certain “hurdle” rate of return. The individual partners of the GP, not the GP itself, are taxed on these payments.

family's income-tax liability to zero; any additional credit is lost. Higher-income families generally benefit more from the exclusion than from the credit, since the excluded income avoids both income and payroll taxes, but it is only available to those taxpayers whose employers offer it. Families with children and income between \$75,000 and \$200,000 benefit most from the credit: they make up 30 percent of all families with children and get more than a third of the total credits.

- b. The Administration proposes to increase the income limit for the maximum 35-percent credit to \$85,000. The credit rate would phase down by 1 percentage point for each \$2,000 of income over that threshold until it hits a minimum of 20 percent for families with income over \$113,000. The maximum creditable expenses would remain at \$3,000 for one child and \$6,000 for two or more children.
- (i) For families with income between \$43,000 and \$85,000, the maximum credit would increase from \$600 to \$1,050 (from \$1,200 to \$2,100 for families with two or more children).
  - (ii) More than half of benefits from extending the phase out would accrue to families in the middle income quintile. Because it is nonrefundable, the larger credit would do almost nothing for families in the bottom fifth of the income distribution, and only about 17 percent of the benefits would accrue to families in the second quintile.

Child And Dependent Care Credit President's Proposal			
Adjusted Gross Income	Credit Rate	Maximum Credit	
		One Child	Two or More Children
\$85,000 or less	35	1,050	2,100
85,001 - 87,000	34	1,020	2,040
87,001 - 89,000	33	990	1,980
89,001 - 91,000	32	960	1,920
91,001 - 93,000	31	930	1,860
93,001 - 95,000	30	900	1,800
95,001 - 97,000	29	870	1,740
97,001 - 99,000	28	840	1,680
99,001 - 101,000	27	810	1,620
101,001 - 103,000	26	780	1,560
103,001 - 105,000	25	750	1,500
105,001 - 107,000	24	720	1,440
107,001 - 109,000	23	690	1,380
109,001 - 111,000	22	660	1,320
111,001 - 113,000	21	630	1,260
113,001 and over	20	600	1,200

## **10. American opportunity tax credit**

The economic stimulus act (“American Recovery and Reinvestment Act of 2009”) established and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended the “American Opportunity” tax credit (AOTC) as a replacement for the Hope credit through 2012. The AOTC is a partially refundable tax credit equal to 100 percent of the first \$2,000 plus 25 percent of the next \$2,000 spent on tuition, fees, and course materials during each of the first four years of postsecondary education for students attending school at least half time. The maximum credit is \$2,500 a year. In contrast, the Hope credit was available for only the first two years of postsecondary education and was not refundable. Each student in a household may claim the AOTC, the Lifetime Learning credit, or the deduction for tuition expenses in a given year -- but not more than one of them. All students in the same home need not choose the same tax benefit.

The Administration proposes to make the AOTC permanent and index for inflation both the maximum expenditures eligible for the credit and the income thresholds above which the credit phases out, beginning after 2012. The larger, refundable credit would continue to extend educational assistance to low-income students, making it easier for them to afford college and thus encouraging attendance. Indexing both the credit and the phase out ranges would maintain the real value of the credit over time.

## **11. Require automatic enrollment in IRAs and enhanced small employer startup credit**

The Administration proposes to establish automatic enrollment in IRAs for employees without access to an employer-sponsored saving plan. Currently, workers who wish to contribute to an IRA must first establish the account, actively make a decision to contribute each year, transfer funds into the IRA, and decide how to invest their contributions. The Administration proposes to make this process automatic. Under the proposal, most employers who do not currently offer retirement plans -- except those with less than 10 employees or firms in business less than two years -- would have to enroll employees in a direct-deposit IRA account unless the worker opts out. The default contribution rate would equal 3 percent of compensation, and contributions would automatically go into standard, low-cost investments. Furthermore, the default option would be a **Roth IRA**, funds for which come from after-tax income and are untaxed upon withdrawal, as opposed to a deductible IRA, which is funded from pretax income and from which withdrawals are subject to income tax.

- a. Research has shown that changing the default from an opt-in provision to an opt-out provision markedly increases worker participation in 401(k)-type plans, especially for demographic groups with traditionally low saving rates. The administration suggests that this trend will hold for automatic enrollment in IRAs, increasing saving rates for workers without workplace retirement plans and helping to reverse the nation’s prolonged trend of low saving rates.
- b. In conjunction with automatic enrollment, the administration proposes a credit of up to \$250 per year per business, for not more than two years, to help small businesses cover the costs of automatic enrollment. In addition, the proposal would double the existing tax credit for small businesses starting new employee retirement plans from \$500 to \$1,000, available for a maximum of three years.

## 12. Transfer tax

The 2010 tax act reinstated the tax with an effective \$5 million exemption and a 35-percent tax rate. The act also for the first time allowed portability of the exemption between spouses: any of the \$5 million exemption not used when one spouse dies may be added to the exemption available for the second spouse (if he or she has not remarried). However, unless Congress acts, the estate provisions in effect prior to 2001 would be reinstated starting in 2013. Under these provisions, estates valued at \$1 million or more would again be subject to tax at progressive rates as high as 60 percent, and portability would disappear.

- a. The Budget proposes permanently setting the estate tax at its 2009 level beginning in 2013: estates worth more than \$3.5 million would pay 45 percent of taxable value over that threshold. It would also make portability permanent, allowing couples to share a combined exemption of \$7 million. The Tax Policy Center estimated that approximately 3,600 estates would owe estate tax in 2011, less than 0.2 percent of deaths in that year. If the pre-2001 estate tax applied, more than 40,000 estates would have owed tax, about 2 percent of decedents. Had Congress made the 2009 estate tax permanent as the president proposed in his 2011 budget, about 5,500 estates would have paid the tax.

### **Note:**

The reduction of the exemption level can present “claw-back” issues later on if the taxpayer exceeds the reduced level. Thus, a taxpayer making gifts of \$5,000,000 when the exemption is \$5,000,000 would not be subject to a gift tax when the gift is made, but even when the taxpayer dies (when the estate tax exemption is reduced to \$3,500,00) with no assets, the taxable estate (including the \$5,000,000 adjusted taxable gifts) would result in a pre-credit tax liability on \$5,000,000, but the estate could only claim the credit attributable to the first \$3,500,000, with the result that the taxpayer now gets taxed on the now (but not then) excess of the gift over the exemption. This may temper some strategies that at present seem viable.

- b. The 2010 tax act included an estate tax provision that allows a surviving spouse to use any excess estate tax exemption not used by the deceased spouse, but only through 2012. The Administration proposes to make this provision permanent. Although many couples could have done effectively the same thing under prior law through estate planning, doing so required advance planning and could not necessarily cover increases in the surviving spouse’s wealth over the individual exemption. Allowing portability of a couple’s exemptions between spouses allows couples to take advantage of their combined exemption without having to re-title assets and include special provisions in their wills.
- c. Assets transferred by gift or bequest must be valued in specified ways in determining estate and gift taxes. The resulting value generally becomes the recipient’s basis for the asset. The administration proposal would require recipients to use as their basis no higher value than that used by the donor and require that either the donor or the estate executor provide recipients with appropriate values. As a result, recipients of gifts or bequests could not reduce taxes they would subsequently owe on asset sales by claiming a higher basis and hence a lower capital gain.
- d. Transfers of property by gift or bequest are generally subject to gift or estate tax. Provisions in the Internal Revenue Code attempt to prevent various methods of reducing the value of such transfers -- and hence the applicable tax -- but some restrictions have become less effective. The Administration proposes to limit valuation discounts on family-controlled entities (FLPs).

- e. If an interest in a trust is transferred to a family member, tax law requires that any interest retained by the grantor have zero value in determining any transfer tax except if the retained interest is “qualified.” One case of qualified interest is a grantor-retained annuity trust (GRAT) in which the grantor receives the annuity for a specified period (based on how long the grantor expects to live) and the residual trust passes to beneficiaries. In such a case, the present value of the annuity is subtracted from the value of the trust in determining transfer taxes. (If the grantor dies during the term of the annuity, some portion of the trust’s assets is included in the decedent’s estate.)
  - (i) GRATs can minimize transfer taxes, particularly if the trust’s assets appreciate in value. Minimizing the term of the GRAT reduces the likelihood that the grantor will die during its term.
  - (ii) The president proposes to require that GRATs have a minimum term of 10 years, that any remainder interest have a value greater than zero, and that the annuity cannot be reduced during the GRAT’s term. Those restrictions would minimize the value of the GRAT by increasing the risk that the grantor dies during its term and thus loses potential tax savings.
- f. The Administration proposes to limit the tax exemption for generation-skipping transfers by limiting the term over which such exemption applies. The provision aims to prevent perpetual (dynasty) trusts through which assets can pass tax-free through multiple generations.

### **13. Eliminate taxation of capital gains on qualified small business stock**

Since 1993 noncorporate taxpayers have been allowed to exclude a portion of the capital gain on qualified small business stock from tax if the stock is held for at least five years. In general, 50 percent of the gain is excluded (60 percent for businesses in empowerment zones); the remaining gain is taxed at a maximum rate of 28 percent. The 2009 stimulus bill (the American Recovery and Reinvestment Act) raised the exclusion to 75 percent for stock acquired between February 17, 2009, and January 1, 2011. The Small Business Job Act again raised the exclusion, to 100 percent, for stock acquired after September 27, 2010, and before January 1, 2011. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended the 100 percent exclusion to stock acquired before January 1, 2012. For stock acquired before September 27, 2010, a portion of the excluded gain is an AMT preference item (that is, it is added to the AMT measure of income and thus subject to the alternative tax). The AMT preference is currently 28 percent of the excluded gain on stock acquired since 2001 and before September 27, 2010, and 42 percent on stock acquired before 2001. The budget proposes to permanently exempt capital gains on qualifying small business stock acquired after December 31, 2012 -- thus reducing the effective tax rate to zero -- and to eliminate the AMT preference. By eliminating the second layer of tax, it would also encourage more qualifying firms to incorporate as C-corporations.

#### **Note:**

Without modification, this proposal would have the 100-percent exclusion return to 50 percent in 2012 before returning in 2013, making investment in 2011 or 2013 more valuable than in 2012.

### **14. Revise tax treatment of inventories**

Because the purchase of inventory represents an exchange of cash for an equal value of assets, firms cannot deduct inventory when purchased. Instead, firms deduct the cost of inventory against the sale of goods in computing net profit. Because otherwise-identical goods moving out of inventory can have

different costs, depending on when they were acquired, firms rely on specific conventions to account for the costs of goods sold. Most companies use the first-in-first-out (FIFO) method, which assumes that the goods first purchased are the ones first sold. The cost of the goods on hand at the end of the year -- the firm's inventory -- reflects the most recent purchases.

- a. Alternatively, companies can elect to use the last-in-first-out (LIFO) method if they also use LIFO for financial statement purposes. This method assumes that the goods last purchased are the ones first sold. This means that goods first purchased make up the firm's inventory at the close of the year. If prices are rising, LIFO allocates higher costs to goods sold than FIFO, which reduces current taxable income and assigns a lower value to the year-end inventory.
  - (i) The president's budget proposes repeal of the election to use LIFO for income-tax purposes. Taxpayers that currently use the LIFO method would be required to write up their beginning LIFO inventory to its FIFO value in the first taxable year beginning after December 31, 2011. This one-time increase in gross income from the write-up of existing inventory would be taken into account ratably over the 10 years beginning after December 31, 2011.
  - (ii) Under LIFO, as long as sales during a year do not exceed purchases, all sales are matched against purchases in the same year, and the opening inventory is never considered to have been sold. Therefore, a company that has used LIFO for many years will have a stock of inventory on its tax returns with a much lower value than its current acquisition price. Repealing LIFO and making companies pay tax on the accrued difference between the LIFO and FIFO valuations of their inventory would impose a substantial one-time tax (paid over 10 years under the proposal) and a smaller permanent annual tax as long as prices are increasing.

**Note:**

LIFO has no real value as a management tool and serves only to cut tax liability for a relatively small number of firms, and is currently prohibited under the International Financial Reporting Standards.

- b. Companies that do not use LIFO may write down the value of their inventories by applying the lower-of-cost-or-market (LCM) method rather than the cost method, or write down the value of "subnormal" goods (ones that cannot be sold at the normal price or cannot be used as intended). The budget proposes to prohibit the use of the LCM or subnormal methods for taxable years beginning after December 31, 2012. The one-time increase in income due to revaluing existing inventories that were valued using these methods would be taken into account ratably over four years.

**15. Expand FUTA and make unemployment insurance surtax permanent**

Unemployment insurance (UI) is financed by a combination of state and federal taxes on employers based on the wages of each employee. Due to the length of the current downturn and the relatively low levels of state reserves at the beginning of the recession, states have accrued a large level of debt to the federal UI trust fund. The Federal Unemployment Tax Act (FUTA) currently imposes a federal payroll tax on employers of 6.2 percent of the first \$7,000 paid annually to each employee. The tax funds a portion of the federal/state unemployment benefits system. This 6.2-percent rate includes a temporary surtax of 0.2 percent (begun in 1976 and extended since then). Employers in states that meet certain federal requirements are allowed a credit for state unemployment taxes of up to 5.4 percent, making the minimum net federal tax rate 0.8 percent.

- a. While states could set their taxable wage bases below the federal taxable wage base, employers in these states would not receive the entire credit. Currently, no state has a taxable wage base below the federal level; instead, 47 states set their taxable wage base at a higher level, with Washington the highest at \$37,300 for 2011. Federal requirements are also not satisfied when states have exhausted their funds and need to borrow from the federal government to pay benefits. States are required to pay back the borrowed amount including interest. Thus, net federal tax rates on employers increase in indebted states (since they are not eligible for the full credit) to repay the loans.
- b. The president's budget would make the existing 0.2 percent surtax permanent, and provide short-term relief to employers by suspending interest payments on state UI debt and suspending the FUTA credit reduction for employers in borrowing states in 2011 and 2012.
  - (i) The proposal would also raise the annual FUTA wage base to \$15,000 per worker in 2014, index the wage base to subsequent wage growth, and reduce the net federal UI tax from 0.8 percent (after the proposed permanent extension of the FUTA surtax) to 0.38 percent.
  - (ii) States with wage bases below \$15,000 would have to conform to the new FUTA base. States would retain the ability to set their own tax rates.

### **16. Extend certain expiring provisions through 2012**

The revenue code includes dozens of "temporary" tax incentives, many of which have been extended one year at a time for a decade or more. The most significant in terms of revenue provides temporary relief from the alternative minimum tax. Most others are highly targeted subsidies that benefit business. The most significant of these in terms of revenue is the research and experimentation credit. The budget indicates there are almost ninety temporary tax provisions, all but three of which are temporary tax cuts. The budget does not identify beyond those listed above which items it would further extend.

### **17. Other proposals**

- Provide \$250 refundable tax credit for certain retirees not eligible for Social Security benefits.
- Provide \$250 payments to Social Security beneficiaries, disabled veterans, and retired railroad workers.
- Deny deduction for punitive damages.

## **B. Social Security**

The Budget Proposal does not address Social Security.

## **C. What tax reform would (and would) not do**

### **1. Higher tax rates**

Many proposals assume that the amount of income would not be affected by tax rates so that if tax rates increase, government revenues from taxes rise as well.<sup>4</sup>

- a. From 1951 to 1963, the lowest tax rate was 20 to 22 percent, while the highest rates were 90 to 92 percent! The highest capital gains tax rate was 40 percent in 1976-1977. Yet the ratio of revenues from the individual income tax to Gross Domestic Product has

<sup>4</sup> Based on article in the *Wall Street Journal*. Reynolds, "Obama's Soak-the Rich Tax Hikes Won't Work," (April 14, 2011).

remained approximately 8 percent of GDP in various tax rate environments and in various economies. The budget proposal's assumption that this ratio could increase to over 9 percent by increasing the taxes on the wealthy has no empirical basis.

Interestingly in the very high rate time frame, the ratio was about 7.9 percent; when the top tax rate was 39.6 percent (1993-1996); and fully 8.1 percent when the top tax rate was 28 percent (1988-1990). A higher percentage of GDP was collected when tax rates were lower than when they were higher. Almost half of the instances in the past 100 years when the ratio reached 9 percent or more occurred during recessions because GDP fell. The lesson: **to raise revenues, increase GDP and the economy, and the revenues at current or lower rates will follow.**

- b. All this is dovetailed into spending plans that would double the size of the deficit in ten years. They assume that there is no recession in that time period, that the period of low-interest rates continues indefinitely, and, as alluded to above, that economic behavior would not be influenced by the tax rates.

**Note:**

The plan is based on a repeat of the revenue tsunami that attended the end of the 20<sup>th</sup> century (1997-2000) when the ratio reached 9.6 percent. This was an era dominated by New Economy companies that leveraged the NASDAQ index to more than twice what they are today before they began their decline that was further accelerated by the aftermath of the 9/11 attacks on the nation's financial, military, and government institutions. That era was characterized by an unprecedented explosion of the option markets in part as compensation for the Internet industry. Capital gains tax rates dropped from 28 percent to 20 percent and revenues from capital gains of 10.8 percent of all individual tax revenue reaching 13 percent in 2000. Among the top 1 percent of taxpayers, capital gains represented just 13 to 22 percent of reported income when the gains were taxed at 28 percent but rose to 29 to 32 percent in the three years following the drop in tax rates. This leads to what many call the "lock-in" effect, that when tax rates increase, economic behavior that would increase reported income is stifled, and sales of assets is deterred. More revenues are generated by lower tax rates that apply to more sales than to a higher rate applied to few sales. Increased tax rates on capital gains and dividends do not result in higher revenues as a general rule.

- c. The average tax rate on the top 400 taxpayers (by adjusted gross income) fell from 29.9 percent in 1995 when the tax rate was 28 percent to 23.3 percent in 2000 when the tax rate was 20 percent, but the revenues more than doubled during this era. From 22.9 percent in 2002, the last year preceding the decline of to capital tax rates to 15 percent, to 16.6 percent in 2007, the average tax rate continued to fall, but again the tax revenue generated from the top 400 doubled. Revenues from capital gains seem to be lowered when the tax rates increase.
- d. The *Wall Street Journal* concluded that in light of historical data that shows that all tax revenues are approximately 18 percent of GDP and individual tax revenues 8 percent of GDP, revenues will not be enhanced by raising tax rates but by **increasing GDP**. There is some reason to believe that increasing tax rates may stifle rather than promote the growth of the economy.

Period	Lowest/highest tax rates	Revenues as a percentage of GDP
1951-63	20/91%	7.7%
1964-81	14/70%	8.0%
1982-86	11/50%	8.3%
1988-90	15/28%	8.1%
1991-92	15/31%	7.8%
1993-96	15/39.6%	8.0%
1997-02	15/39.6\$	9.4%

Capital gains tax was reduced from 28% to 20% in 1997 and a new 10% bracket was added in 2001. 1987 is omitted because the 1986 Tax Reform Act was phased in and the surtax years of 1969-70 are also excluded. Source: U.S. budget historical data.<sup>5</sup>

## 2. Eliminating tax loopholes (deductions, exclusions, and credits)

When Willie Sutton, a notorious bank robber of the 1940s and 1950s, was asked why he robbed banks, his reputed reply, commemorated in Bartlett's Quotations, was, "Because that's where the money is." Activity-based costing (ABC), widely used in the public sector, is a costing model that identifies activities in an organization and assigns the cost of each activity resource to all products and services according to the actual consumption by each. The Willie Sutton rule holds that ABC should be applied "where the money is," meaning where the highest costs are incurred, and thus the highest potential of overall cost reduction is. The current proposals each identify the tax expenditure problem by seeking a solution where the money is.

- a. Mortgage interest is the largest tax expenditure of the government. It will cost the government \$99.8 billion in the 2011 fiscal year and \$107 billion in fiscal 2012. Another factor currently adding to the deduction's vulnerability is its apparent contribution to the housing market crises by encouraging taking on higher and higher levels of debt.
  - (i) The deficit-reduction commission has proposed replacing the deduction with a 12- percent tax credit and capping eligible mortgages at \$500,000. The proposal would also eliminate tax breaks for second homes and home equity loans.
  - (ii) The bipartisan task force has proposed replacing the deduction with a 15-percent tax credit.
  - (iii) The Administration's 2012 budget would have limited the deduction for families in the top tax brackets to 28 percent (while apparently retaining the \$1,000,000 and \$100,000 levels of mortgage debt and retaining the second, vacation home eligibility).
- b. Charitable contributions are a significant tax expenditure, yet, because such deductions require itemization, and only about a third of taxpayers do so, the majority of taxpayers who donate to charity do not get a tax reduction. Reducing the deduction would probably not stop those philanthropically inclined to make charitable gifts, but it will influence the time and the amount of such gifts. Charities are uneasy because the limitation on the deduction (presumably more by a credit-oriented system) is estimated to reduce contributions by somewhere between 25 percent and 36 percent in addition to the effects of any secondary recession.
  - (i) The replacement of the current deduction with a 12-percent credit. In addition, the credit would be limited to contributions that exceed 2 percent of the taxpayer's adjusted gross income.
  - (ii) The deficit reduction would replace the deduction with a 15-percent tax credit.

<sup>5</sup> Adapted from a chart in article in the *Wall Street Journal*. Reynolds, "70% Tax Rates Won't Work" (June 16, 2011), refuting the notion that higher tax rates will bring higher revenues.

**Note:**

The credit levels in these proposals would mean a potential tax break for the two-thirds of the tax filers who do not itemize but a significant reduction of the tax benefit for upper-income taxpayers (who currently can realize a tax benefit of 35 percent of the charitable contribution).

- (iii) The budget proposal would retain the deduction but limit its tax value to upper-income taxpayers limiting the value of the charitable tax break for high-income taxpayers.

**Note:**

Because it retains the contribution as a below-the-line deduction, it does not provide a tax break to lower-income taxpayers but does reduce the tax expenditure of upper-income taxpayers, but perhaps not as greatly as the credit-based proposals which would reduce it to no more than a 15 percent of the contribution while currently they could realize as much as the equivalent of a 35-percent credit (or a 28-percent credit under the budget proposal).

- c. State income-tax deductions are substantial tax expenditures that are of particular importance in high tax states, such as California and New York. The average deduction for state and local taxes among taxpayers who earn \$50,000 to \$100,000 is about \$6,000, according to CCH. That results in a tax savings of \$1,500 for taxpayers in the 25-percent bracket.
  - (i) Both of the outside proposals would eliminate deduction (a \$1,500 tax benefit on average to the profiled taxpayer).
  - (ii) The government recommendation would limit the tax benefit to 28 percent of the taxes paid, not affecting the profiled taxpayers but reducing the benefit of the upper-income taxpayers.
- d. The most significant tax expenditure is the exclusion from income and payroll taxes of employer-sponsored health insurance. More than 40 percent of taxpayers receive this tax break, which costs the government more than \$200 billion a year in lost income and payroll taxes.
  - (i) Both the commission and the panel proposed capping the amount of health insurance that is excluded from taxes, and the panel would phase out the exclusion.
  - (ii) The Administration favors a tax on high-cost health insurance plans.
- e. Most Americans save far less than \$20,000 a year.
  - (i) Both the commission and the panel proposed limiting annual tax-advantaged contributions to \$20,000 or 20 percent of income, whichever is lower. They would also consolidate §401(k) plans, individual retirement accounts and other plans into a single retirement plan.
  - (ii) It is claimed that a ceiling on contributions could deter small company business owners from setting up retirement plans for workers if the level of contribution they can make on their own behalf is overly limited. They are more likely to invest the funds for their own account in nonqualified (and permissibly discriminatory) investment vehicles, contributing no funds to their employees for savings.

## ***IV. Summary***

We approach the future with little assurance of what the federal income tax will look like in 2013 following the delaying tactic the Administration executed at the end of 2010 by the extension legislation. In the absence of any legislation, income-tax rates increase, but some of the proposals suggest lower rates but with fewer deductions and credits. But in the meantime taxpayers have to take advantage both of what is available now and with an eye to potential changes.

Under current law, if a gridlocked Congress does nothing, in 2013 the top rate on ordinary income will rise from 35 percent to 39.6 percent, while the rate on long-term capital gains will go from 15 percent to 20 percent. Even if some version of tax reform were to pass, the capital gains rate is unlikely to go lower, making 2011 or 2012 a good time to recognize big capital gains, say from the sale of a business.

The bipartisan panels have proposed solutions that reduce tax rates but largely reduce or eliminate tax expenditures; this is in striking opposition to the current budget proposal that increases some tax rates and is reluctant to eliminate wide-ranging tax expenditures, although it might limit the benefit a “wealthy” taxpayer could derive from them.

It is unclear that any such legislation will pass, so taxpayers must adopt a two-year planning window (2011 and 2012) where they can be reasonably certain of the tax structure and rates but understand what they must do -- whether in 2011 or 2012 -- to deal with a 2013 that may include both a 39.6-percent income-tax rate and an additional 3.8-percent Medicare tax on certain unearned income, a 0.9-percent Medicare tax on certain earned income, and possible increase in the taxable wage base that would increase significantly the amount of OASDI tax on compensation.

But in the meanwhile tax advisors need to help clients navigate through the next two years and beyond. In the following chapter, various opportunities and strategies, appropriate to a wide range of “wealthy” and “near wealthy” taxpayers based on their returns, are presented.



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# What Does the 1040 Tell You?

## *I. Introduction*

At the end of the day – the tax day – when you’ve had a chance to take a deep breath and consider the tax returns you’ve prepared, what do they add up to? Perhaps the greatest service a CPA can provide a client is to explain the meaning of the tax return, and not just the bottom line. More important is divining from the return the missed opportunities to reduce the client’s bottom line, and what can be done, starting right now, to formulate a plan of action the client can consider and implement. For the return-preparer professional, it is a critical skill to review a return now filed, and from it, imagine another return that would reflect different strategies.

**Note:**

These post-tax season reflections, being set in the context of the swirl of tax changes coming in 2013 (?), are perhaps as important as they have been in ten years. Many taxpayers are about to be inundated with new taxes without careful planning. Some changes are inevitable; they will occur without further action as the 2001 tax law disappears in the legislative sunset at the end of 2012. Others, while not as certain because of the need for legislative intervention, nonetheless seem likely to be enacted in whole or perhaps a scaled-down version. Tax professionals understanding the fiscal tides can serve their clients well by taking a close look at their returns and discuss with them the need to formulate tax strategies to cope with the incoming wave of tax changes. Because some of the tax changes are not likely to crystallize into law until late in 2012, some of the strategies must be contingent; but being in place and having been discussed earlier allow them to be implemented in an environment less chaotic than the mad scrambling that would arise if the professional had to meet with all the clients at the end of 2012, explain the options, await a decision, and then rush to implement them often before year-end.

What we want to do here is provide a roadmap through the high points of the return. No course can do full justice to all of the material on a Form 1040 and the potential tax issues raised by it, so we must be selective in the topics. Some will require additional information from a client to bring focus to the process. We will begin by stating issues that we have found, in practice or by inclination, most frequently relevant. We will then provide valuable, detailed explanations of the issues and how they might relate in a particular circumstance.

We cannot address every possible issue in the context of varying client needs, but we can provide a basis for initiating a valuable client service that can move into other areas not explored here. It is well worth creating a matrix of these issues for tax season, so that as returns are prepared, reviewed, or even just after filing, they may be preliminarily cross-referenced for potential further actions. The most important contact a CPA has with a client begins with, “Did you know that you can...?”

## ***II. Principles of tax planning in the current environment***

### **A. Increases in tax rates on ordinary income**

**Note:**

The Obama Administration has again proposed an increase in taxes on the wealthy with no increases in the taxes on the non-wealthy as its tax policy going forward following the sunset of the 2001 tax legislation. The definition of wealthy and non-wealthy has a base similarity by references to the \$250,000 or \$200,000 levels but has modifications that likewise must be taken into account.

When and where tax rate changes occur is up in the air, but if no legislation can be passed, one must take into account what will happen in 2013 under various scenarios. If no legislation at all is passed, income tax brackets and rates will increase for all taxpayers, and the Medicare additional taxes will apply; if health care reform is in turn reformed, it is possible one or both of those surtaxes will not apply, even as the higher income tax rates come into effect; if the sunset of the 2001 and 2003 laws are again extended, there may be a Medicare tax but no income tax rate increase. Tax planners should become familiar with all of these scenarios, identify clients who are affected, and discuss planning strategies with them.

#### **1. Marginal rates**

In general, the taxpayer will pay less tax on income when the marginal rate on such income is lower than when it is higher. Conversely, more taxes are saved if a deduction is taken when the marginal rate is higher than when it is lower.

The focus is on the **marginal rate**, which is not the same as the statutory bracket rates. The marginal rate attempts to measure the additional (or less) tax that is paid as a result of the inclusion of additional income or deduction, so **exclusions, deductions, and credits** can affect the income tax, but even more so **phaseouts** operate to cause a tax differential that is not the same as the Code's bracket rates multiplied by the amount of the item.

In general, the phaseout ranges of AGI or MAGI differ for different items, but in some cases multiple phaseouts may apply to certain bands of AGI or MAGI, which can result in significant disparities between the marginal tax rate and the nominal bracket rate.

**Note:**

The thrust of the budget proposals involves the concepts of the “wealthy” and the “non-wealthy.” The distinction centers around income of \$250,000 and \$200,000, although the concept of income is different in different contexts.

- Prior to the 2001 tax law, the highest individual income-tax rate was 39.6 percent. Thus, beginning in 2013, the highest income-tax rate would be 39.6 percent.
- Likewise, the second highest individual income-tax rate was 36 percent, which was reduced temporarily to 33 percent. Thus, beginning in 2013, the second highest tax rate would be 36 percent. The taxable income levels at which that rate begins to apply would vary by filing status and would be indexed annually for inflation. The 28-percent tax-rate bracket would be expanded so that taxpayers earning less than these amounts would not see their taxes rise as a result of the increased tax-rate brackets.
- Prior to the enactment of EGTRRA, otherwise allowable itemized deductions (other than medical expenses, investment interest, theft and casualty losses, and gambling losses) were reduced by three percent of the amount by which AGI exceeded a statutory floor that was indexed annually for inflation, but not by more than 80 percent of the otherwise allowable deductions. Itemized deductions (other than medical expenses, investment interest, theft and casualty losses, and gambling losses) would be reduced by three percent of the amount by which AGI exceeds indexed statutory floors but not by more than 80 percent of the otherwise allowable deductions.
- Prior to the enactment of EGTRRA, all personal exemptions were reduced or completely phased out simultaneously for higher-income taxpayers. For a taxpayer with adjusted gross income (AGI) in excess of the threshold amount for the taxpayer's filing status, the amount of each personal exemption was reduced by two percent of the exemption amount for that year for each \$2,500 (\$1,250 if married filing separately) or fraction thereof by which AGI exceeded that threshold. For 2013, the AGI floors would be adjusted for inflation starting with a value of \$250,000 in 2009 for married taxpayers filing jointly (\$125,000 if filing separately) and \$200,000 in 2009 for single taxpayers. After 2013, the AGI floors would be indexed annually for inflation.

What the budget tax proposals do in the first instance is to create a new set of marginal tax rates for different ranges of income, caused in part by the change in the statutory bracket rate and in part on the updated or adjusted phaseout ranges.

As noted below, without taking into account the effects of phaseouts and the like on the effective marginal tax rates, many taxpayers may find themselves in a 39.6-percent rate; some of these will incur **additional Social Security taxes of up to 3.8 percent on unearned income** beginning in 2013.

Not taking into account the AMT or the effect of potential phaseouts, many taxpayers may experience a marginal tax-rate increase of **13.14 percent**  $([39.6 - 35]/35)$  in the tax rate on ordinary income (for those in the 33-percent rate going to the 36-percent rate, there is a marginal tax-rate increase of **9.09 percent**  $([36 - 33]/33)$ ).

- a. The health care legislation has several tax provisions. In the case of an employee, there is imposed on every taxpayer (other than a corporation, estate, or trust) a tax equal to 0.9 percent of **wages** that are received with respect to employment (as defined in §3121(b)) during any taxable year beginning **after December 31, 2012**, and that are in excess of \$250,000 (joint return),<sup>1</sup> \$125,000 (married taxpayer filing a separate return),<sup>2</sup> or

<sup>1</sup> I.R.C. §3101(b)(2)(A).

<sup>2</sup> I.R.C. §3101(b)(2)(B).

\$200,000 (all other cases).<sup>3</sup> An analogous provision applies to self-employed persons. In addition to the general 2.9 percent Medicare tax on self-employment income of every taxpayer (other than a corporation, estate, or trust) for each taxable year beginning after December 31, 2012, there is imposed a tax equal to 0.9 percent of the amount of the **self-employment income** for such taxable year that is in excess of \$250,000 (joint return),<sup>4</sup> \$125,000 (married taxpayer filing a separate return),<sup>5</sup> or \$200,000 (all other cases).<sup>6</sup>

**Note:**

Net earnings from self-employment means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed that are attributable to such trade or business, plus the distributive share (whether or not distributed), of the income (or minus the loss) from any trade or business carried on by any partnership of which he is a member. Where an individual is engaged in more than one trade or business, his net earnings from self-employment consist of the aggregate of the net income and losses of all such trades or businesses carried on by him. Thus, a loss sustained in one trade or business carried on by an individual will operate to offset the income derived by him from another trade or business.

**Example 1:** J (married filing jointly) is a partner in a partnership and a sole proprietor. For the year J has \$300,000 income from the partnership and a \$50,000 loss from the sole proprietorship. Since J has net self-employment income of \$250,000, J is not subject to the .9 percent tax.

**Example 2:** J (married filing jointly) is a partner in two partnerships. For the year J has \$200,000 income from the first partnership and \$100,000 income from the second partnership. Since J has net self-employment income of \$300,000, J is subject to the .9 percent tax on the \$50,000 in excess of the threshold.

- (i) These amounts are reduced (but not below zero) by the amount of wages taken into account in determining the additional FICA tax imposed with respect to the taxpayer's wages.<sup>7</sup>
- (ii) In the case of an individual, a self-employed taxpayer may deduct for the taxable year an amount equal to one-half of the self-employment taxes imposed for such taxable year, but this does not include **the additional Medicare tax**.<sup>8</sup>

**Note:**

The focus for this tax is solely the taxpayer's earned income. AGI or MAGI is irrelevant.

- b. The health care law further imposes, for taxable years beginning **after December 31, 2012** on individuals, estates, and trusts, a new tax that is in addition to any other tax imposed. This tax is applied annually in an amount equal to 3.8 percent of the lesser of **net investment income** for such taxable year,<sup>9</sup> or the excess (if any) of: (i) the **modified adjusted gross income** (MAGI) for such taxable year,<sup>10</sup> over (ii) the **threshold amount**.<sup>11</sup> For these purposes, the threshold amount means: (i) in the case of a taxpayer

<sup>3</sup> I.R.C. §3101(b)(2)(C).  
<sup>4</sup> I.R.C. §1401(b)(2)(A)(i).  
<sup>5</sup> I.R.C. §1401(b)(2)(A)(ii).  
<sup>6</sup> I.R.C. §1401(b)(2)(A)(iii).  
<sup>7</sup> I.R.C. §1401(b)(2)(B).  
<sup>8</sup> I.R.C. §164(f)(1).  
<sup>9</sup> I.R.C. §1411(a)(1)(A)(i).  
<sup>10</sup> I.R.C. §1411(a)(1)(B)(i).  
<sup>11</sup> I.R.C. §1411(a)(1)(B)(ii).

making a joint return or a surviving spouse, \$250,000; (ii) in the case of a married taxpayer filing a separate return, 1/2 of that dollar amount determined under paragraph (i); and (iii) in any other case, \$200,000.

***Planning point:***

Net investment income does not include any distribution from a plan or arrangement described in §§401(a) (qualified plans), 403(a) (qualified annuity plans), 403(b) (tax-deferred annuities), 408 (IRAs, SIMPLEs, and SEPs), 408A (Roth IRAs), or 457(b) (governmental and tax-exempt organization deferred-compensation plans).<sup>12</sup>

HOWEVER, distributions from such plans are generally fully taxable (in contrast to, say, a Roth IRA or Roth §401(k) plan) and add to the taxpayer's AGI (and MAGI). Thus the effect is secondary. Although retirees will not be taxed on retirement distributions themselves, the distributions may cause some or all of the taxpayer's other investment income, traditionally a large percentage of a retiree's income, to be subject to the additional 3.8-percent Medicare tax.

**2. Acceleration of income**

The effect of a proposed upward bracket shift is to make income for many taxpayers more heavily taxed in 2013 than in 2011 or 2012; conversely, deductions COULD provide greater savings in 2013 than they do in 2010. Not taking into account the AMT or the effect of potential phaseouts, many taxpayers will experience a marginal tax-rate increase of 13.14 percent ( $([39.6 - 35]/35)$ ) in the tax rate on ordinary income. For taxpayers who must consider whether the payment of a smaller current tax outweighs the time value of a higher tax payment for (generally) one year, and for rates of return less than 13.14 percent, the answer is generally yes. But the AMT must be considered. High-income taxpayers in the AMT have already phased out the exemption so they will not generally be subject to a higher AMT tax rate than the regular income-tax rate. However, lower-income taxpayers in the AMT that are phasing out the exemption must be careful because the effective AMT rate can exceed the regular income-tax rate so acceleration may increase the tax and income should probably not be accelerated. Some taxpayers in the 33-percent regular tax-rate bracket are phasing out the AMT exemption and are thus in the 35-percent effective AMT tax bracket; they may be in the 36- or 39.6-percent (projected) bracket in 2011 and the time value of money analysis could point to the deferral of income. Sometimes it is better to take IRA or retirement plan distributions (above any required by the minimum-distribution rules) when the client is in the AMT. The actual increase in tax liability is often smaller than the tax that would be paid in a later year (determined on a time-value basis).

**Example:** Because the highest marginal tax rate is 28 percent for the AMT,<sup>13</sup> a taxpayer in the AMT can, to some extent, accelerate income to the current year at a lower tax rate than will be enjoyed in later years. A conversion to a Roth IRA may be indicated for a taxpayer in the AMT in 2011 or 2012 because tax-rate increases will reduce the likelihood of being in the AMT in a later year when there is a greater likelihood of being in a higher regular tax bracket.

<sup>12</sup> I.R.C. §1411(b)(5).

<sup>13</sup> It is actually a bit more complicated than that, because during certain levels of alternative minimum tax income (AMTI), the phaseout of the AMT exemption can trigger marginal AMT tax rates of 32.5 percent or 35 percent. In addition, certain levels of additional income may increase the taxpayer's regular tax liability above that computed for the AMT, at which point the taxpayer is out of the AMT.

**Note:**

One should not accelerate nonqualified deferred compensation, as in most cases, this will trigger an additional 20-percent levy on nonqualified deferred compensation that is triggered too early in the current year together with accrued interest.<sup>14</sup> But those who have the option in 2011 or 2012 between nonqualified deferred compensation or current payment should generally opt for current compensation unless they believe that they will be in a lower bracket in the year of receipt.

Nonqualified deferred compensation is subject to Social Security taxes in the earlier of the year in which it is vested or the year in which it is paid, so to the extent nonqualified deferred compensation vests before 2013, it will not be subject to the additional 0.9 percent Medicare tax on excess wages in the post-2012 year in which it is paid or vests.

- Make the §454(b) election to accelerate all accrued interest on U.S. savings bonds.
- Take a bonus in 2012 rather than in 2013.
- Cash-method taxpayers will want to accelerate income this year if they will be in a higher rate in the following year.
- Consider a §83(b) election, if still possible.<sup>15</sup>

**3. Other income strategies**

Increase tax-favored income.

- a. Converting taxable interest to tax-exempt interest will serve to reduce AGI and MAGI, which will accomplish the following:
  - Reduce the effect of certain phaseouts based on AGI;
  - Limit the excess over the \$250,000 threshold to minimize or eliminate any additional Social Security tax on wages or unearned income; and
  - Limit the exposure to a higher tax bracket through rate increases.<sup>16</sup>

**Planning point:**

One has to take the costs of conversion into account. The sale of a corporate bond could produce gain or loss, while withdrawal of funds from a money-market account into tax-exempt bonds or fund (or a tax-exempt money-market account) would not.

**Caution:**

Taxpayers who might be subject to the alternative-minimum tax should not invest in tax-exempt private activity bonds because the interest on such instruments is included in determining alternative-minimum-taxable income.

On the other hand, taxpayers who are not subject to the AMT may benefit from the purchase of such bonds because the AMT compels such bonds to trade at slightly higher yield than other tax-exempt funds. The consequence is that the taxpayer may net more after-tax cash on those investments.

<sup>14</sup> I.R.C. §409A(a) provides that if at any time during a taxable year a nonqualified deferred compensation plan fails to meet certain requirements, or is not operated in accordance with such requirements, all compensation deferred under the plan for the taxable year and all preceding taxable years shall be includible in gross income for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income.

<sup>15</sup> Such an election must be made within 60 days of the receipt of the restricted property.

<sup>16</sup> However, it will be included in the side computation of determining the amount of Social Security benefits included in gross income.

**Planning point:**

Under the American Recovery and Reinvestment Act of 2009, tax-exempt interest on private activity bonds issued in 2009 and 2010 is not an item of tax preference for purposes of the alternative minimum tax.<sup>17</sup> Interest on tax-exempt bonds issued in 2009 and 2010 (after December 31, 2008 and before January 1, 2011) is not included in the corporate adjustment based on current earnings.<sup>18</sup>

Such bonds become more attractive in a tax-planning environment where reduction of MAGI may also help to avoid stealth Medicare taxes as well.

**Planning point:**

Higher income taxes on income and higher Social Security tax on compensation will put an added premium on items perhaps overlooked by some taxpayers that have favorable treatment on both accounts.

On the income-tax side, exclusions will serve not only to avoid the income tax but also, by limiting the amount included in income, can serve to avoid any new Social Security tax on compensation, both by avoiding excess compensation and the \$250,000 threshold of AGI.

Any fringe benefit is taxable and must be included in the recipient's pay unless the law specifically excludes it. However, exclusions apply to certain fringe benefits. Any benefit not excluded is taxable.

- (i) If the recipient of a taxable fringe benefit is an employee, the benefit is subject to employment taxes and must be reported on Form W-2. If the recipient of a taxable fringe benefit is not an employee, the benefit is not subject to employment taxes.
- (ii) The Code provides special treatment for certain benefits that are:
  - **Not taxable** to the recipient of the benefit;
  - **Deductible** to the provider of the benefit; and
  - **Not subject to employment taxes.**
- (iii) Examples of the latter benefits are:
  - Accident and health benefits;
  - Achievement awards;
  - Adoption assistance;
  - Athletic facilities;
  - De minimis (minimal) benefits;
  - Dependent-care assistance;
  - Educational assistance;
  - Employee discounts;
  - Employee stock options;
  - Group-term life insurance coverage;
  - Health savings accounts (HSAs);
  - Lodging on the business premises;
  - Meals;
  - Moving expense reimbursements;
  - No-additional-cost services;
  - Retirement planning services;
  - Transportation (commuting) benefits; and
  - Working condition benefits.

- b. Converting taxable interest to tax-deferred interest or income may reduce the level of current income.

<sup>17</sup> I.R.C. §57(a)(5)(C)(vi)(I).

<sup>18</sup> I.R.C. §56(g)(4)(B)(iv)(I).

**Note:**

Now may be a good time to purchase tax-exempt bonds. As the *Wall Street Journal* has noted, the municipal bond market has been beset by a generally weak demand and now offers “opportunistic investors” a high yield from borrowers.<sup>19</sup> Of course, one problem for the demand is the fear of inflation following the massive amounts of money printed by the government over the past three years without a surge in the economy. Whatever opportunity high-yields may be present in a deflationary context, inflation will push bond prices lower and the yields may prove wholly inadequate in an inflationary environment.

- The interest on U.S. Series EE bonds or inflation-indexed U.S. Series I savings bonds is generally deferred until redemption or maturity of the bond or the election by the taxpayer to include all accrued interest.
- The appreciation on stocks is generally not subject to current taxation. Purchase of undervalued stocks today gives the taxpayer further flexibility to time when to recognize gains. Many such “growth” stocks have enhanced appreciation potentiality by reason of their policy of not paying dividends, reducing further the amount subject to current taxation, and to inclusion in MAGI and investment income.
- Investment in **tax-deferred annuities** can postpone the tax effects of the income accruals on the underlying investments until distributions occur; during the accumulation phase, there is no addition to MAGI or unearned income.
- Investment in life insurance contracts and borrowing amounts out of such contracts for cash-flow purposes, if needed, will not cause MAGI problems.

**Note:**

Not only the increase in income-tax rates but also the post-2012 tax on investment income will be selling points for salespersons in the insurance annuity industry in the coming years.

- A Coverdell education savings account may be established for qualified higher education expenses of a designated beneficiary. Earnings on contributions are distributed tax-free to the beneficiary, provided they are used to pay the beneficiary’s qualified education expenses. The contribution may not exceed \$2,000 (reset to \$500 in 2013), is not deductible, and may fund both elementary and secondary education expenses (kindergarten through grade 12) whether in a public, private, or religious school. The earnings on those contributions are tax-deferred, while held by the account. Qualified expenses include tuition, fees, books, supplies, equipment, and room and board. This contribution is phased out for joint filers having MAGI between \$190,000 and \$220,000 (reset in 2013 to between \$150,000 and \$160,000), but generally other persons who are not in the phaseout can make contributions, including the minor to whom a cash gift has been made. As noted, without a legislative fix, lower amounts apply.

<sup>19</sup>

Neumann and Ng, *Misery Continues for Munis*, Wall Street Journal (C-1, April 4, 2011).

**Planning point:**

The income limitations on contributions have been circumvented by having a taxpayer who is below the phaseout threshold make the contribution, following a gift from a parent above the phaseout range in the same amount.

There have been greater investment choices in Coverdells in comparison to qualified tuition programs, and they permit the owner to switch investments as often as one likes in contrast to the once-a-year option offered in a QTP.

- Nondeductible contributions may be made to state-sponsored and private institution tuition-guarantee §529 plans. Unlike the Coverdell, contributions are not AGI limited. In theory there is no contribution limit, but the contribution will be treated as a gift (of a present interest); this limits the amount to a \$13,000 annual exclusion (\$26,000 with spousal gift-splitting) without incurring a taxable gift, but donors can elect to treat a lump-sum gift as if made ratably over a five-year period, increasing the amount that can be so given in one year to \$65,000 (\$130,000 with gift-splitting). Distributions from state-run qualified tuition programs that are used to pay **qualified higher education expenses** are permanently tax-free, while those from a Coverdell lose this tax favor after 2010.

**Planning point:**

A §529 account may be moved from one generation to the next without estate or GST tax. This enables the perpetuation of an income-tax-free savings account for multiple generations. They are, however, subject to gift tax,<sup>20</sup> although a special five-year smoothing is possible that can eliminate any taxable gift for substantial amounts of transferred funds; a married couple for example could transfer \$130,000 in 2011 and not incur any taxable gift.<sup>21</sup>

**Note:**

The Coverdell and §529 plans, while not deductible, nevertheless generate tax-deferred income, which, when distributed, may be converted into tax-free income to the extent the beneficiary incurs qualified education expenses.

**Planning point:**

A §529 account may be formed for the benefit of the donor. Since there is no age limitation as there is in a Coverdell with respect to the designated beneficiary, a working taxpayer may contribute amounts on his own behalf. An individual who anticipates being in the wealthy category during his working years can avoid the tax on the investment income that would have been generated outside the program, taking a distribution in the taxpayer's post-retirement years, and at that time, if it is used for educational purposes by the taxpayer, such as taking courses at a college and university, without incurring any income tax either.

- As noted elsewhere, a contribution to a Roth IRA and a deductible contribution to a traditional IRA are often precluded by phaseout limitations, even though both of these vehicles provide tax-exempt accumulation while contributions are held in the IRA. On the other hand, **nondeductible contributions to a traditional IRA** are not subject to phaseout. Taxpayers may make up to \$5,000 (or \$6,000 for

<sup>20</sup>

But treated under the Code as a present interest gift subject to the annual exclusion.

<sup>21</sup>

This is the product of five years and the \$26,000 a couple can transfer that is subject to the annual exclusion. However, if a donor dies before the end of the five years, the balance is brought back into the donor's gross estate.

those over 50) of nondeductible contributions permitting the returns on such contributions to accumulate tax-free during a taxpayer's high-income tax years.

- c. Family income-shifting and C corporation income-splitting must be more seriously considered.
- (i) Shifting earned income to a child serves the goals of reducing the compensation subject to additional Medicare tax, spreading the AGI around to reduce or eliminate the potential for excess MAGI for any member of the economic unit, and reducing the overall tax burden by shifting income to a taxpayer in a lower tax bracket. Since the kiddie tax applies only to **unearned income** of a young child, the shifting of **earned income** to the child by paying the child a salary through the family business is not affected by the kiddie tax.
- However, this may have the effect of increasing the Social Security tax burden because the higher income taxpayer may have already passed the taxable wage base and is only subject to the Medicare tax, while a child is likely to have the first dollar of wages subject to both Medicare and Old Age and Supplemental Disability Income tax.
  - Such compensation is limited by the standard of reasonableness without triggering additional tax problems.
  - Compensation may permit an additional IRA/retirement plan participant.
- (ii) The **kiddie tax** applies not only to children under age 18 (regardless of any other circumstance) but also to children who are 18 years old or who are full-time students over age 18 but under age 24, but only if such children's earned income does not exceed one-half of the amount of their support. Payroll taxes apply only to employee compensation. Therefore, both the kiddie tax and payroll taxes can be avoided by shifting unearned income to **certain children** age 18 or over, particularly if the parents are in a 35- or 39.6-percent tax bracket.

**Note:**

One potential planning point is to structure the child's relationship to familial businesses to generate earned income rather than unearned income sufficient to meet the one-half threshold for children age 18 and above.

- (iii) Earned income has taken on a larger and larger role in consideration of income-shifting planning. A child within the new suspect age ranges can avoid the kiddie tax if he or she has enough earned income. The accounting problem raised is that the measuring rod is the total amount of support the child has. As noted in the above paragraph, one may be denied the dependency exemption – for example, if the child provides more than half of his total support – yet the kiddie tax could still apply if the child's earned income is less than half of that number. Thus, many taxpayers are thrown back into the calculation of the amount of support the child receives to determine the proper tax rates that apply to the child's income.
- (iv) At a minimum, the property transferred to a child will move from current ordinary-income producing assets like most stocks and bonds to assets held strictly for appreciation, and then perhaps with a plan to realize such gains once the period of enhanced kiddie tax is over. Thus, non-dividend-paying growth stock may be employed if the child will soon emerge from full-student status, and, depending on the circumstances, then be able to use the lower or zero tax rates.

***Planning point:***

Below-market loans continue to be an effective, albeit limited, income-shifting tactic. There is a gift element that is subject to gift tax, but the reason for the use of a loan rather than an outright gift is the lesser gift-tax consequences. Where the transfer of funds is structured as a below-market loan, the gift element consists solely in the foregone interest, i.e., the excess of a hypothetical level of interest that could have been earned on the loan and the interest actually charged. For example, if a parent lends a child on January 1 a demand loan of \$10,000 at zero interest that remains unpaid on December 31, where the standard interest charge is four percent, the foregone interest of \$400 during the year is a reportable gift for gift-tax purposes; however, for income-tax purposes, a loan not exceeding \$10,000 is exempt from the below-market loan rules.<sup>22</sup> On the other hand, if the parent were to make a gift of the \$10,000, the gift for gift-tax purpose would be \$10,000. For estate-planning purposes, the lower gift-tax cost provides great leverage to the donor, particularly if the child makes in effect the same investment the parent would have made with the funds. This shifts the appreciation and income element out of the estate.

The interest deemed received on a below-market loan not exceeding \$100,000 cannot exceed the net investment income of the borrowing child. If the child purchases dividend- or interest-bearing investments, such income could be fully includable as interest to the parent if it is less than the amount otherwise calculable. Zero deemed interest could arise in a case where the child purchases non-income producing property whose appreciation is not recognized.

However, the outright gift to a child severs the income-tax consequences to the parent where the below-market loan may not necessarily do so.

- (v) Loans between family members can have the effect of shifting investment returns from a higher-bracket taxpayer who might be subject to the additional Medicare tax on investment income to an individual in a lower tax bracket who may not be subject to that new tax. If a **below-market-interest-rate loan** is made, the lender is deemed to have made the loan at a higher interest rate than that fixed by the loan agreement and the borrower is generally deemed to have paid this interest rate to the lender; the source of the "payment" depends on the particular circumstances. This has the effect of increasing the amount of interest, if any, the **donor** is considered to have received.

***Planning point:***

Where the imputed interest rate is far below the return that can be earned by the borrower, the inclusion of interest income as computed where interest rates are low may be an acceptable trade-off in shifting income to the child. It is important to keep track of interest rates to determine whether an exemption or limitation should be aimed for or whether a below-market loan nonetheless produces an acceptable outcome on balance.

<sup>22</sup>

This does not apply to a gift loan directly attributable to carrying of income-producing assets.

**Note:**

Most gift loans between parents and children are structured as demand loans. One reason for that is that for gift-tax purposes, the amount of the gift in the year the loan is made is determined over the entire term; there will be no further gifts considered made in later years of the term. In contrast, the amount of the gift for a demand loan is determined on a daily basis, so there is greater flexibility. If a child were to somehow come into a source of money with which to repay the loan, in the case of a demand loan, its payment would stop the making of a daily gift of interest foregone, but in the case of a term loan, any repayment during the term would not alter the amount of the gift made when the loan was made.

If the loan between a parent and a child is deemed a below-market loan, the imputed interest will be ordinary income to the parent and potentially nondeductible interest to the child (either because it is personal interest, or, if investment interest under the tracing rules, either the child has no investment income or the child does not itemize deductions).

**Planning point:**

The current – April 2011 – rates have sunk to nearly historic lows. The AFR rates are .55 percent, 2.47 percent, and 4.21 percent, semi-annual, for short-term, mid-term, and long-term, respectively. The 7520 rate is 3.0 percent.<sup>23</sup> Such historically low rates make this the time to take advantage of them.

**Note:**

Consider the conversion of a non-service LLC, partnership, or sole proprietorship to an S corporation to create pass-through income not subject to self-employment tax for taxpayers who otherwise would have in excess of \$250,000 of income. Employees can receive up to \$250,000 of wages and take the balance as pass-through income not subject to Social Security; presumably this is **not** treated as **unearned income to the shareholder** if the shareholder materially participates in the business.

**Note:**

A C corporation should be considered as an alternative business form, as the use of a pass-through does not permit the owners as many tactics to thwart individual income tax rates.

<sup>23</sup>

Rev. Rul. 2010-11, 2009-14 IR.B. 516.

### **Tactics to Reduce AGI:**

Converting taxable compensation into nontaxable fringe benefits.  
Shifting income to others  
Splitting income with a C corporation  
Deferring income through nonqualified deferred compensation in a non-passthrough business.  
Using installment reporting, if available, on sales of property)  
Reducing business income by reimbursement of employee-paid expenditures  
Reducing business or rental real estate, S corporation, and partnership income by maximizing expensing allowance and bonus depreciation (if then available)  
Tax-exempt interest income  
Exclusions of gain on the sale of principal residence  
Exclusions of gain on like-kind exchanges  
Exclusions of gain on the sale of business structured as a reorganization  
Making charitable contributions directly from an IRA to the charity rather than receiving a distribution that is included in income but only offset below the line  
Increasing elective deferrals and contributions to qualified plans  
Changing qualified plan to defined benefit plan to increase the amount deductible  
Increasing contributions to IRAs, if not phased out.  
Increasing contributions to HSAs

### **4. Deduction strategies**

A deduction taken at a higher marginal tax rate is generally more valuable than one at a lower bracket (although time-value-of-money principles may make the opposite true in particular circumstances). This means that, in general, deductions should be accelerated if the taxpayer is moving to a lower tax bracket in later years, but deferred if the taxpayer expects higher rates in the future.

#### **Note:**

For higher-income taxpayers, otherwise allowable itemized deductions (other than medical expenses, investment interest, theft and casualty losses, and gambling losses) were reduced prior to 2010 if AGI exceeded a statutory floor that was indexed annually for inflation. Prior to the 2001 tax law, itemized deductions were reduced by three percent of AGI over the threshold but not by more than 80 percent of the otherwise allowable deductions. EGTRRA reduced the itemized deduction limitation in three steps. For 2006 and 2007, itemized deductions were reduced by two percent of AGI over the threshold, but not by more than 53-1/3 percent. For 2008 and 2009, itemized deductions were reduced by one percent of AGI over the threshold, but not by more than 26-2/3 percent. For 2010, the reduction was completely eliminated. However, beginning in 2011, the full itemized deduction reduction of three percent of AGI exceeding the floor, but not by more than 80 percent, is scheduled to be reinstated.

The new Administration budget proposal would adjust the 2013 income thresholds beyond which itemized deductions are reduced to \$250,000 (indexed for inflation from 2009) for married taxpayers filing jointly and \$200,000 (indexed for inflation from 2009) for single taxpayers. Thereafter, the thresholds would be indexed for inflation annually.

**After the itemized deductions have been so reduced, the proposal would limit the value of all itemized deductions to 28 percent** whenever they would otherwise reduce taxable income in the 36- or 39.6-percent tax brackets. A similar limitation also would apply under the AMT.

Other proposals would merely eliminate miscellaneous itemized deductions, which might not be as big a problem, as many of these deductions are currently being disallowed by the 2 percent of AGI floor.

**Note:**

The major deductions affected are the charitable deduction, state and local taxes, and mortgage interest.<sup>24</sup> The impact of this provision is, for some taxpayers, to eliminate the “wash” of income and deduction. For example, heretofore, a taxpayer who earned an additional dollar of income could eliminate its tax effect to the extent it was applied to itemized deductions (other than any applicable phaseouts) in like amount. Thus, if a taxpayer made \$100 and used it for a charitable purpose, the cash would just flow through the taxpayer without triggering an income-tax effect. Under the proposal, the \$100 would trigger a \$39.60 tax liability yet only garner a \$28 offsetting tax reduction. The taxpayer would pay an \$11.60 toll charge on zero net cash flow. Those who wind up in the 36-percent bracket would pay an \$8 (\$36 - \$28) toll charge.

This may **understate the actual tax cost**. The interaction of the phaseout of itemized deductions with the maximum value applied to those not phased out can be substantial. For taxpayers who are subject to the 80-percent floor, since only 20 percent of the deductions are allowable and their tax value cannot exceed 28 percent, the tax benefit of the itemized deductions amounts to only 5.6 percent of the aggregate expenditures. For example, suppose a taxpayer has \$100,000 of “itemized deductions” that are reduced by reason of the phaseout to \$20,000; the maximum benefit to the taxpayer is only \$5,600. Since the \$100,000 of income used to fund the expenditures is presumably taxed at 39.6 percent, this zero net cash flow model results in a net tax detriment of \$34,000.

The most radical proposal calls for the elimination of these deductions altogether while reducing tax rates on all taxpayers. In such case, discretionary items such as charitable contributions may need to be managed to maximize their tax benefit. This involves acceleration of these deductions into 2011 and 2012, often using a vehicle such as a charitable trust to fund a significant amount in lieu of future contributions. While such contributions are deductible in those years, their future as a carryover is murky at best, and taxpayers should not rely on a special grandfather rule to permit taking the unused deduction in 2013 and later years. Because the taxpayer may be seeking to make a contribution that represents what might have but for a deduction shutdown been made over the course of many years, there is a distinct possibility that the contribution may exceed the 50 percent of AGI limitation that generally applies to individuals.<sup>25</sup> Now a taxpayer may determine that an acceleration of income in 2011 (or 2012) will enable maximize use of the charitable deduction through an enhanced AGI limitation and, in the case of 2011 contributions, at least one year of carryover in which to absorb excess amounts.

- a. Assume there is no rate cap on itemized deductions.
  - (i) Defer deductions to 2013. Deductions the timing of which is somewhat discretionary, such as charitable contributions, may produce greater tax savings if deferred.

<sup>24</sup> It would also affect the dwindling medical expense deduction.

<sup>25</sup> A charitable conservation gift may be subject to a 100 percent limitation if it arises in a farming activity. Gentlemen farmers may so qualify if they control their other income sufficiently that more than 50 percent of gross receipts for the year of the contribution arise from farming (agriculture and livestock). This probably only works for a contribution in 2011, since that is the year in which a taxpayer may have a low enough level of income to qualify yet still have 2012 in which to carry over the excess of the contribution in a relatively high-income year where the carryover contribution will have sufficient AGI.

**Planning points:**

In most cases, if tax rates will increase, deductions should be deferred and income accelerated; conversely, if tax rates remain the same, deductions should generally be recognized and income deferred.

One factor that must be brought to bear is the time value of money. While it is true that a future deduction may be more valuable in the following year in absolute dollar amounts by reason of the increase in rates, in present value terms a current deduction may be more valuable than its deferral. For example, if tax rates increase from 35 percent to 39.6 percent, the deduction of \$1,000 today is worth \$350; the deduction of \$1,000 a year later is worth \$396 at that time. At the present time it is worth  $\$396/(1 + i)$ , where  $i$  is the taxpayer's after-tax time value of money. If  $i$  is 13.14 percent, the time-adjusted value of the later deduction is \$350—the same dollar amount as the current deduction. For return levels above that, the time value of the current deduction outweighs the value of the deferred deduction. At current interest rates and proposed levels of tax increase, this will not likely tip the scales in most instances. Likewise, if tax rates were to increase from 35 percent to 36 percent, the future cost of the deferred income is \$360, which discounts down to a present tax cost of \$350 when the discount rate is about 2.86 percent: for taxpayers with discount rates below this amount the deferral is more costly, while for those above that time value of money, the additional return for one year makes up for the increased dollar amount.

The deferral strategy does not apply if the itemized-deductions limitation is enacted for taxpayers who will now be in a higher tax bracket on the income side than on the deduction side. Ideally, as noted elsewhere, deductions can be pushed above the line into depreciation, HSAs, pension contributions and the like that affect the calculation of MAGI.

- (ii) Clients should be encouraged to increase the deductions in certain discretionary areas, where the deduction is above-the-line for 2013 and later years.
  - Increase contributions to §401(k) plans, SIMPLE pension plans, and other arrangements that are deductible by the taxpayer (such items, while not deductible as such, nevertheless reduce the taxpayer's AGI and MAGI).

**Note:**

A qualified plan is a retirement plan that satisfies the requirements of §401(a). In exchange, the plan is eligible for special tax treatment. Essentially these special tax rules provide that the employer receives **deductions for contributions** to the plan, that the trust established as a funding instrument under the plan is **not subject to tax**, and that employees only have income **when benefits are paid** out of the plan.

Retirement plans provide an effective way to reduce income of the employee while also **eliminating employment taxes generally**. Payments made to or on behalf of an employee from or to a qualified trust, a SEP, a cafeteria plan if such payment would not be treated as wages are not subject to employment taxes. However, one major exception to this rule is that elective deferrals by an employee to a §401(k) arrangement are subject to current Social Security when contributed to the plan.

By contrast, a profit-sharing plan, which is generally funded by employer contributions only, does not subject contributions on behalf of the participants to Social Security.

Employing a spouse may also be used to provide a spouse with pension benefits.<sup>26</sup> Be careful of the following.

- A spouse may be eligible to receive a \$10,000 retirement annuity without regard to the spouse's compensation in a defined-benefit plan if the spouse has never participated in the employer's defined-contribution plan. Of course, nondiscrimination rules will require a similar offer be offered to all other employees, but it may be well-suited in the case of a sole proprietor.<sup>27</sup>
- A spouse may have access to §401(k) elective deferrals that can be as much as \$16,500, as much as doubling the amount the couple could defer.<sup>28</sup>
- The spouse may have access to a profit-sharing plan, which could defer up to an additional \$49,000 of income.<sup>29</sup>
- The spouse may have access to a SIMPLE plan that could defer up to an additional \$23,000.<sup>30</sup>

<sup>26</sup> The repeal of the family aggregation rules permits the usage of the compensation of all family members up to the maximum compensation that can be taken into account.

<sup>27</sup> The major limitation is that the participant in the defined-benefit plan must not have ever been a participant in any contribution plan of the employer. This life annuity is treated as meeting the limitations on the amount of the annual-benefit maximums, which depend on the level of compensation and the years of service; this limit in turn may be cut back for a participant having participation or years of service less than 10. But since the \$10,000 annuity is deemed to meet the limitations on annual benefits, a spouse could work for as little as one year and for as little as \$1. Now, in practical terms, the compensation should probably be enough for the spouse to fund a Roth (if not phased out), and the nondiscrimination rules would require the same definition of "years of service" for the spouse as any other employee for participation purposes.

<sup>28</sup> While the rule is generally that the employer contribution (for all employees) cannot exceed 25 percent of participants' compensation, employee contributions are not counted in this calculation; the operable limitation is that the annual addition (which includes both employer contributions and elective deferrals) for the participant cannot exceed 100 percent of compensation. Now, in a §401(k) plan with no employer match or other contributions, the spouse could be "paid" \$16,500 (net of employment taxes) and defer the entire amount as an elective contribution. In that case, the spouse has no taxable income. If the spouse is at least 50 years of age, an additional \$5,500 catch-up contribution is available without regard to any of these limitations; in that case, the spouse could be "paid" \$22,000 (net of employment taxes) and still not incur any income tax.

<sup>29</sup> The employer contribution to a profit-sharing plan cannot exceed the dollar annual addition limitation for a participant; at the same time, except in certain age-weighted or cross-tested plans discussed later in these materials, the employer cannot deduct a contribution in excess of 25 percent of compensation. This means that the \$49,000 would only be available if the spouse were making at least \$195,000. For the very serious employment of the spouse, the business owner should consider shifting duties and salary to the spouse. The compensation that can be taken into account for plan purposes cannot exceed \$245,000; so in many cases, a business owner can reduce his or her own wages without suffering any reduction in his or her own retirement contribution while reducing the company's (or in the case of an S corporation shareholder/partner/member/proprietor, the individual's own) income tax by reason of the additional contribution. The couple's income otherwise remains the same.

<sup>30</sup> The SIMPLE plan operates in a like manner to a §401(k) plan in that the employee makes an elective deferral of salary. Because the maximum elective deferral for a SIMPLE plan is \$11,500 (an additional \$2,500 for those at least 50 years of age [net of employment taxes]), and the maximum employer contribution is three percent of compensation, at this level the total contribution is only \$7,350. The compensation that may be taken into account is not limited, but the maximum match is the amount of the income deferred by the employee. Thus, only when the participant reaches compensation of \$383,333 can the maximum \$23,000 contribution (\$2,500 more if the spouse has reached age 50) be realized.

**Planning point:**

SIMPLE plans are not subject to the special ADP nondiscrimination rules that are applied to §401(k) arrangements, and thus do not suffer from the potential loss of qualification that can happen to a §401(k) plan when non-highly compensated employees fail to participate in sufficient numbers and relative amounts.

**Note:**

However, §401(k) and SIMPLE plans are somewhat disadvantaged in 2013 and later years when the additional .9-percent Medicare tax on compensation applies on compensation above \$250,000 as elective deferrals made by the employee are subject to current Social Security tax (and *presumably* then to the additional Medicare tax). This may be avoided to the extent the employer provides all of the contribution, but in that case, a profit-sharing plan may prove easier to administer. However, §401(k) plans will continue to serve to restrain increases to AGI that may limit or eliminate any excess MAGI when the taxpayer is more concerned with, and exposed to, the 3.8-percent tax on investment income.

- Increase contributions to a health savings account (HSA), if the taxpayer is an eligible individual. Individuals who are covered by a qualifying high-deductible health plan (and are generally not covered by any other health plan that is not a qualifying high-deductible health plan) may make deductible contributions to an HSA, subject to certain limits. Taxpayers may deduct their contributions above-the-line (and thus reduce AGI and MAGI) or not have it included at all when financed by employer contributions. Distributions from an HSA to pay qualified medical expenses are not taxable and thus do not increase the taxpayer's AGI or MAGI in those years. Distributions used for non-medical purposes are taxable, and if made before age 65, are subject to a 10-percent penalty tax. An individual's HSA contribution level may be based on expected out-of-pocket medical expenses, but an individual may make deductible contributions up to the maximum allowable, regardless of expected expenses. These contributions in excess of medical needs can be withdrawn from the HSA and used for any purpose without penalty (but subject to tax) once the individual reaches age 65.

**Note:**

This serves not only to remove the income from the amount invested from adjusted gross income while it is held in the account but also manages the medical deduction more efficiently by avoiding the AGI haircut of medical expenses. One ultimately funds future medical expenses with before-tax dollars, but gets to exclude the proceeds to the extent applied to medical uses. This becomes more important in 2013 when the haircut on deductible medical expenses rises from 7.5 percent to 10 percent of AGI for all but senior taxpayers.

- Defined benefit plans in specific circumstances may prove valuable in creating a deduction larger than that available for a defined contribution plan. In 2011, the maximum contribution to a defined contribution plan is \$49,000, and is indexed for inflation in years thereafter. In contrast, the amount of the contribution to a defined benefit plan (and consequently the employer deduction) is based on actuarial data that often produce a far higher amount.

**Example:** To appreciate the quantum of difference, consider a 55-year-old sole practitioner in an S corporation who makes in excess of \$245,000. A defined benefit plan can be designed to determine a maximum benefit at retirement (assumed age 65) of \$195,000 a year. Simplifying some of the actuarial complications and assuming that the taxpayer will: (a) survive to retirement; and (b) live to life expectancy (assumed 21 years), and assuming a five-percent discount rate, the money needed in 10 years is \$2,500,125. This means, in turn, that to fund this amount over 10 years, level contributions must be made in the amount of approximately \$198,771 – a lot more than a \$49,000 contribution – almost \$150,000 more, avoiding as much as \$6,000 in additional Social Security tax annually while sheltering \$150,000 from current income tax, which in turn could represent another \$60,000 of income tax savings.

- Deductions must be carefully managed. For example, a loss from an S corporation or partnership is currently deductible only to the extent the investor has basis in the entity. Therefore, taxpayers must be prepared to make **contributions** in order to reap deductions. These losses are above-the-line and thus can be used (without application of any potential limitation on below-the-line deductions) to manage both income and excess MAGI in the face of the higher tax rates.

**Note:**

However, a current deduction may not be warranted if 2012 is a bad year for the investor, since a deduction in like amount may be more valuable in 2013 if the investor's marginal rate will be higher then. A **distribution** from the entity that reduces the investor's basis to zero or near zero will effectively "trap" the loss deduction so that it can only be taken in a subsequent tax year when the investor has sufficient basis. The deduction will be deferred, and will offset the income that is taxed at a higher marginal tax rate in that later year than 2011 or 2012.

- Losses arising from passive activities may only be used to offset passive activity income. However, if a taxpayer disposes of his entire interest in such an activity in a fully taxable transaction, then any loss from the activity for the tax year of disposition (including suspended losses), over any net income or gain for the tax year from all other passive activities (including suspended losses), is treated as a loss that is not from a passive activity. In many cases, the gain on disposition will be capital but the suspended loss will be ordinary. This is a reverse of the situation where the income is taxed at a higher rate than the offsetting deduction. The net effect is a reduction of income tax.

**Example:** R owns an interest in a passive activity in which R invested \$100,000. The interest is fully written off (resulting in a zero basis), but all of the losses were suspended under the passive loss rules. If R sells the interest for cost, R recognizes a \$100,000 capital gain (taxable at presumably either a 15-percent or 20-percent rate) and an allowed unsuspended \$100,000 loss (taken above-the-line at presumably either a 39.6-percent, 36-percent, or 28-percent rate). The arbitrage on these rates ranges from 13 percent to 19.6 percent, so the sale at \$100,000 translates into tax savings of between \$13,000 and \$19,600. When the gain and loss are less, the tax savings are less.

**Planning point:**

Because such losses become available for use in offsetting nonpassive income only as the payments are received and in proportion to the amount of gain recognized with respect to these payments, an election out of an installment method may accelerate income or gain. However, it will also accelerate the deduction freed up by the disposition.

- Use of an IRA by taxpayers who are at least 70-1/2 years old for charitable contributions can allow a taxpayer to make a contribution of up to \$100,000. While the taxpayer cannot deduct such amounts, the contribution to a charity from the IRA is not included in gross income, thereby reducing the AGI and MAGI and thus preventing or limiting in some instances the phase out of other tax deductions or credits. However, this is limited in amount, and then only in 2011 by reason of the extender legislation. Were it made permanent and the dollar limitation increased, this provision could be used to avoid the itemized-deduction limitation as to value (or the disallowance of all charitable contributions).
- b. Assume there is a rate cap on itemized deductions.
- (i) First, consider potentialities for converting deductions above the line where possible.
- Purchase investments that bear depreciation, §179 deductions, or §199 deductions.
  - Deductions can be associated to rental and royalty-producing activities.
  - Utilize IRA, HSA, elective deferrals, and/or qualified contributions of a self-employed taxpayer.
  - Replace some portion of wages with excludable fringe benefits.

**Note:**

Before jumping on the 100 percent bonus depreciation allowance, as discussed later, one should understand the available “opt out” in the context of these changing rates. If rates increase, depreciation will be more valuable in high income years than in lower rates, so a reason for deferral of the deduction (by taking depreciation over the recovery period rather than all at once) may be valuable. In addition, for sole proprietors, depreciation is a deduction that is taken above-the-line that reduces AGI and MAGI, so depreciation deductions in 2013 and later years may be worth considerably more than a current deduction of the entire amount in 2011 (or 50 percent deduction in 2012).

- (ii) This effect does not apply to nonwealthy taxpayers (by definition in the 28 percent or lower tax bracket), so wealthy taxpayers in one taxable year must consider the possibility of being nonwealthy in a future year; and conversely, a nonwealthy taxpayer in one taxable year must consider the possibility of becoming a wealthy taxpayer in a subsequent taxable year when determining the timing of discretionary itemized deductions (such as charitable deductions and the fourth-quarter state-estimated income tax payments). This can save a toll charge or avoid what might be an unnecessary toll charge. A taxpayer who is “nonwealthy” but who will be “wealthy” in the next taxable year may avoid an \$8 (36% - 28%) or \$11.60 (39.6% - 28%) toll charge by accelerating a \$100 charitable deduction or the January 15, 2013 \$100 payment of state income taxes to the current year. By contrast a “wealthy” taxpayer who anticipates being

“nonwealthy” in the following year would consider deferring a \$100 charitable contribution and not accelerating the fourth-quarter estimated income tax payment.

***Planning point:***

Family-income splitting or deferral of current income in a C corporation may enable the taxpayer to structure the tax profile into a 28-percent tax bracket year that may enable a more efficient use of itemized expenses in that year.

- (iii) If the charitable contribution of proceeds from an IRA were made permanent, the charitable contribution is in effect brought above the line since it offsets the income that would have been distributed to the donor.

***Planning point:***

Split charitable gifts may be used to reduce income, MAGI, and investment income so as to avoid tax rates as high as 43.4 percent (39.6-regular tax rate + maximum 3.8-percent additional Medicare tax) on unearned income. Trusts established in 2011 would (as noted above perhaps with some tax planning) permit the charitable deduction to produce a tax benefit commensurate with the taxpayer’s bracket if the limitation on itemized deductions is enacted. Even if it is not, such trust would be effective to eliminate some of the high tax cost of investment income going forward.

- A non-grantor charitable lead trust shifts current investment income away from the taxpayer subject to these taxes to a charity, which is not. The income not attributed to the taxpayer during the term of the trust does not add to the trust grantor’s MAGI.
- A charitable remainder trust is likewise not subject to the income or Medicare taxes. The taxpayer can smooth the income like an installment sale because under the four-tier system, the grantor is taxed currently and includes in MAGI no more than the annuity or unitrust amount distributed to the grantor for the year. The grantor may spread income and AGI around multiple beneficiaries, which may, but do not have to, include the donor. This is particularly attractive on the sale of highly appreciated publicly traded stock (which otherwise does not allow installment reporting).

- (iv) Because the value of mortgage interest on a principal residence will decline for many taxpayers, the value of high-end real estate (property purchased by taxpayers who are wealthy [above the \$250,000/\$200,000 thresholds]) will decline since the after-tax cost of financing will increase.

***Planning point:***

In many cases, such taxpayers should consider selling now before the mortgage-interest limitation kicks in, or paying off their mortgage as the higher tax cost of the interest deduction.

***Example:*** W is in the 35-percent bracket in 2012 and projects to be in the 39.6-percent bracket in 2013. If W would pay \$10,000 of mortgage interest, that \$10,000, while representing \$0 net cash flow, requires W to increase taxes by \$1,160 (\$3,960 taxes on the income - \$2,800 taxes saved by the deduction of the interest). On the other hand, if the investment generating the \$10,000 of income were used to pay down or off the mortgage, W would achieve a \$0 cash flow through no income and no deduction, but in this case retaining the \$1,160 of tax W would otherwise have paid.

**Planning point:**

Taxpayers who are seeking to purchase a personal residence may consider doing so for cash. The savings from not paying interest coupled with the exclusion on certain gains on the disposition of a personal residence may make this purchase a more effective investment than other alternatives.

**Example:** J can purchase a house for \$1.2 million or invest \$1.2 million in a mutual fund that will yield 7.2 percent. The real estate appreciates at six percent annually. After five years, the real estate is worth approximately \$1.6 million, while the mutual fund is worth approximately \$1.70 million. On a sale at that time, J realizes after tax \$1.606 million on the real estate, while J realizes only \$1.599 million on the mutual fund (i.e., assuming a 20-percent capital-gains rate).

For longer holding periods, the return on the real estate becomes less favorable than the mutual fund, if it continues to be owned. On the other hand, J can sell the property, reinvest \$500,000 (or any amount, depending on the purchase price of the new home) in the mutual fund and purchase a new home for \$1 million, starting a new investment cycle.

- c. If the deductions are eliminated completely, consider accelerating all expenditures to a pre-2013 year or years.

## **B. Capital gains**

### **1. In general**

A separate rate structure applies to long-term capital gains and qualified dividends. In 2011 and 2012, the maximum rate of tax on the adjusted net capital gain of an individual is 15 percent. In addition, any adjusted net capital gain otherwise taxed at a 10- or 15-percent rate is taxed at a zero-percent rate. These rates apply for purposes of both the regular tax and the alternative minimum tax (AMT). Qualified dividends generally are taxed at the same rate as capital gains. Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct up to \$3,000 of capital losses from ordinary income in each year. Any remaining unused capital losses may be carried forward indefinitely to a future year. The zero- and 15-percent rates for qualified dividends and capital gains are scheduled to sunset for taxable years beginning after December 31, 2012. In 2013, the maximum rate on capital gains would increase to 20 percent for wealthy taxpayers, while the tax rates for dividends would go back to the higher ordinary tax rates of as much as 39.6 percent.

**Note:**

Gains are generally included in net investment income and thus may subject a taxpayer to an additional Medicare tax on gains recognized in 2013 and later years.

### **2. Tax consequences of gains**

Some capital assets may generate gains that are taxed more favorably than gains taxed at new, higher rates. Gains on the sale of **qualified small business stock**, depending on when it is issued, can be 50 percent, 75 percent, or 100 percent excluded. If the maximum capital gains tax rate increases to 20 percent, the effective tax rate on such gains would be 10 percent, 5 percent, or 0 percent, even if the taxpayer is in the highest ordinary income tax brackets. Details concerning the eligibility for, and operation of, this provision are discussed later.

**Planning point:**

Because the capital gain from small business stock is excluded from gross income, it not only eliminates the income tax, but it also has the effect of not increasing AGI or MAGI, and is itself not subject to the Medicare tax on net investment income in 2013 and later years.

**Note:**

Apart from ordinary market forces, a tax hike on capital gains generally has a depressing immediate effect on stocks. It can also trigger a depressing effect on real estate. Suddenly, taking the gains and running may make some sense. If done before the market anticipates the tax hit and the taxpayer reinvests after market corrections, a taxpayer may emerge relatively unscathed.

**3. Acceleration of long-term capital gains**

Because there is no wash-sale rule for gains, investors may sell the appreciated portion of their portfolios and purchase the same securities back immediately at the higher basis, reducing the amount subject to a later, higher-taxed, long-term capital gain. This enables the taxpayer to lock in the current lower tax rates on the more substantial gains. It probably is not worth the transaction costs for small gains, but for stocks and bonds with a substantial gain that are not likely to be held by the investor until death (when a basis adjustment is highly likely to be available), there may be real savings to be enjoyed, but without having to cut off the investment. Family business owners already considering an ultimate sale to younger-generation members may consider making the sale, in whole or in part, before the end of the year. Again the AMT must be taken into account, because taxpayers in the AMT phase out may find capital gains taxed near or above the 20-percent level in 2013.

**Planning point:**

Two points arise. Some taxpayers may find themselves in the 15-percent bracket on capital gains following the tax increases, so such taxpayers who otherwise wish to hold the stock for the long term will have no need to consider a sale and repurchase of appreciated investments.

A time-value-of-money analysis should be made concerning the upfront tax cost of an immediate sale and purchase at 15 percent or zero percent compared to the tax on the same gain at 20 percent in the future. At a five-percent discount rate, the deferred taxes are the same on a present-value basis as the immediate tax at six years. If the projected holding period from today is longer than that, the deferred taxes are less than the current tax and there is no good tax reason to recognize the gains currently. A projected period of less than six years will generally indicate a 2012 sale and repurchase. At an eight-percent discount rate, the break-even holding period is just under four years; at 10 percent, approximately three years.

**Note:**

Should a taxpayer have an underwater real estate investment near the end of 2012, consideration should be given to a sale or a clear abandonment of a partnership interest should be structured to have the gain taxed at the lower capital gains tax rate that would otherwise apply to the disposition of an investment with liabilities in excess of basis.

**Example:** D has owned for six years a limited partnership interest that owns real estate with respect to which D shares \$200,000 of the mortgage liability. D's basis in the partnership is \$40,000 (due to depreciation deductions). D's share of the property's worth is \$150,000. If D disposes of the limited partnership interest in 2010, D recognizes a \$160,000 gain subject to a 15-percent maximum tax rate, while an abandonment or other disposition of the LP interest in 2011 would subject D to a 20-percent tax, assuming D is then in the two top tax brackets.

#### **4. Short-term gains**

Consideration of accelerating gains that would be taken as short-term capital gains in 2012 rather than in 2013. Such gains are taxed at ordinary rates so this strategy arises from, and is subject to the AMT considerations, noted above with respect to the higher tax rates on ordinary income.

**Note:**

However, gains are still included in net investment income and subject to the Medicare tax on unearned income, so short-term gains in 2013 and later years could be taxed at rates as high as 43.4 percent (assuming the highest income tax rate reverts to 39.6 percent).

#### **5. Capital losses**

Rather than taking certain capital losses in 2011 or 2012 to offset current lower-taxed long-term capital gains, taxpayers who anticipate having their future capital gains taxed at 20 percent should take capital losses later to offset higher-taxed gains in future years. Taxpayers without current-year, long-term capital gains may choose to take them currently, because the excess over \$3,000 will carry over into the higher bracket years.

However, the \$3,000 loss in one year does not carry over to reduce net gain component of net investment income in a following year. It does not reduce net investment income in the year it is incurred. So a portion of the tax savings from recognizing the loss may be recovered from the higher net gain in later years for taxpayers in the Medicare unearned income tax.

**Planning point:**

Capital losses: Many taxpayers have built-in capital losses in investments that must be carefully timed. Individuals cannot carry capital losses back, so recognition of gains is not available as an offset to future losses. Here the wash-sale rules will apply so one must cut off investment in the loser for at least 31 days to recognize the loss. But investors must also take into account that a current capital loss only offsets 15-percent income while a future capital loss *may* offset a higher capital gain. Thus, an investor with a portfolio having winners and losers may decide to defer the recognition of gains to higher capital-gains rates years if they have offsetting capital losses that: (a) will be taken before such gains, and (b) will not be disallowed by a purchase within the 61-day window.

The good news is that current capital losses that should be taken for investment purposes may offset \$3,000 of ordinary income in a year the investor has no gains and offset any higher-taxed capital gains recognized in a later year. The key is to recognize losses first: they have a future. Don't recognize them after gains because they have no past.

#### **6. Gifting depreciated property**

Making gifts of property that has declined in value to family members in lower tax brackets accomplishes several objectives, including shifting at a reduced gift-tax cost qualifying dividends and capital gains to lower-bracket taxpayers, some of whom may be eligible for a zero-percent tax rate, but at a minimum at a lower tax rate on such income in 2013 and later years. The reduction in value is even further reduced by making certain transfers in trust, such as by transferring the taxpayer's personal residence to a QPRT.

#### **7. Installment sales**

Be careful in using installment reporting, as this pushes gain into *presumably* higher tax-rate years. As to installment sales executed in 2012, taxpayers should consider electing out of current installment sales treatment at the end of the year if it appears the tax rates will increase. As to installment sales executed

in an earlier year, taxpayers cannot elect out but may accelerate the remaining long-term capital gain to 2011 or 2012 by selling such installment notes or by making substantial modifications to such notes with the lender in those years.

**Note:**

In the case of real estate, a substantial portion of the gain may be subject to the higher (25%) tax rate on unrecaptured §1250 gain. There is no change to this rate in 2011, thereby eliminating or at least reducing the tax-rate differential. Note that all unrecaptured §1250 gain is recognized in a capital gain before any of the gain subject to the regular capital-gains tax rate. Such gain is certain to be taxed at the higher rate absent its acceleration into 2012. However, as the acceleration of 25-percent tax gain is also accelerated, in many cases the present value of the accelerated 25-percent tax-rate gain will outweigh the lower tax on the gain subject to the lower rate.

**Planning point:**

Reduction of the future gain, if recognized in 2013 or later years, can serve to reduce both the gain included in investment income and in the taxpayer's MAGI. A similar analysis should be applied in 2012 to determine whether a sale will then effectively reduce the impact on the excess Medicare tax going forward.

### **III. Investment income**

#### **A. Transfers to individuals**

**Note:**

Below-market loans continue to be an effective, albeit limited, income-shifting tactic. There is a gift element that is subject to gift tax, but the reason for the use of a loan rather than an outright gift is the lesser gift tax consequences. Where the transfer of funds is structured as a below-market loan, the gift element consists solely in the foregone interest, i.e., the excess of a hypothetical level of interest that could have been earned on the loan and the interest actually charged. For example, if a parent loans a child on January 1 a demand loan of \$10,000 at zero interest that remains unpaid on December 31, where the standard interest charge is 4 percent, the foregone interest of \$400 during the year is a reportable gift for gift tax purposes, regardless of the income tax consequences described below. On the other hand, if the parent were to make a gift of the \$10,000, the gift for gift tax purpose would be \$10,000. For estate planning purposes, the lower gift tax cost provides great leverage to the donor, particularly if the child makes in effect the same investment the parent would have made with the funds. This shifts the appreciation and income element out of the estate.

However, the outright gift to a child severs the income tax consequences to the parent where the below-market loan may not necessarily do so.

#### **1. In general**

In general, the interest rates now applicable to inter-family loans have reached historic lows. Loans entered into in May 2011 need only bear interest of .79 percent (in the case of a demand loan) or 2.87 percent (in the case of a mid-term loan) compounded annually to avoid the imputation of interest under §7872. Likewise, the discount rate for determining the value of an interest for life, a term of years, a remainder interest, or reversion is set at 3.4 percent.

**Note:**

Gifts are usually limited to the annual exclusion amount (\$13,000, \$26,000 with gift-splitting, in 2011). This has had the effect of limiting transfers to donees. But transfers made as bona fide loans are not taxable gifts. With the increased exclusion applicable to gifts made in 2011 and 2012.

**Example:** Peggy makes a below-market loan to Linc that results in foregone interest of \$5,000. Peggy includes \$5,000 in income as taxable interest but Linc cannot deduct the \$5,000 interest he is deemed to have paid her.

Accordingly, §7872 recharacterizes a below-market loan as two transactions:

- An arm's-length transaction in which the lender makes a loan to the borrower in exchange for a note requiring the payment of interest at the applicable Federal rate; and
- A transfer of funds by the lender to the borrower ("imputed transfer").

**Note:**

If the imputed transfer by the lender is characterized as a gift, the provisions of chapter 12 of the Internal Revenue Code, relating to gift tax, also apply.

In the case of a gift, the lender is treated as making a gift of the interest to the borrower but the borrower nonetheless still is treated as transferring that amount to the lender as interest. However, if a taxpayer makes a gift loan that is a term loan, the excess of the amount loaned over the present value of all payments which are required to be made under the terms of the loan agreement is treated as a gift from the lender to the borrower on the date the loan is made. If a taxpayer makes a gift loan that is a demand loan, the amount of foregone interest attributable to that calendar period is treated as a gift from the lender to the borrower.

The **de minimis exception** applies to the gift-tax treatment of a gift loan. This excepts from the application of the income tax or gift tax a below-market loan that does not exceed \$10,000. In the case of a term-gift loan, however, once §7872 applies to the loan, the de minimis exception will not apply to the loan at some later date regardless of whether the aggregate outstanding amount of loans does not continue to exceed the limitation amount.

## **2. Loans to children**

Persons can enhance their investment return by providing funds at above the historically low current interest rates to children or other related parties at rates that also are below the rate that the related party might otherwise have to pay. The Code provides a backstop to such loans by also requiring generally that they bear a market rate of interest or trigger adverse income tax consequences. Section 7872 generally treats certain loans in which the interest rate charged is less than the applicable federal rate as economically equivalent to loans bearing interest at the applicable federal rate, coupled with a payment by the lender to the borrower sufficient to fund all or part of the payment of interest by the borrower. Such loans are referred to as "below-market loans." This has the effect of including taxable interest in the income of the lender and treating the borrower as paying interest, a payment that is generally not deductible. Not only is the interest income taxable at the lender's highest rate, but even if the borrower is in the same tax bracket – and this is generally not the case – there is a creation of net income out of nothing.

- a. Ideally, these loans could be made at very low or no interest. Up to \$10,000 can be loaned interest-free without income-tax consequences. However, generally, such loans do have an income-tax effect. But with interest-rates at historical lows, now is the time to take advantage of them at very little tax cost. This tactic can be used now to lock-in current interest rates before the rates return to higher levels.

**Note:**

Care should be taken in documenting the transaction to preserve any potential bad-debt deduction in the even of nonrepayment.

- b. The rules regard foregone interest in the context of a gift as a gift loan. The forgone interest on a gift loan is treated as having been transferred by the lender to the borrower as a gift, and then transferred back by the borrower to the lender as interest. In determining the amount of the gift, the AFR discount rate is applied to the required payments to be made. The differences in valuation for different types of loans are discussed below.

**Note:**

In many cases, the amount of the interest deduction would be largely irrelevant to a low-bracket taxpayer, and in cases not involving the mortgaging of the principal residence largely precluded by reason of the interest-tracing rules. While the borrower has no interest income, the lender can have interest income and potential gift-tax liability (or application of some part of the applicable exclusion amount). However, if the foregone interest is less than the annual exclusion, the entire amount may escape the gift-tax system. Nevertheless, if the loan could extend into 2013, the arrangement could produce investment income to the lender that may be subject to the additional Medicare tax.

- c. Another opportunity lies in making gift loans that do not exceed \$100,000. As long as the aggregate principal amount of loans between the borrower and the lender does not exceed \$100,000, the interest deemed transferred by the borrower to the lender is limited to the borrower's net investment income.

**Planning point:**

This is particularly appropriate in circumstances where the borrower has little or no investment income. In fact, if the borrower has investment income of less than \$1,000, the borrower is treated as having no investment income, so in that case, the lender has no imputed interest income at all. (Of course, since investment income is defined the same as that used in the context of the investment-interest-expense provisions, the election by the borrower to include capital-gains income could have adverse income-tax consequences to the lender either by increasing investment income above the \$1,000 floor or by increasing the amount that may be treated as imputed interest.)

**Example:** On January 1, 2011, parent P makes a \$50,000 below-market gift loan to C, P's child, who uses the calendar year as the taxable year. Assume that C's net investment income for 2011 is \$500. The limitation on the amount of imputed interest payment applies to the \$50,000 loan for the entire year beginning on January 1, 2011. Accordingly, the imputed interest payment on the \$50,000 loan for 2011 is \$0.

- d. The mechanics of §7872 turns on the concept of the applicable federal rate (AFR), which depends upon the term of the loan.

Term of the loan	Interest rate <sup>31</sup>
No more than three years	Federal short-term rate
More than three years, but no more than nine years	Federal midterm rate
More than nine years	Federal long-term rate

- e. In the case of a term loan, the interest rate is considered **below market** if the amount loaned exceeds the **present value** of all payments received under the loan.<sup>32</sup> Generally, the present value is determined by using a discount rate equal to the applicable Federal rate compounded semiannually, that is, the AFR in effect the day the loan was made.<sup>33</sup>

**Planning point:**

What is often a disadvantage of a term loan may be advantageous in the current environment. The entire amount of the imputed interest over the term of the loan is included, but will be calculated using only the interest rate when the loan is entered into. This creates a tax arbitrage where the rate of return on the borrowed money is greater than the AFR. It shifts the taxation on such income to the lower-bracket child.

- f. A demand loan is considered as carrying a below-market interest rate if its interest rate is below the applicable Federal short-term interest rate (i.e., three years or less) that is in effect during the period for which the interest rate is being determined.<sup>34</sup> Amounts are treated as transferred on a daily basis. Thus, the AFR for any day is the relevant rate for the month in which such day falls. This is in contrast to term loans in which the AFR is always the rate in effect for the day in which the loan was made.

**Note:**

If interest rates rise (and they probably will), the interest differential and imputed interest will rise for a demand loan and will be recalculated each year the loan is outstanding, while the benefits of a low-interest rate may be fixed in a term loan.

- g. Alternatively, the client can make a low-interest-rate loan of the down payment or the full mortgage amount. Such loans are generally subject to §7872 rules that require a minimum (or will be deemed to have) interest rate at the AFR. This produces taxable interest income to the parent's tax rate (including the Medicare tax in 2013 and later years), thereby reducing the amount of the subsidy as calculated above. The child, even if the loan from the parent is collateralized by the residence, may not be able to deduct the interest if the child cannot itemize deductions. Currently – May 2011 – the applicable long-term annual AFR is 4.47 percent (comparable to a conventional 4.5 percent mortgage rate), so the benefit of the credit will be reduced by the additional taxes paid by the parent. However, no interest rate need be (and none will be deemed to be) applicable **if the gift loan does not exceed \$10,000, and applies to loans in excess of \$10,000 but not in excess of \$100,000 only to the extent of the child's net investment**

<sup>31</sup> I.R.C. §7872(e)(1)(A). Jan-11, semiannual AFRs: 0.43% (short), 1.94% (mid) and 3.84% (long). Rev. Rul. 2011-2, 2011-2 I.R.B. 256.

<sup>32</sup> These are the same as used in original-issue-discount rules under I.R.C. §1274.

<sup>33</sup> I.R.C. §7872(e)(1)(B).

<sup>34</sup> I.R.C. §7872(f)(2)(B).

**income for the year.** Avoiding the imputed interest could save the lender up to 43.4 percent of the interest that in theory could be imputed.

***Planning point:***

Although we will discuss circumstances where the imputation of interest does not apply, it is important to note that where the imputed interest rate is far below the return that can be earned by the lender, the inclusion of interest income as computed where interest rates are low may be an acceptable trade-off in shifting income to the child because it can reduce the lender's AGI (and investment income) that the lender would have had had he invested the lent amount in the investment the borrower makes. It is important to keep track of interest rates to determine whether an exemption or limitation should be aimed for or whether a below-market loan nonetheless produces an acceptable outcome on balance.

***Note:***

Most gift loans between parents and children are structured as demand loans. One reason for that is that for gift tax purposes, the amount of the gift in the year the loan is made is determined over the entire term; there will be no further gifts considered made in later years of the term. In contrast, the amount of the gift for a demand loan is determined on a daily basis, so there is greater flexibility. If a child were to somehow come into a source of money with which to repay the loan, in the case of a demand loan, its payment would stop the making of a daily gift of interest foregone, but in the case of a term loan, any repayment during the term would not alter the amount of the gift made when the loan was made.

***Planning point:***

Loans between family members can have the effect of shifting investment returns from a higher-bracket taxpayer who might be subject to the additional Medicare tax on investment income to an individual in a lower tax bracket who may not be subject to that new tax. If a **below-market-interest-rate loan** is made, the lender is deemed to have made the loan at a higher interest rate than that fixed by the loan agreement and the borrower is generally deemed to have paid this interest rate to the lender; the source of the "payment" depends on the particular circumstances. This has the effect of increasing the amount of interest, if any, the **donor** is considered to have received.

- (i) A gift loan may be structured to take advantage of the exemption accorded loans not exceeding \$10,000 in principal amount from the below-market loan rules.
- (ii) Another limitation applies to a gift loan directly between individuals. The amount treated as retransferred by the borrower to the lender as of the close of any year shall not exceed the borrower's **net investment income** for such year where the aggregate of such loans between the borrower and lender does not exceed \$100,000.<sup>35</sup>
  - For these purposes, net investment income is defined not to include either qualifying dividends or net long-term capital gains unless and to the extent the taxpayer elects to treat them as such.
  - If the net investment income from any borrower for any year does not exceed \$1,000, the net investment income of such borrower for such year shall be treated as zero.

<sup>35</sup>

I.R.C. §7872(d)(1).

**Planning point:**

This should be distinguished from the \$10,000 rule. On the one hand, if the child were to purchase a business interest that does not in fact pay dividends, the lender might not have any imputed income at all. The “might” arises from the fact that the \$100,000 rule does not trace the net investment income solely to the asset purchased with the funds. If the child has an investment portfolio (even purchased with the child’s own funds) that generates investment income, that income will be counted toward the limitation. If this portfolio is modest in the sense of producing no more than \$1,000 annually, the income is not counted. Of course, if the business itself is paying dividends, such dividends and any qualifying dividends from the portfolio would not be counted toward the \$1,000 limitation as long as the child does not need to make the election in order to take currently the investment interest expense deduction. Such expenses are not lost but may be deferred until such time as the taxpayer has sufficient net investment income to cover them.

**Note:**

One problem with even a low-interest rate loan is that it can impute income subject to the Medicare tax on unearned income that can result in additional tax, while an outright gift will not generate income; for those with plenty of exclusion available and little fear of the clawback problem, an outright gift would seem a better choice. In many instances, parents have structured a loan, but conveniently forgiven loan principal and interest annually; the fear was that a gift in excess of the annual exclusion should be avoided, but many taxpayers were found by the Service and the courts to have made a gift of the entire amount of the “loan” upfront, so the gift is not so much different than what has been done in the past.

**3. Tax on unearned income**

Beginning in 2013, a tax is applied annually in an amount equal to 3.8 percent of the lesser of **net investment income** for such taxable year,<sup>36</sup> or the excess (if any) of: (i) the **modified adjusted gross income** (MAGI) for such taxable year,<sup>37</sup> over (ii) the **threshold amount**.<sup>38</sup> For these purposes, the threshold amount means: (i) in the case of a taxpayer making a joint return or a surviving spouse, \$250,000; (ii) in the case of a married taxpayer filing a separate return, 1/2 of that dollar amount determined under paragraph (i); and (iii) in any other case, \$200,000.

- a. The tax does not apply when the taxpayer has MAGI under the threshold. Thus, one strategy to avoid the tax is to structure the taxpayer’s MAGI to be less than the threshold.
  - (ii) In some cases, a conversion of the character of the income received can be beneficial if it is excluded because it does not enter into the AGI calculation. Examples of this are health care premiums and other fringe benefits.
  - (ii) Modified adjusted gross income means adjusted gross income increased by the excess of the amount excluded from gross income under §911(a)(1), over the amount of any deductions (taken into account in computing adjusted gross income) or exclusions disallowed under §911(d)(6) with respect to the amounts excluded from gross income under §911(a)(1).<sup>39</sup>

**Note:**

This is an example of an amount otherwise not included in gross income being included in MAGI for purposes of this limitation.

<sup>36</sup> I.R.C. §1411(a)(1)(A)(i).  
<sup>37</sup> I.R.C. §1411(a)(1)(B)(i).  
<sup>38</sup> I.R.C. §1411(a)(1)(B)(ii).  
<sup>39</sup> I.R.C. §1411(d).

- (iii) The only deductions allocable to the classes of gross income described above that are taken above the line and thus can reduce MAGI are those attributable to rents and royalties. Otherwise, the entire gross income can push the MAGI above the threshold level without any reduction for deductions. Many of the below-the-line deductions will be miscellaneous itemized deductions which will not be fully deductible. Expenses paid to an investment manager to manage an investment portfolio are subject to the 2 percent floor.

**Example:** J, a high-income individual earns \$100,000 of gross interest income in 2013 from a hedge fund, but the interest income is subject to a \$20,000 management fee that is a miscellaneous itemized deduction that the individual investor is not otherwise able to deduct. J would be subject to an additional Medicare tax of \$3,800 (\$100,000 x 3.8 percent), even though the investor will receive only \$80,000 after payment of the manager's fee. The effect is to gross up the effective Medicare tax rate on the cash received.

**Planning point:**

When possible, take a deduction above-the-line rather than below it.

- (iv) A C corporation can be used to manage the extent of a taxpayer's MAGI. If it makes no distributions, nothing is added to MAGI, which in many cases will limit or eliminate the amount of unearned income subject to Medicare tax. In other years, where the MAGI is so low that the inclusion of a dividend (or compensation) will not increase the MAGI above the threshold amount.
- b. The tax does not apply to the extent the taxpayer has no net investment income. Thus, another strategy is to minimize the extent of net investment income. For these purposes, net investment income means the excess (if any) of --
- (i) The sum of:
- **Gross income** from interest, dividends, annuities, royalties, and rents, other than such income that is derived in the ordinary course of a trade or business not described below;<sup>40</sup>
  - Other **gross income derived from a trade or business described below**;<sup>41</sup> and
  - Net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business not described in the preceding bullet;<sup>42</sup>
- (ii) Over:
- The deductions allowed that are properly allocable to such gross income or net gain.<sup>43</sup>

**Note:**

The trade or business for which the tax applies is a trade or business that is a passive activity with respect to the taxpayer,<sup>44</sup> or a trade or business of trading in financial instruments or commodities.<sup>45</sup>

<sup>40</sup> I.R.C. §1411(b)(1)(A)(i).  
<sup>41</sup> I.R.C. §1411(b)(1)(A)(ii).  
<sup>42</sup> I.R.C. §1411(b)(1)(A)(iii).  
<sup>43</sup> I.R.C. §1411(b)(1)(B).  
<sup>44</sup> I.R.C. §1411(b)(2)(A).  
<sup>45</sup> I.R.C. §1411(b)(2)(B).

There are items that are not included in gross income at all, such as tax-exempt interest that fit into the category of investment income but do not constitute gross income. However, such income, if recognized from a trade or business of trading in financial instruments or commodities, or with respect to which the taxpayer is passive, such interest would be included in net investment income.

**Example:** J, who has MAGI greatly in excess of the threshold amount, has purchased tax-exempt bonds on his own account (Lot A) and is a limited partner in a hedge fund that has acquired the same tax-exempt bonds as part of its portfolio (Lot B). For purposes of determining the net investment income subject to the 3.8 percent tax, A does not include the interest from Lot A, but does include the interest from Lot B if the hedge fund is a trade or business (even if J were a general partner) and in any event because J is passive with respect to the partnership as a limited partner.

**Note:**

In the case of pass-through income of a partnership or S corporation, the separately stated items of interest, dividends, annuities, royalties, and rents will be included in the investor's net investment income. With respect to the trade or business income of the entity that passes through to the investor, (a) in the case of a partnership, (i) a limited partner, being passive with respect to the partnership activity, includes the sum in net investment income, while (ii) a general partner does not include such income in net investment income unless the partner did not materially participate, or the activity is rental real estate; (b) in the case of an S corporation, the shareholder includes such income in net investment income only if the shareholder is passive with respect to the S corporation activity; and this can arise where the activity is a rental activity or where the shareholder does not materially participate. Thus, it is necessary to test material participation in an activity for which there are no losses.

Distributions from an IRA or qualified plan are expressly excluded from net investment income, but except for a Roth-variety arrangement or except to the extent of the return of after-tax contributions, it is included in the taxpayer's gross income and MAGI. Such distributions, while themselves not subject to the tax may push the excess MAGI above or increase its excess to require more of the unearned income to be included in net investment income.

**Example:** J, married, has MAGI from all other sources of \$230,000, which includes \$50,000 of unearned income. J receives a distribution from an IRA of \$40,000. If the IRA is a traditional IRA (with no after-tax contributions), J's MAGI increases to \$270,000. The lesser of the MAGI excess of \$20,000 (\$270,000 - \$250,000) and the \$50,000 net investment income is \$20,000. J is liable for \$760 tax (\$20,000 x .038). If the distribution was from a Roth IRA, the excess MAGI would be \$0 (\$230,000 - \$250,000), so none of the earned income would be subject to the Medicare tax.

The net gain attributable to the disposition of property may be included in net investment income. If it is held not in a trade or business or is held in a trade or business that is a passive activity or financial instrument trade or business is included in gross income if or to the extent such income is not excluded in determining taxable income. For example, only the boot gain recognized in a like-kind exchange by an individual not in a trade or business would be included in net investment income. Gain from the sale of property held in any other trade or business is not included.

**Note:**

In the case of a disposition of an interest in a partnership or S corporation, gain from such disposition shall be taken into account as net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business in the third bullet above only to the extent of the net gain, which would be so taken into account by the transferor if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest.<sup>46</sup> A rule similar to that rule applies to a loss from such disposition.<sup>47</sup>

The sale of an S corporation stock would generally be treated wholly as capital gain that is investment income; this rule bifurcates the gain into what would have been pass-through investment income and that which would have been pass-through business income had the corporation sold all of its assets. This resembles the bifurcation that occurs on the sale of a partnership interest between hot assets and other assets.

**Example:** R sells his 100% stock interest in a cash method S corporation for \$300,000 in 2013 when his basis is \$60,000. The underlying assets of S are \$40,000 of unrealized receivables, work-in-process of \$30,000 and \$230,000 of cash and goodwill.

R recognizes \$240,000 of capital gain. However, for purposes of the additional Medicare tax, only the gain attributable to the cash and the goodwill (assuming that goodwill is considered to generate non-business income – although this could be debated) since a sale of the receivables and work-in-process would have resulted in business income, while the sale of the cash or the goodwill would presumably not. Thus, \$70,000 of the \$240,000 gain would be excluded from the net investment income for these purposes only, and only \$170,000 would be subject to the additional 3.8 percent Medicare tax.

**Planning point:**

Formation of a C corporation can create a taxpayer that can accrue such items without incurring a Medicare tax (although it may be subject to the accumulated-earnings or personal holding company tax. It also can accumulate income without triggering the Medicare tax on earned income, by not paying compensation to certain individuals. This may work particularly well in a 2011 start-up that qualifies as qualified small business stock as the failure to pay dividends (assuming the penalty corporate taxes do not apply) does not necessitate a double tax, since a subsequent sale will exclude the gain attributable to the retained earnings (if within the limitations under §1202).

Avoiding the tax on earned income is not available in a partnership, as earned income passes through as such and the partner may, thereby, be subject to tax on unearned income as such and on the earned income of the partnership as such.

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<sup>46</sup> I.R.C. §1411(b)(4)(A).  
<sup>47</sup> I.R.C. §1411(b)(4)(B).

## B. Shifting income

### *Planning point:*

Family income-shifting and C corporation income-splitting must be more seriously considered. Shifting earned income to a child serves the goal of reducing the compensation subject to **additional Medicare tax, spreading the AGI around** to reduce or eliminate the potential for excess MAGI for any member of the economic unit, and **reducing the overall tax burden by shifting income to a taxpayer in a lower tax bracket**. Since the kiddie tax applies only to **unearned income** of a young child, the shifting of **earned income** to the child by paying the child a salary through the family business is not affected by the kiddie tax.

- However, this may have the effect of **increasing the Social Security tax burden** because the higher-income taxpayer may have already passed the taxable wage base and is only subject to the Medicare tax, while a child is likely to have the first dollar of wages subject to both Medicare and Old Age and Supplemental Disability Income tax.
- Compensation may permit an additional IRA/retirement plan participant.

### 1. Earned income

Since the kiddie tax applies only to **unearned income** of a young child, the shifting of **earned income** to the child by paying the child a salary through the family business is not affected by the kiddie tax.

- a. The reasonable compensation standard has been a long-standing obstacle to this **income-shifting** technique. As a practical matter, however, the reasonable compensation standard may no longer be important in such cases. With much lower individual income-tax rates and increasing payroll taxes, generous salary payments from the family corporation to the children may no longer be attractive.
- b. The maximum amount of savings can be achieved with salary payments of \$5,800. This is the regular standard deduction amount for 2011; after the first \$5,800 is paid (\$10,800 if an IRA is set up), the income-tax savings to the family unit decline. Note that although substantial salary payments from the family corporation to the child, regardless of age, may not generate substantial income-tax savings, they do offer transfer-tax savings.
- c. This suggests paying a \$5,800 salary and shifting \$1,900 of unearned income to the child under age 18 or certain students under age 24. A dependent's standard deduction is limited to the greater of \$950, or earned income plus \$300 (with a maximum standard deduction for single taxpayers of \$5,800).<sup>48</sup> Therefore, it is generally desirable for a dependent to have earned income of at least \$5,800. The structure of the kiddie-tax rules makes it generally desirable for a dependent to have unearned income of at least \$1,900.

### *Planning point:*

In some cases beginning in 2013, the owner will be subject to both the Medicare tax (1.45 percent) and the additional Medicare tax (.9 percent), and the employer a 1.45 percent, yet the shifting of earned income to the younger family member will trigger generally the full 15.3 percent OASDI/Medicare tax for both the employer and employee. But, this not only shifts the tax burden to a lower bracket but also reduces the owner's AGI, which could help the owner to avoid the additional Medicare tax on investment income. This is an example of spreading the AGI around to lower the overall taxes of the economic unit.

- d. Keep in mind that the definition of a kiddie, while patterned after the age thresholds for a child to be treated as a qualifying child for purposes of the dependency deduction, does

<sup>48</sup> I.R.C. §63(c)(5).

not require that the child in fact be a dependent. Note also that it is not necessary that the child actually apply the earned income (or any other income) towards his support, so a child can avoid the kiddie tax at the same time his parent can still qualify for the dependency exemption deduction.

- e. Earned income has taken on a larger and larger role in consideration of income shifting planning. A child within the new suspect age ranges can avoid the kiddie tax if he or she has enough earned income. The accounting problem raised is that the measuring rod is the total amount of support the child has. As noted in the above paragraph, one may be denied the dependency exemption – for example, if the child provides more than half of his total support – yet the kiddie tax could still apply if the child's earned income is less than half of that number. Thus, many taxpayers are thrown back into the calculation of the amount of support the child receives to determine what the proper tax rates apply to the child's income.

**Note:**

The amount of earned income could be somewhat uncertain if the amount paid is unreasonable. In addition, and in probably a thornier issue, an accountant must be prepared to substantiate the base amount of support against which the earned income will be compared.

- f. For planning purposes, the possibilities grow dim if the parent does not own a business through which he can reasonably assure the child will obtain such earned income. In addition, where an S corporation is involved, the mix between compensation and pass-through income will need to be planned more precisely as the former class will provide a child with earned income, but the latter may well not.

**Note:**

However, the Congress has recently suggested that it may have to resuscitate an idea first floated at the end of 2007 that would treat the pass-through income in a service-oriented S corporation as earned income for payroll tax purposes for all shareholders performing services for the corporation.

## **2. Unearned income**

The **kiddie tax** applies not only to children under age 18 (regardless of any other circumstance) but also to children who are 18 years old or who are full-time students over age 18 but under age 24, but only if such children's earned income does not exceed one-half of the amount of their support. Payroll taxes apply only to employee compensation. Therefore, both the kiddie tax and payroll taxes can be avoided by shifting unearned income to **certain children** age 18 or over, particularly if the parents are in a 33- or 35-percent tax bracket (with even greater effect when the tax rates increase to 36- and 39.6-percent rates). However, if the child has not reached the age and circumstance that would allow them not to be treated as a kiddie, the unearned income of the child in excess of \$1,900 (for 2010) will be taxed at the highest marginal rate of the child's parents. The first \$950 of unearned income will be allocated to the child's basic standard deduction. The next \$950 will be taxed at the child's marginal rate.

**Planning point:**

The impending 3.8 percent tax on unearned income gives a taxpayer an additional incentive of shifting unearned income to a lower bracket taxpayer, or more precisely to a taxpayer with a lower AGI, one low enough that the addition of the unearned income shifted will not cause his or her AGI to exceed the applicable \$200,000/\$250,000 level. This not only reduces the amount of the regular income tax liability but reduces or eliminates in some cases the additional 3.8 percent Medicare tax on such income.

**Note:**

One potential planning point is to structure the child's relationship to familial businesses to generate earned income rather than unearned income sufficient to meet the one-half threshold for children age 18 and above.

**Note:**

However, it appears that although the excess unearned income might be taxed for income tax purposes at the adult taxpayer's income tax rate, it does not impact that taxpayer's AGI and the kiddie tax only applies to the income tax so it does not cause the child's unearned income to be treated as the parent's investment income for purposes of the tax under §3111.

- a. Even if the kiddie tax applies to the unearned income, such tax is calculated as if it were added to the parent's taxable income. This has no effect on the parent's AGI or on the parent's "modified adjusted gross income." The Medicare tax is computed by examining the taxpayer's net investment income (which is not affected by the kiddie tax calculation) and the excess of the MAGI (which is not affected by the kiddie tax calculation) over the threshold amount. In essence, the unearned income shifted to the child is not clawed back to the parent. The Medicare tax does not apply to the parent even if the parent's taxable income is used to determine the kiddie's income tax.
- b. This is also true for AMT purposes: The regular income tax liability is not increased by the Medicare tax, so the parent does not increase his regular income tax liability by either the kiddie's income tax or any Medicare tax the kiddie pays; the kiddie likewise does not compute its AMT by increasing the regular income tax by any Medicare tax on unearned income.

### **3. Gifts**

The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 changes to the federal gift, estate, and generation-skipping transfer taxes that will be effective in 2011 and 2012 may create significant new estate planning opportunities. The estate tax applicable exclusion amount is increased to \$5,000,000 for decedents dying in 2010-2012. Similarly, the GST exemption amount is increased to \$5,000,000 for generation-skipping transfers made in 2010-2012, and the gift tax applicable exclusion amount increases to \$5,000,000 for gifts made in 2011-2012.

**Note:**

A general feature of the legislation as it applies to the estate planning area is a sunset of the provisions, whether new or extended-EGTRRA rules, at the end of 2012. Thus, the scenario just played out – no reform until the last minute (and then generally as a deferred sunset) – seems to be in the offing in the future. After 2012, the applicable exclusion amounts return to their pre-EGTRRA amounts (\$1,000,000 with no inflation adjustments for gift and estate tax purposes without further legislation. Most commentators do not believe that the Congress will permit this to occur, and just about as many believe that even a return to 2009 levels is unlikely. So while these provisions may turn out to be “permanent” in some sense, like many income tax provisions the Congress can neither say no to or make permanent, they may become hostage to a general uncertainty of continued application. In other words, one may plan on their basis but also may require sufficient exit strategies, often in convoluted formulary clauses that provide alternative actions or dispositions in response to anticipated potential changes in the law.

**Planning point:**

The amounts stated are with respect to an individual taxpayer. In the case of a married couple, the availability of gift-splitting doubles these numbers: A married couple can give away \$10,000,000 without incurring a gift tax liability, either by each spouse making individual gifts or by gift-splitting (treating a gift as being made one-half by the donor's spouse). Similarly, the reversion in 2013 would limit the total amounts a couple could give to \$2,000,000 without triggering a tax payment liability (\$7,000,000 under the Democratic proposal discussed below).

- a. The increase in the gift tax exclusion removes the previous restraint taxpayers harbored in making gifts to children for estate and income tax purposes. Those who would not pay any gift tax were essentially limited to \$1,000,000 in gifts to all their children, which translates to a shift of \$50,000 of income assuming a 5 percent rate on income-producing assets. With a \$5,000,000 level, however, the amount of shift that can be achieved under the assumed rate of return jumps to \$250,000, which means all or a significant portion of almost all taxpayers' unearned income could be diverted to taxpayers safe from the clutches of the Medicare tax. While transferring that entire sum to a single donee would present problems for the donee with respect to the tax on unearned income, splitting the \$5,000,000 or lesser gift among several donees could minimize or eliminate this exposure. With gift-splitting, a couple can double the amount of such unearned income shifted.

**Note:**

This strategy works even if some of the donor's income is unearned income subject to the Medicare tax; it reduces the tax on unearned income within the economic unit in any event.

**Planning point:**

Because of the uncertainty as to the estate and gift tax structure and exclusions in 2013, the only time to make a series of property transfers totaling \$5,000,000 is 2011 or 2012. Under current law, the gift tax exclusion will revert to \$1,000,000 in that year if the Congress does nothing.

- b. There may be some reasons not to use the full \$5,000,000 exclusion because of certain quirks in the law as written. It is assumed that the key motivator for the transfer is the absence of a transfer tax. This is true in cases where the exclusion remains constant or increases, but is not true in the case where the exclusion declines, which is scheduled to do under current law (to \$1,000,000) or Democratic proposals (\$3,500,000).
  - (i) The estate tax is computed by adding to the taxable estate the taxpayer's adjusted taxable gifts (those in excess of the annual exclusion amounts,

computing the tentative tax and then applying credits, including the applicable credit amount.

- (ii) The applicable exclusion amount is that which applies at the death of the decedent, not what applied at the time of the gifts. When rates stay constant but the exclusion level declines, the applicable exclusion amount will be less at death than it was at the time of a lifetime transfer. Thus, a gift made seemingly without transfer tax at the time it is made could result in an estate tax later on, thereby undermining the motivation to transfer assets limited by the lack of a tax liability. This is referred to in the tax (and bankruptcy) community as a “claw-back.”

**Example:** Widow J, after making her annual annual exclusion gifts, makes a \$5,000,000 gift to her five children, \$1,000,000 to each in 2011; she applied the entire \$1,730,800 gift tax credit applicable in 2011. She dies in 2013 with a zero taxable estate; no law was passed and the tax rates and applicable credit amount reverted to the historical levels. She computes the tentative estate tax on the sum of her taxable estate (\$0) and her adjusted taxable gifts (\$5,000,000), which under the historical rates on \$5,000,000 is \$2,390,800; the applicable credit amount on a \$1,000,000 applicable exclusion amount is \$345,800. J’s estate is on the hook for \$2,045,000. And J thought the gifts were tax-free.

Now this may be an unintended result, and the Congress could clarify this by technical correction to the statute or it could just avoid the problem by not allowing the exclusion amount to decline.

**Planning point:**

Again, as with purely income tax strategies the unsettled nature of the law is likely to cause many taxpayers to do nothing out of fear that they will guess wrong on what the Congress will do (or not do). Wealthy families should consider taking advantage of tax benefits likely never to be offered again.

Even if there are no income tax advantages to the gifts, now is a time to make transfers to asset protection trusts and other asset vehicles before the rules change again.

- Suppose the exclusion is \$1,000,000 and the maximum tax rate is reset at 55%.
- Suppose the current rules are extended.
- Suppose the rates and exclusions are adjusted to some middle ground between the extremes.
- Suppose the transfer taxes are simply repealed.

In any event, decisions need to be made, and tax advisors must be prepared to discuss both the income tax and the estate planning implications of the current and potential future laws.

**Note:**

Charitable gifts are not adjusted taxable gifts, so charitable dispositions may avoid the problems referred to above and thus far, many taxpayers uncertain of the future tax landscape have opted to establish charitable trusts or gifts, largely due to a lack of confidence in the durability of the \$5,000,000 gift tax exemption — or, as in the Administration’s budget proposals, the full tax value of a current charitable deduction will continue in the future — will not be around forever.

Gift Tax Rate Schedule for Gifts Made in 2010

And Gift, Estate, and Generation-Skipping Transfers in 2011 and 2012

If the amount with respect to which the tentative tax to be computed is:	The tentative tax is:
Not over \$10,000	18% of such amount.
Over \$10,000 but not over \$20,000	\$1,800, plus 20% of the excess over \$10,000.
Over \$20,000 but not over \$40,000	\$3,800, plus 22% of the excess over \$20,000.
Over \$40,000 but not over \$60,000	\$8,200, plus 24% of the excess over \$40,000.
Over \$60,000 but not over \$80,000	\$13,000, plus 26% of the excess over \$60,000.
Over \$80,000 but not over \$100,000	\$18,200, plus 28% of the excess over \$80,000.
Over \$100,000 but not over \$150,000	\$23,800, plus 30% of the excess over \$100,000.
Over \$150,000 but not over \$250,000	\$38,800, plus 32% of the excess over \$150,000.
Over \$250,000 but not over \$500,000	\$70,800, plus 34% of the excess over \$250,000.
Over \$500,000	\$155,800, plus 35% of the excess over \$500,000.

**Note:**

Despite the legislative attention given, fears have arisen that transfers in excess of the exclusion amount at the time of death could retroactively be subject to tax at death by a claw-back that would subject the excess of lifetime adjusted taxable gifts over the exclusion existing at death to estate tax even though they had escaped tax liability when the gifts were made. Thus, if the exclusion were adjusted down to the \$1,000,000 level and a decedent had used the entire current exclusion of \$5,000,000 to shield these gifts from taxation when they are made, somehow the \$4,000,000 excess would be taxed at the decedent's death.

While it is true that the tax base on which the estate tax liability is based would include the \$5,000,000 (in adjusted taxable gifts), the calculation takes this into account. The tentative tax is based on the sum of the taxable estate and adjusted taxable estate, reduced by the aggregate amount of gift tax that would have been payable had certain modifications to the calculation of the gift tax been made. These are that the rates of tax in effect at the date of decedent's death are used to determine the gift taxes payable and to determine the gift tax applicable credit amount and the prior credits offsetting the amount.

- c. While the kiddie tax can be minimized by shifting only assets held for appreciation that are planned to be realized after the period of enhanced kiddie tax expires, such assets could just as easily be held by the parent while shifting the income-producing assets and assets likely to be sold to the kiddie to reduce the Medicare income tax hit where the parent is at, near, or over the AGI threshold.

**Example:** Dad has MAGI has \$400,000 of AGI, including \$150,000 of unearned income, while Son has \$150,000 of MAGI. Without more, Dad would be taxed on all

\$150,000, since Dad's net investment income of \$150,000 and the excess MAGI of \$150,000 are the same. But if Dad were able to shift \$50,000 of unearned income to Son, Dad would now be subject to Medicare tax only with respect to \$100,000 (both MAGI and unearned income are reduced by the \$50,000). Son, assumed single, now has \$200,000 of MAGI, and because that means Son has no excess MAGI, he is not subject to Medicare tax regardless of net investment income. The family has saved \$1,900 (\$50,000 x .038).

#### 4. Making gifts - II

In addition to facilitating income shifting (particularly of unearned income), the \$5,000,000 gift tax exclusion makes 2011 and 2012 the time when certain estate planning transactions should be given considerable discussion.

- a. One can help a child (or several children) obtain a home without significantly changing the taxpayer's transfer tax profile (or triggering immediate gift tax), as noted elsewhere.
- b. Business owners should take the opportunity to facilitate succession planning. In doing so, the use of classic discounting techniques may enable the transfers of substantial value with little or no immediate tax liability. Typically, the business interest is the most difficult and most valuable asset in the estate, and one that is often the fastest appreciating (notwithstanding the economy of the past several years), so taxpayers interested in reducing exposure to estate taxes should consider making gifts of the business to the successor or other family members during life. These gifts can take many forms from outright transfers to transfers in trust, such as GRATs, GRUTs, CRUTs, CRATs, and CLATs. All of these techniques are explored further in *The Complete Trust Workshop* (TCTW) and *Selected Critical Issues for the Estate Planner* (SCEP); both of these books are published by Surgent McCoy CPE, LLC (website: [www.cpenow.com](http://www.cpenow.com)).

#### Note:

Just because the exclusion amount has significantly increased does not mean that the taxpayer can drop his guard and not use it in combination with other longstanding techniques that can further reduce valuation.

- (i) In general, when transferring a business in trust, control may be kept by the trustee, possibly the grantor or a family associate, for a period of years until the remainder interest vests in the younger-generation family member, but as an immediate transfer it establishes the valuation date for transfer tax purposes. Under ordinary principles the value of the remainder interest is a fraction of the entire amount transferred, and since one cannot make a gift to oneself, such a transfer can establish a **discount for the gift** by reason of its deferral. The Code, however, provides that for the purpose of determining: (i) whether a transfer in trust to or for the benefit of a **member of the family** of the transferor is a gift; and (ii) the value of such gift, the value of any interest in the trust retained by the transferor or any **applicable family member** is generally treated as zero. Thus, if a transfer is made to a trust benefiting a member of the transferor's family, the transferor is generally treated as making a gift of the entire amount transferred to the trust. The definition of a member of the transferor's family is the member's spouse, ancestors, or lineal descendants (including those of the spouse), siblings, and the spouses of ancestors, lineal descendants, and siblings. An applicable family member is the transferor's spouse, ancestor of either, or the spouse of any such ancestor.

- (ii) Fortunately, the Code also provides that for some retained interests in trust, the subtraction method of valuation will be used to determine the gift-tax value of transfers in trust. This exception will apply to the valuation of retained interests that provide “qualified” payments to the holder of the retained interest. Retained interests that qualify are annuity or unitrust interests. This exception might be helpful for transferring closely held business interests, particularly S corporations, to the next generation. When the retained interest is the right to receive **fixed amounts** payable at least annually (a GRAT -- grantor-retained annuity trust interest), these amounts can either be stated as a fixed annual dollar amount or a fixed percentage of the amount initially contributed to the trust.
- (iii) The irrevocable transfer of the remainder interest in the GRAT or GRUT is an immediate gift for gift-tax purposes. However, since the subtraction method of valuation is available, the gift is discounted from the full fair market value of the property transferred to the GRAT or GRUT by subtracting the value of the grantor’s retained interest as determined under the normal actuarial valuation rules. Since the gift provides a future interest to the remainder beneficiaries, the gift does not qualify for the \$13,000 gift-tax annual exclusion. The grantor’s applicable credit amount must be used, to the extent of the grantor’s remaining credit, to shelter the transfer from tax, but in 2011 and 2012, at least, this credit (\$1,730,800 for a \$5,000,000 exclusion amount) is substantial enough that almost all taxpayers will be able to use this liberally.
- (iv) The estate-tax consequences depend on two issues that cannot be clearly predicted.
- The first is whether the grantor of the trust lives until the termination of the retained interest. If the grantor survives the retained interest term in a qualified GRAT or GRUT, §2036 does not apply and the trust principal, including any appreciation that occurs prior to the initial transfer, is excluded from the grantor’s gross estate. This is the freeze benefit of the GRAT or GRUT since an appreciating business interest can be transferred to family successors for a significantly discounted estate- or gift-tax cost. However, the estate-tax benefits are reduced or eliminated if the grantor fails to survive the term because some (or all) value of the retained rights returns to the gross estate. Thus, when planning a GRAT or GRUT, select a term that the grantor has a reasonable likelihood of surviving based on the grantor’s health, family medical history, and actuarial life expectancy.
  - The second involves potential changes in the estate tax rate and exclusion amount. As noted elsewhere, many planners are worried about a possible clawback of the benefits of the gift tax if, when the donor dies, the estate tax exclusion amounts have declined (from its current level of \$5,000,000). This is because the estate tax is computed on the sum of the taxable estate and the decedent’s adjusted taxable gifts (gifts made in excess of annual exclusion gifts). A reduction of the exclusion amount will bring with it a reduction in the applicable credit a decedent’s estate can apply against its tax liability. As a consequence, the credit applied against the estate tax could be considerably less than the credit that was used to insulate the gift from current tax liability.

**Planning point:**

The use of a trust reduces the impact of this possibility as the leverage of the gift effectively removes all of the post-gift in trust appreciation from the transfer tax system and only includes the fractional portion of the transfer corresponding to the remainder interest only (rather than the entire property or business interest transferred).

## **C. Capital Investment in 2011**

### **1. Section 179 expensing in lieu of bonus depreciation**

A taxpayer that satisfies limitations on annual investment may elect under §179 to deduct (or "expense") the cost of qualifying property, rather than to recover such costs through depreciation deductions. For 2009, the maximum amount that a taxpayer may expense was scheduled to be \$133,000 of the cost of qualifying property placed in service for the taxable year. The \$133,000 amount was reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeded \$525,000. The American Recovery and Reinvestment Act of 2009 extended the provision in the Economic Stimulus Act of 2008 that replaced these amounts under §179 to \$250,000 and \$800,000, respectively, to apply in 2009 as well. The \$250,000 and \$800,000 amounts were not indexed for inflation.

The §179 maximum expensing allowance has been increased to \$500,000 retroactively through 2010 and prospectively through 2011 by the Small Business Jobs Act of 2010. In such years, the phaseout begins at \$2,000,000 (and ends at \$2,500,000).

- It is also expanded, at the **election** of the taxpayer to certain depreciable real property acquired by purchase for use in the active conduct of a trade or business, and is neither used for lodging nor air conditioning or heating units.
  - The provision also temporarily expands the definition of property qualifying for §179 to include certain real property -- specifically, **qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property.**<sup>49</sup>

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<sup>49</sup> For purposes of the provision, qualified leasehold improvement property has the meaning given such term under §168(e)(6), qualified restaurant property has the meaning given such term under §168(e)(7) (and includes a building described in §168(e)(7)(A)(i) that is placed in service after December 31, 2009 and before January 1, 2012), and qualified retail improvement property has the meaning given such term under §168(e)(8) (without regard to §168(e)(8)(E)).

**Note:**

The term “qualified restaurant property” means any §1250 property<sup>50</sup> that is a building, or an improvement to a building, if more than 50 percent of the building’s square footage is devoted to preparation of, and seating for on-premises consumption of, prepared meals. It is generally excluded from the definition of qualified property for purposes of bonus depreciation. The Committee reports and Service guidance indicate that it does qualify if it is also qualified leasehold property.<sup>51</sup>

The term “qualified retail improvement property” means any improvement<sup>52</sup> to an **interior portion of a building** that is **nonresidential real property** if such portion is **open to the general public** and is **used in the retail trade or business of selling tangible personal property to the general public**, and such improvement is **placed in service more than three years after the date the building was first placed in service**. Such term shall not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefitting a common area, or the internal structural framework of the building. It is generally excluded from the definition of qualified property for purposes of bonus depreciation. The Committee reports and Service guidance indicate that it does qualify if it is also qualified leasehold property.<sup>53</sup>

- The **maximum amount of total expensing** with respect to real property that may be expensed under the proposal is **\$250,000**.<sup>54</sup> In addition, §179 deductions attributable to qualified real property that are disallowed under the trade or business income limitation may only be carried over to taxable years in which the definition of eligible §179 property includes qualified real property. Thus, under the provision, if a taxpayer’s §179 deduction for 2010 with respect to qualified real property is limited by the taxpayer’s active trade or business income, such disallowed amount may be carried over to 2011 in the manner under present law. Any such amounts that are not used in 2011, plus any 2011 disallowed §179 deductions attributable to qualified real property, are treated as property placed in service in 2011 for purposes of computing depreciation. The carryover amount from 2010 is considered placed in service on the first day of the 2011 taxable year.<sup>55</sup>

<sup>50</sup> This is any real property (other than §1245 property) which is or has been property of a character subject to the allowance for depreciation. This excludes personal property, but also certain single purpose agricultural or horticultural structures, storage facilities used in the connection with the distribution of petroleum, any railroad grading or tunnel bore, AND so much of any real property which has an adjusted basis in which there are reflected adjustments for amortization for pollution control facilities, §179, energy-efficient commercial buildings, advanced mine safety equipment, removal of architectural transportation barriers to handicapped and elderly, and reforestation expenditures. Most important currently then are the §179 expenditures for qualified leasehold improvements, qualified retail improvements, and qualified restaurant improvements.

<sup>51</sup> I.R.C. §168(e)(7).

<sup>52</sup> In the case of an improvement made by the owner of such improvement, such improvement shall be qualified retail improvement property (if at all) only so long as such improvement is held by such owner. I.R.C. §168(e)(8)(B).

<sup>53</sup> I.R.C. §168(e)(8).

<sup>54</sup> For example, assume that during 2010, a company’s only asset purchases are §179-eligible equipment costing \$100,000 and qualifying leasehold improvements costing \$350,000. Assuming the company has no other asset purchases during 2010, and is not subject to the taxable income limitation, the maximum §179 deduction the company can claim for 2010 is \$350,000 (\$100,000 with respect to the equipment and \$250,000 with respect to the qualifying leasehold improvements).

<sup>55</sup> For example, assume that during 2010, a company’s only asset purchases are §179-eligible equipment costing \$100,000 and qualifying leasehold improvements costing \$200,000. Assume the company has no other asset purchases during 2010, and has a taxable income limitation of \$150,000. The maximum §179 deduction the company can claim for 2010 is \$150,000, which is allocated pro rata between the properties, such that the carryover to 2011 is allocated \$100,000 to the qualified leasehold improvements and \$50,000 to the equipment. Assume further that in 2011, the company had no asset purchases and had taxable income of \$0. The \$100,000 carryover from 2010 attributable to qualified leasehold improvements is treated as placed in service as of the first day of the company’s 2011 taxable year. The \$50,000 carryover allocated to equipment is carried over to 2012 under §179(b)(3)(B).

- The amount that is disallowed for such taxable year that is attributed to qualified real property shall be the amount that bears the same ratio to the total amount so disallowed as: (i) the aggregate amount attributable to qualified real property placed in service during such taxable year, increased by the portion of any amount carried over to such taxable year from a prior taxable year that is attributable to such property; bears to (ii) the total amount of §179 property placed in service during such taxable year, increased by the aggregate amount carried over to such taxable year from any prior taxable year. For purposes of the preceding sentence, only §179 property with respect to which an election was made, is taken into account.
- The treatment of computer software as §179 property is extended through 2011.
- The availability of revoking a §179 election is extended through 2011.
- The provision also permits a taxpayer to elect to exclude real property from the definition of §179 property.

Under the Tax Relief, Unemployment Compensation Reauthorization, and Job Creation Act of 2010, for taxable years beginning in 2012, the maximum amount a taxpayer may expense is \$125,000 of the cost of qualifying property placed in service for the taxable year. The \$125,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$500,000. The \$125,000 and \$500,000 amounts are indexed for inflation.

- In addition, the provision extends the treatment of off-the-shelf computer software as qualifying property,<sup>56</sup> as well as the provision permitting a taxpayer to amend or irrevocably revoke an election for a taxable year under §179 without the consent of the Commissioner for one year (through 2012).
- For taxable years beginning in 2013, and thereafter, the maximum amount a taxpayer may expense is \$25,000 of the cost of qualifying property placed in service for the taxable year. The \$25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000.

***Planning point:***

Going into 2011, planners will be examining the issue of §179 expensing (limited) versus an unlimited 100-percent bonus depreciation. In general, when purchases qualify under either section, the bonus depreciation would generally be indicated. But remember that “old” property, qualified restaurant property, and qualified retail improvement property do not qualify for bonus depreciation.

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<sup>56</sup> The temporary extension of the definition of qualifying property to include qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property is not extended.

**Note:**

In general, qualifying property is defined as depreciable, tangible, personal property that is purchased for use in the active conduct of a trade or business. Off-the-shelf computer software placed in service in taxable years beginning before 2013 is treated as qualifying property.

The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations).

**Note:**

Check state law to determine the expense and extent to which federal provisions are coupled.

- a. The business can over-purchase assets and lose the benefits of the expense. Thus, some businesses should take care in timing their capital equipment. The amount of expense wasted does not carryover to later years. It is better to spend up to the limit and defer further capital expenditures to a later year.
  - (i) The limitations apply at both the entity level and the owner level, a concept often overlooked in a pass-through entity situation.
  - (ii) Another possibility is to defer the placing in service of such property until the following year.
- b. The second area where one can go off is the taxable income limitation: the aggregate cost of §179 property elected to be expensed under §179 that may be deducted for any taxable year may not exceed the aggregate amount of **taxable income of the taxpayer** for such taxable year that is derived from the **active conduct by the taxpayer of any trade or business** during the taxable year.
  - (i) For these purposes, the aggregate amount of taxable income derived from the active conduct by an individual, a partnership, or an S corporation of any trade or business is computed by aggregating the net income (or loss) from all of the trades or businesses actively conducted by the individual, partnership, or S corporation during the taxable year. Items of income that are derived from the active conduct of a trade or business include §1231 gains (or losses) from the **trade or business** and **interest from working capital** of the trade or business.

**Planning point:**

Here the use of a single member LLC may be helpful to an individual who might be denied the expense by reason of the taxable income limitation. Since such entity is not a separate entity, only the individual's taxable income limitation would apply, and such taxable income from an active trade or business also includes any compensation from the entity business.

- (ii) Taxable income derived from the active conduct of a trade or business is computed without regard to the deduction allowable under §179, any §164(f) deduction (for self-employment taxes), any net operating loss carryback or carryforward, and deductions suspended under any section of the Code.<sup>57</sup>

<sup>57</sup>

Treas. Regs. §1.179-2(c)(1).

- (iii) The amount not currently expensable by reason of the taxable income limitation does carry over. So the lack of taxable income should not be an impediment to its current use.
- (iv) A limited partner, for as long as he is a limited partner, cannot have any taxable income derived from the active conduct of the trade or business of the partnership. However, absent a special allocation of §179 expense, LP will still be allocated his share of §179 expense that he will remain unable to use by reason of the taxable income limitation. Furthermore, he will continue to reduce his basis in the partnership by the full amount of the §179 expense. The LP may have some options. (These may be negated by passive-loss limitations, if applicable.)
  - First, if he operates a sole proprietorship that generates taxable income derived from the active conduct of a trade or business in the current or later year, he may be able to apply the §179 expense from the partnership.
  - Second, if he ever becomes a general partner, he may be able to enjoy a catch-up through the generation of taxable income derived from the active conduct of a trade or business, but this may take several years, and, if the partnership makes additional §179 expenses, LP may find this use further deferred because the maximum amount that a partner may take will be limited by the excess of the dollar limitation in that year over the actual elected §179 expenses for that year.
  - Alternatively, the partnership can simply allocate the §179 expense to the general partners. However, in many limited partnerships, the general partners may have a low basis and capital account because the deal is structured as one in which the general provides minimal capital but takes a large profits interest or a guaranteed payment. The consequence is that the general partner may run out of basis to take the current loss.
- (v) However, depreciation is not subject to the taxable income limitation. Accordingly, in some cases where the taxable income limitation may be in effect for several years, the ability to take depreciation deductions may produce a higher tax benefit than a deferred §179 expense.
- c. The amount expensed is not taken into account as a purchase for purposes of the mid-quarter convention. This means that taking an expense on property purchased in the fourth quarter may avoid the application of the mid-quarter convention, while taking the expense on property purchased in any other quarter may make the mid-quarter convention more likely.
- d. The expense gives more bang for the buck if made with respect to property having longer recovery periods under MACRS. This could be in conflict with the mid-quarter convention avoidance rule above.
- e. The expense is not subject to adjustment in the AMT system.

## 2. Bonus depreciation in general

The Economic Stimulus Act of 2008 reinstated the concept of 50-percent bonus first-year depreciation with respect to qualified property. Bonus depreciation was retroactively extended for qualifying property placed in service by December 31, 2010 by the Small Business Jobs Act of 2010. Qualified property is depreciable property that meets all of the following requirements in the first taxable year in which the property is subject to depreciation by the taxpayer whether or not depreciation deductions for the property are allowable:

- A kind of property;
- An original use;
- An acquisition date;<sup>58</sup> and
- A placed-in-service date.

### Note:

The Tax Relief, Unemployment Compensation Reauthorization, and Job Creation Act extended and expands the additional first-year depreciation to equal **100 percent of the cost** of qualified property placed in service after September 8, 2010 and before January 1, 2012 (before January 1, 2013 for certain longer-lived and transportation property), and provides for a 50-percent first-year additional depreciation deduction for qualified property placed in service after December 31, 2011 and before January 1, 2013 (after December 31, 2012 and before January 1, 2014 for certain longer-lived and transportation property). The provision expanding the additional first-year depreciation deduction to 100 percent of the basis of qualified property applies to property placed in service by the taxpayer after September 8, 2010, in taxable years ending after such date.

## 3. What kinds of property qualify?

- a. There are four broad categories:
  - (i) MACRS property that has a recovery period of 20 years or less;
  - (ii) Computer software;
  - (iii) Water utility property; and
  - (iv) Qualified leasehold improvement property.
- b. Qualified leasehold improvement property means any **improvement**, which is **§1250 property**, to an **interior portion** of a **building** that is **nonresidential real property**<sup>59</sup> if:
  - The improvement is made under or pursuant to a lease<sup>60</sup> **by the lessee (or any sublessee)** of the interior portion, **or by the lessor** of that interior portion;
  - The interior portion of the building is to be **occupied exclusively by the lessee (or any sublessee)** of that interior portion; and
  - The improvement is placed in service **more than three years after the date the building was first placed in service by any person.**

<sup>58</sup> For purposes of the additional first-year depreciation deduction, depreciable property will meet this requirement if the property is acquired on or after January 1, 2008 and before January 1, 2013.

<sup>59</sup> Nonresidential real property has the same meaning as that term is defined in §168(e)(2)(B).

<sup>60</sup> Lease has the same meaning as that term is defined in §168(h)(7). In addition, a commitment to enter into a lease is treated as a lease, and the parties to the commitment are treated as lessor and lessee. However, a lease between related persons is not considered a lease. For these purposes, related persons are members of an affiliated group and persons having a relationship described in §267(b) substituting "80 percent or more" for "more than 50 percent."

**Note:**

Specifically excluded from the definition of qualified leasehold improvement property is any improvement for which the expenditure is attributable to: (i) the enlargement<sup>61</sup> of the building;<sup>62</sup> (ii) any elevator or escalator;<sup>63</sup> (iii) any structural component<sup>64</sup> benefiting a common area;<sup>65</sup> or (iv) the internal structural framework<sup>66</sup> of the building.

#### 4. Original use

The additional first-year depreciation deduction requires that the **original use** of the depreciable property commence with the taxpayer. In general, original use means the first use to which the property is put, whether or not that use corresponds to the use of the property by the taxpayer. Thus, additional capital expenditures incurred by a taxpayer to recondition or rebuild property acquired or owned by the taxpayer satisfy the original-use requirement. However, the cost of reconditioned or rebuilt property does not satisfy the original-use requirement. The question of whether property is reconditioned or rebuilt property is a question of fact. Property that contains used parts will not be treated as reconditioned or rebuilt if the cost of the used parts is not more than 20 percent of the total cost of the property, whether acquired or self-constructed.

**Note:**

In other words, the property must be new property in the hands of the taxpayer.

- a. If a taxpayer initially acquires **new property for personal use** and **subsequently uses the property** in the taxpayer's trade or business or for the taxpayer's production of income, the taxpayer is considered the original user of the property. If a person initially acquires new property for personal use and a taxpayer subsequently acquires the property from the person for use in the taxpayer's trade or business or for the taxpayer's production of income, the taxpayer is not considered the original user of the property.
- b. If a taxpayer initially acquires new property and holds the **property primarily for sale to customers** in the ordinary course of the taxpayer's business, and subsequently withdraws the property from inventory and uses the property primarily in the taxpayer's trade or business or primarily for the taxpayer's production of income, the taxpayer is considered the original user of the property. If a person initially acquires new property and holds the property primarily for sale to customers in the ordinary course of the person's business and a taxpayer subsequently acquires the property from the person for use primarily in the taxpayer's trade or business or primarily for the taxpayer's production of income, the taxpayer is considered the original user of the property. For these purposes, the original use of the property by the taxpayer commences on the date on which the taxpayer uses the property primarily in the taxpayer's trade or business or primarily for the taxpayer's production of income.

<sup>61</sup> Enlargement has the same meaning as that term is defined in §1.48-12(c)(10).

<sup>62</sup> Building has the same meaning as that term is defined in § 1.48-1(e)(1).

<sup>63</sup> Elevator and escalator have the same meanings as those terms are defined in §1.48-1(m)(2).

<sup>64</sup> Structural component has the same meaning as that term is defined in §1.48-1(e)(2).

<sup>65</sup> Common area means any portion of a building that is equally available to all users of the building on the same basis for uses that are incidental to the primary use of the building. For example, stairways, hallways, lobbies, common seating areas, interior and exterior pedestrian walkways and pedestrian bridges, loading docks and areas, and rest rooms generally are treated as common areas if they are used by different lessees of a building.

<sup>66</sup> Internal structural framework has the same meaning as that term is defined in §1.48-12(b)(3)(i)(D)(iii).

- Example 1:** On August 1, 2004, A buys from B for \$20,000 a machine that has been previously used by B in B's trade or business. On March 1, 2011, A makes a \$5,000 capital expenditure to recondition the machine. The \$20,000 purchase price does not qualify for the additional first-year depreciation deduction because the original-use requirement is not met. However, the \$5,000 expenditure satisfies the original-use requirement and, assuming all other requirements are met, qualifies for the 50-percent additional first-year depreciation deduction, regardless of whether the \$5,000 is added to the basis of the machine or is capitalized as a separate asset.
- Example 2:** On April 1, 2006, E acquires a horse to be used in E's thoroughbred racing business. On January 1, 2011, F buys the horse from E and will use the horse in F's horse breeding business. The use of the horse by E in its racing business prevents the original use of the horse from commencing with F. Thus, F's purchase price of the horse does not qualify for the additional first-year depreciation deduction.
- Example 3:** On December 1, 2007, JJ, an equipment dealer, buys new tractors that are held by JJ primarily for sale to customers in the ordinary course of its business. On March 1, 2011, JJ withdraws the tractors from inventory and begins to use the tractors primarily for producing rental income. The holding of the tractors by JJ as inventory does not constitute a "use" for purposes of the original-use requirement and, therefore, the original use of the tractors commences with JJ on March 1, 2011. However, the tractors are not eligible for the additional first-year depreciation deduction because JJ acquired the tractors before January 1, 2008.

## 5. Automobiles

The limitation on the amount of depreciation deductions allowed, with respect to certain passenger automobiles, is increased by \$8,000 for automobiles that qualify (and do not elect out of the increased deduction).<sup>67</sup>

Depreciation limitations for passenger automobiles (that are not trucks or vans) placed in service by the taxpayer in calendar year 2011, for which the additional first-year depreciation deduction does not apply:

Tax Year	Amount
1st year	\$3,060
2nd year	\$4,900
3rd year	\$2,950
Succeeding years	\$1,775

Depreciation limitations for passenger automobiles (that are not trucks or vans) placed in service by the taxpayer in calendar year 2011, for which the additional first-year depreciation deduction applies:

Tax Year	Amount
1st year	\$11,060
2nd year	\$4,900
3rd year	\$2,950
Succeeding years	\$1,775

<sup>67</sup> Rev. Proc. 2011-21, 2011-12 I.R.B. 1, Tables 1 through 4.

Depreciation limitations for trucks and vans placed in service by the taxpayer in calendar year 2011, for which the additional first-year depreciation deduction does not apply:

<b>Tax Year</b>	<b>Amount</b>
1st year	\$3,260
2nd year	\$5,200
3rd year	\$3,150
Succeeding years	\$1,875

Depreciation limitations for trucks and vans placed in service by the taxpayer in calendar year 2011, for which the additional first-year depreciation deduction will apply:

<b>Tax Year</b>	<b>Amount</b>
1st year	\$11,260
2nd year	\$5,200
3rd year	\$3,150
Succeeding years	\$1,875

- The additional \$8,000 applies to both §179 expensing and depreciation.
- The §179 expense does not require that the purchased property have its original use with the taxpayer. The purchase of a used car does not qualify for additional first-year depreciation.
- There is no AMT depreciation adjustment for qualified property for the entire recovery period of qualified property.
- Certain SUVs are not listed property, making them qualified property but not listed property. As a result, they are entitled to an additional depreciation deduction in the placed-in-service year equal to 50 percent of the adjusted basis of the SUV. Such vehicles are also eligible for expensing under §179. If expensing is claimed, the amount expensed will reduce the cost basis on which the additional 50-percent first-year depreciation is computed. Since first-year depreciation is in addition to regular depreciation, the amount of such deduction as a percentage of cost can be quite high.

**6. Does bonus depreciation make sense?**

Only businesses with significant profits in 2012, or recent earlier years, will get full benefit of the depreciation in 2011, as excess amounts may represent a net operating loss that is carried forward. Companies that are in relatively low tax brackets now or in carryback years may have a lesser tax benefit than deferring depreciation benefits to later years when their tax brackets are higher, despite the deferral. Similarly, companies that have expiring net operating losses may waste some of the carryforward if the depreciation charges reduce taxable income too much to absorb it fully.

**Note:**

A compromise solution to front-loading too much of the depreciation deduction where deferral might be indicated is to claim bonus depreciation, but elect slower (150-percent declining balance); if made, it applies to all property within a recovery class placed in service within the year.

- Expense old property because only new qualifies for bonus.
- Bonus depreciation skews different classes of property differently. Consult the tables below.
- While regular depreciation may result in AMT adjustments if 200-percent declining balance is used, no AMT adjustments apply to any property for which bonus depreciation is taken, and not just the bonus depreciation itself.
- There is no phaseout of the bonus depreciation based on the amount of capital investment.
- There is no taxable income limitation, so it may be carried forward more effectively than a §179 expense.

**Note:**

If the business has net operating losses that are about to expire, any additional deductions to current-year income could result in a waste of expiring losses. Secondly, the up-front value of the deductions may be less than their value taken in the future, if the tax brackets in those future years are higher than a relatively low-bracket current year.

**Note:**

Congress has threatened to end all of the tax breaks for SUVs by reclassifying most popular models as listed property, a change, which if enacted this year and applied retroactively, could end the \$25,000 limit on §179 expensing and disqualify them from full bonus depreciation. What would be left in such a case would be the additional \$8,000 first-year depreciation.

## **7. Guidance on 100-percent bonus depreciation**

The IRS has issued guidance on amendments to §168(k) that extend the placed-in-service date for property to qualify for the 50-percent additional first-year depreciation deduction and temporarily allow a 100-percent additional first-year depreciation deduction for some new property.<sup>68</sup> The context for this guidance are two 2010 laws: the Small Business Jobs Act of 2010 initially extended the bonus depreciation retroactively for 2010 (at 50 percent); and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act, which enhanced the additional first-year depreciation deduction to 100 percent of the cost of qualified property acquired by a taxpayer placed in service after September 8, 2010 and before January 1, 2012.

- a. Depreciable property is eligible for the 100-percent additional first-year depreciation deduction if the property is **qualified property**, and also meets the additional requirements below in the first taxable year in which the property is subject to depreciation by the taxpayer, whether or not depreciation deductions for that property are allowable.<sup>69</sup>

<sup>68</sup> Rev. Proc. 2011-26; 2011-16 I.R.B. 1.

<sup>69</sup> For purposes of determining whether depreciable property is qualified property, rules similar to the rules in Treas. Regs. §1.168(k)-1 for "qualified property" or for "30-percent additional first year depreciation deduction" apply.

**Note:**

**Qualified property** means property: (i) which has a recovery period of 20 years or less; (ii) which is computer software for which a deduction is allowable; (iii) which is water utility property; or (iv) which is **qualified leasehold improvement property**, and if (X) the original use of which commences with the taxpayer after December 31, 2007; (Y) is acquired by the taxpayer after December 31, 2007, and before January 1, 2013, but only if no written binding contract for the acquisition was in effect before January 1, 2008; or (Z) is acquired by the taxpayer pursuant to a written binding contract that was entered into after December 31, 2007, and before January 1, 2013, and which is placed in service by the taxpayer before January 1, 2013, or, in the case of certain property, before January 1, 2014.

A special rule applies to self-constructed property. In the case of a taxpayer manufacturing, constructing, or producing property for the taxpayer's own use, the requirements of original use are treated as met if the taxpayer begins manufacturing, constructing, or producing the property after December 31, 2007, and before January 1, 2013.

Qualified property does not include any property if the user of such property (as of the date on which such property is originally placed in service) or a person that is related to such user or to the taxpayer had a written binding contract in effect for the acquisition of such property at any time on or before December 31, 2007, or in the case of property manufactured, constructed, or produced for such user's or person's own use, the manufacture, construction, or production of such property began at any time on or before December 31, 2007.

A special rule applies to passenger vehicles. In the case of such qualified property, the deduction limitation on passenger automobiles is increased by \$8,000. But, unlike other bonus depreciation property, excess depreciation (including the \$8,000) may be recaptured by reason of the business use percentage falling below the more-than-50-percent threshold in a later year.

- b. If a taxpayer manufactures, constructs, or produces qualified property for use by the taxpayer in its trade or business or for its production of income, rules similar to the self-constructed property rules in the regulations apply for determining whether this property meets the acquisition requirement.<sup>70</sup> However, this revenue procedure provides a limited exception for **certain components** of a larger self-constructed property. Further, an acquired component that is qualified property is not required to be acquired pursuant to a written binding contract to satisfy the acquisition requirement. For purposes of the additional first-year depreciation deduction, the term "component" is intended to refer to any part used in the manufacture, construction, or production of the larger self-constructed property, which may or may not be the same as the asset for depreciation purposes or the same as the unit of property for purposes of other Code sections.
- (i) Solely for purposes of §168(k)(5), the Treasury Department and the Service will allow a limited exception to the rule above for the components. If before September 9, 2010, a taxpayer begins the manufacture, construction, or production of the larger self-constructed property that is qualified property for use in its trade or business or for its production of income, but this larger self-constructed property meets the requirements of subparagraphs b and c in the preceding paragraph, the taxpayer may elect to treat any acquired or self-constructed component of that larger self-constructed property as being eligible for the 100-percent additional first-year depreciation deduction if the component is qualified property and is acquired or self-constructed by the taxpayer after September 8, 2010, and before January 1, 2012 (before January 1, 2013, in the

<sup>70</sup> See Treas. Regs. §§ 1.168(k)-1(b)(4)(iii).

case of certain qualified property). The taxpayer may make this election for one or more components that are described in this paragraph. The taxpayer must make the election by the due date (including extensions) of the federal tax return for the taxpayer's taxable year in which the larger self-constructed property is placed in service by the taxpayer, and by attaching a statement to that return indicating that the taxpayer is making the election provided in §3.02(2)(b) of Rev. Proc. 2011-26 and whether the taxpayer is making the election for all or some of the components described. If a taxpayer has timely filed its federal tax return for the taxpayer's taxable year in which the larger self-constructed property is placed in service by the taxpayer on or before April 18, 2011, the Regulations provide for an automatic extension of six months from the due date of that federal return (excluding extensions) to make the election.<sup>71</sup>

- (ii) Qualified property shall not include any property if the user of such property (as of the date on which such property is originally placed in service) or a person that is related (within the meaning of §267(b) or §707(b)) to such user or to the taxpayer had a written binding contract in effect for the acquisition of such property at any time on or before September 8, 2010, or in the case of property manufactured, constructed, or produced for such user's or person's own use, the manufacture, construction, or production of such property began at any time on or before September 8, 2010.

**Example 1:** In June 2008, X began constructing an electric generation power plant for its own use. In February 2009, prior to the completion of the power plant, X and Y (an unrelated party) entered into a written binding contract under which X transferred the rights to own and use this power plant to Y for \$2 million. On March 1, 2009, Y began construction to complete the power plant. Between March 2009 and August 2010, Y incurred another \$10 million to complete the construction of the power plant. This \$10 million includes amounts for acquired components that were acquired by Y pursuant to written binding contracts entered into after March 1, 2009, and for self-constructed components, the construction, manufacturing, or production of which began after March 1, 2009. Y completed construction of the power plant in August 2010. On October 1, 2010, Y placed the power plant in service. The power plant is included in asset class that has a recovery period of 20 years.

First, Y must determine if the power plant is qualified property and if its components are qualified property. Y acquired the \$2 million portion of the total \$12 million unadjusted depreciable basis pursuant to a written binding contract entered into after December 31, 2007. Further, Y began construction to complete the power plant after December 31, 2007, and all of its components were self-constructed beginning, or acquired pursuant to written binding contracts entered into, after December 31, 2007. Also, the original use of the power plant began with Y after December 31, 2007, and Y placed the power plant in service before January 1, 2014 (the power plant is certain property). Thus, the power plant is qualified property and all of its components are qualified property.

Y must next determine if the power plant and any of its components are eligible for the 100-percent additional first-year depreciation deduction. Because X and Y are not related parties, the transaction between X and Y will not be a disqualified transaction. Although the original use of the power plant began with Y after September 8, 2010, and Y placed the power plant in service after September 8, 2010, and before January 1, 2013 (the power plant is certain property), the power

<sup>71</sup>

Treas. Regs. §301.9100-2(b).

plant does not meet the acquisition rule. Y acquired the \$2 million portion of the total \$12 million unadjusted depreciable basis before September 9, 2010. Further, Y began construction to complete the power plant before September 9, 2010, and Y acquired or self-constructed all of the components to complete the construction of the power plant before September 9, 2010. Accordingly, Y's total expenditures of \$12 million for the power plant do not qualify for the 100-percent additional first-year depreciation deduction. Instead, Y's total expenditures of \$12 million for the power plant qualify for the 50-percent additional first-year depreciation deduction.

**Example 2:** In August 2009, X began constructing an electric generation power plant for its own use. On September 1, 2010, prior to the completion of the power plant, X and Y (an unrelated party) entered into a written binding contract and X transferred the rights to own and use this power plant to Y for \$5 million. On September 15, 2010, Y began construction to complete the power plant. Between September 15, 2010, and November 2011, Y incurred another \$10 million to complete the construction of the power plant. This \$10 million includes amounts for acquired components that were acquired by Y after September 15, 2010, and for self-constructed components, the construction, manufacturing, or production of which began after September 15, 2010. All acquired components to complete the construction of the power plant were acquired by Y pursuant to written binding contracts entered into after September 1, 2010. Y completed construction of the power plant in November 2011. On December 15, 2011, Y placed the power plant in service. The power plant is included in asset class that has a recovery period of 20 years.

First, Y must determine if the power plant is qualified property and if its components are qualified property. Y acquired the \$5 million portion of the total \$15 million unadjusted depreciable basis pursuant to a written binding contract entered into after December 31, 2007. Further, Y began construction to complete the power plant after December 31, 2007, and all of its components were self-constructed beginning, or acquired pursuant to written binding contracts entered into, after December 31, 2007. Also, the original use of the power plant began with Y after December 31, 2007, and Y placed the power plant in service before January 1, 2014 (the power plant is certain property). Thus, the power plant and its components are qualified property.

Y must next determine if the power plant and any of its components are eligible for the 100-percent additional first-year depreciation deduction. X and Y are not related parties; therefore, the transaction between X and Y will not be a disqualified transaction. Although the original use of the power plant began with Y after September 8, 2010, and Y placed the power plant in service after September 8, 2010, and before January 1, 2013 (the power plant is certain property), not all of Y's total expenditures of \$15 million qualify for the 100-percent additional first-year depreciation deduction. Given that Y acquired the \$5 million portion of the total \$15 million unadjusted depreciable basis before September 9, 2010, that portion qualifies only for the 50-percent additional first-year depreciation deduction. However, because Y began construction to complete the power plant after September 8, 2010, and Y acquired or began self-constructing all of the components to complete the construction of the power plant after September 8, 2010, the \$10 million portion of the total \$15 million unadjusted depreciable basis qualifies for the 100-percent additional first-year depreciation deduction.

**Example 3:** X, a calendar-year taxpayer, began constructing a ship for its own use in March 2010. Between March 2010 and June 2012, X incurred \$25 million to complete the construction of the ship. This \$25 million includes \$15 million for acquired components that were acquired by X after September 8, 2010, and before January 1, 2013, and for self-constructed components, the construction,

manufacturing, or production of which began after September 8, 2010, and before January 1, 2013 (the ship is certain property). All acquired components of the ship were acquired by X pursuant to written binding contracts entered into after March 2010. The original use of all components of the ship commences with X. X completed construction of the ship in June 2012, and placed it in service in August 2012. On its 2012 federal tax return, X makes the election provided. The ship is included in asset class that has a recovery period of 10 years.

First, X must determine if the ship is qualified property and if its components are qualified property. X began construction of the ship after December 31, 2007, and all of its components were self-constructed beginning, or acquired pursuant to written binding contracts entered into, after December 31, 2007. Also, the original use of the ship began with X after December 31, 2007, and X placed the ship in service before January 1, 2014 (the ship is certain property). Thus, the ship and its components are qualified property.

X must next determine if the ship and any of its components are eligible for the 100-percent additional first-year depreciation deduction. Although the original use of the ship began with X after September 8, 2010, and X placed the ship in service after September 8, 2010, and before January 1, 2013 (the ship is certain property), not all of X's total expenditures of \$25 million qualify for the 100-percent additional first-year depreciation deduction. X began construction of the ship before September 9, 2010, but made the election provided. As a result, the \$15 million portion (of the total \$25 million unadjusted depreciable basis for the ship) incurred for the components that were acquired or self-constructed by X after September 8, 2010, and before January 1, 2013, qualifies for the 100-percent additional first-year depreciation deduction. The remaining \$10 million portion of the total \$25 million unadjusted depreciable basis qualifies only for the 50-percent additional first-year depreciation deduction.

**Example 4:** The facts are the same as in **Example 3**, except X did not make the election provided on its 2012 federal tax return. As a result X's total expenditures of \$25 million for the ship, do not qualify for the 100-percent additional first-year depreciation deduction. Although the original use of the ship began with X after September 8, 2010, and X placed the ship in service after September 8, 2010, and before January 1, 2013 (the ship is property described in §168(k)(2)(B)), the ship does not meet the acquisition rule because X began construction of the ship before September 9, 2010. Accordingly X's total expenditures of \$25 million for the ship, qualify only for the 50-percent additional first-year depreciation deduction.

### **8. Qualified leasehold property**

Qualified property that meets the definition of **both qualified leasehold improvement property and qualified restaurant property or qualified retail improvement property** is eligible for the 100-percent additional first-year depreciation deduction (assuming all other requirements are met).

**Example:** If in 2011 a taxpayer constructs and places in service qualified property that is an improvement to a restaurant building and that improvement meets the definition of both qualified restaurant property and qualified leasehold improvement property, the improvement is eligible for the 100-percent additional first-year depreciation deduction (assuming all other requirements are met). However, if in 2011 a taxpayer constructs and places in service a new restaurant building, that building is not qualified leasehold improvement property and is not eligible for any additional first-year depreciation deduction.

**Note:**

The depreciable basis of qualified property that is eligible for any additional first-year depreciation deduction is taken into account in determining whether the mid-quarter convention applies to the property placed in service during the taxable year.

Qualified leasehold improvement property means any improvement, which is §1250 property, to an interior portion of a building that is nonresidential real property if: (i) the improvement is made under or pursuant to a lease by the lessee (or any sublessee) of the interior portion, or by the lessor of that interior portion; (ii) the interior portion of the building is to be occupied exclusively by the lessee (or any sublessee) of that interior portion; and (iii) the improvement is placed in service more than three years after the date the building was first placed in service by any person.

Qualified leasehold improvement property does **not include** any improvement for which the expenditure is attributable to: (i) the **enlargement** of the building; (ii) any **elevator or escalator**; (iii) any **structural component** benefiting a **common area**;<sup>72</sup> or (iv) the **internal structural framework** of the building.

### **9. Electing out of additional first-year depreciation**

The election not to deduct additional first-year depreciation for a class of property applies to all qualified property that is in that class of property and placed in service in the same taxable year.<sup>73</sup>

**Example:** If a calendar-year taxpayer for its taxable year ending December 31, 2010, makes the election not to deduct additional first-year depreciation for five-year property, all five-year property placed in service by the taxpayer during its 2010 taxable year is not qualified property and, therefore, is not eligible for the 50-percent or the 100-percent additional first-year depreciation deduction for the 2010 taxable year.

- a. In recognition of the fact that a taxpayer may have difficulty determining the exact date during a month on which the taxpayer acquires and places in service property, the Treasury Department and the Service will allow a taxpayer to elect to deduct the 50-percent, instead of the 100-percent, additional first-year depreciation for all qualified property that is in the same class of property and placed in service by the taxpayer in its taxable year that includes September 9, 2010, provided the taxpayer does not make an election not to deduct additional first-year depreciation for that class of property for that taxable year. If the taxpayer makes the election provided by this procedure, the allowable additional first-year depreciation deduction is determined for the class of property based on the 50-percent additional first-year depreciation deduction.

**Example:** If a calendar-year taxpayer for its taxable year ending December 31, 2010, placed in service five-year property before September 9, 2010, and other five-year property after September 8, 2010, the taxpayer may elect to claim the 50-percent additional first-year depreciation for all of its five-year property that is qualified property and placed in service during the 2010 taxable year.

<sup>72</sup> Common area means any portion of a building that is equally available to all users of the building on the same basis for uses that are incidental to the primary use of the building. For example, stairways, hallways, lobbies, common seating areas, interior and exterior pedestrian walkways and pedestrian bridges, loading docks and areas, and rest rooms generally are treated as common areas if they are used by different lessees of a building. Treas. Regs. §1.168(k)-1(c)(3)(ii).

<sup>73</sup> Treas. Regs. § 1.168(k)-1(e)(1).

- b. This election must be made by the due date (including extensions) of the federal tax return for the taxpayer's taxable year that includes September 9, 2010, and must be made in the same manner as the general election is made. If a taxpayer has timely filed its federal tax return for the taxpayer's taxable year that includes September 9, 2010, on or before April 18, 2011, the Regulations may permit an automatic extension of six months from the due date of that federal return (excluding extensions) to make the election specified.<sup>74</sup>

**Note:**

The Blue Book indicates that it was the intention of Congress to permit a taxpayer to elect 50-percent bonus in lieu of 100 percent throughout the 100-percent bonus period, but that this would probably take a technical correction to the Code to achieve. This would be broader than the administrative allowance noted above.

### 10. Passenger automobiles

For purposes of applying §1.168(k)-1(f)(8) to passenger automobiles, the dollar limitation for the first taxable year in the recovery period is increased by \$8,000 for a passenger automobile that is eligible for the 100-percent additional first-year depreciation deduction. If the unadjusted depreciable basis<sup>75</sup> of a passenger automobile that is qualified property eligible for the 100-percent additional first-year depreciation deduction exceeds the first-year limitation amount under §280F(a)(1)(A)(i), the excess amount is the unrecovered basis of the passenger automobile and, therefore, is treated as a **deductible expense** in the first taxable year succeeding the end of the **recovery period** subject to the limitation under §280F(a)(1)(B)(ii).

**Example:** If a calendar-year taxpayer places in service in December 2010 a passenger automobile that cost \$20,000, is not a truck or van, and is eligible for the 100-percent additional first-year depreciation deduction, the 100-percent additional first-year depreciation deduction for this property is limited to \$11,060 and the excess amount of \$8,940 (\$20,000 - \$11,060) is recovered by the taxpayer beginning in taxable year 2016 (the recovery period, but not necessarily the deduction, ends in 2015), subject to the dollar limitation under §280F(a)(1)(B)(ii) (which is \$1,875 for automobiles placed in service in 2010).

The Treasury Department and the Service are providing a safe-harbor method of accounting. A taxpayer adopts this safe-harbor method of accounting by applying it to deduct depreciation of its passenger automobile on its federal tax return for the **first taxable year succeeding the placed-in-service year** of the passenger automobile. For a taxpayer with a passenger automobile that has an unadjusted depreciable basis exceeding the first-year limitation amount and that is qualified property eligible for the 100-percent additional first-year depreciation, the safe-harbor method of accounting operates as follows:

- In the placed-in-service year of the passenger automobile, the taxpayer will deduct the lesser of the 100-percent additional first-year depreciation for the passenger automobile or the first-year limitation amount.<sup>76</sup>
- Next, the taxpayer will determine the unrecovered basis of the passenger automobile for its placed-in-service year as though the taxpayer claimed the 50-percent, instead of the 100-percent, additional first-year depreciation for the passenger automobile. For this

<sup>74</sup> Treas. Regs. § 301.9100-2(b).

<sup>75</sup> § 1.168(b)-1(a)(3).

<sup>76</sup> See Rev. Proc. 2011-21, 2011-12 I.R.B. 560, for the first year limitation amount under § 280F(a)(1)(A)(i) for a passenger automobile placed in service in 2010 or 2011 if either the 50-percent or 100-percent additional first year depreciation deduction applies.

purpose, the unrecovered basis is equal to the depreciation that would be allowable for the passenger automobile had the taxpayer claimed the 50-percent additional first-year depreciation deduction less the amount determined in the first bullet.

- If there is any unrecovered basis for the passenger automobile in its placed-in-service year, the taxpayer will determine the depreciation deductions for the passenger automobile for the taxable years subsequent to the placed-in-service year as though the taxpayer claimed the 50-percent, instead of the 100-percent, additional first-year depreciation for the passenger automobile, subject to the dollar limitation amounts under §280F(a)(1)(A). Accordingly, for these purposes, the remaining adjusted depreciable basis of the passenger automobile is equal to its unadjusted depreciable basis reduced by the amount of the 50-percent additional first-year depreciation deemed allowed or allowable, whichever is greater, for the passenger automobile.
- If there is no unrecovered basis for the passenger automobile in its placed-in-service year, the taxpayer will determine the depreciation deduction for the passenger automobile for any 12-month taxable year subsequent to the placed-in-service year by multiplying the adjusted depreciable basis of the passenger automobile by the applicable depreciation rate for each taxable year. If any taxable year is less than 12 months, the depreciation deduction determined must be adjusted for a short taxable year. The taxpayer must not use the optional depreciation tables for computing the depreciation deductions for the passenger automobile. For purposes of determining the applicable depreciation rate, the applicable depreciation method is the method under §168(b), and the applicable convention is the convention under §168(d), that would apply in the placed-in-service year for the passenger automobile had the taxpayer claimed the 50-percent additional first-year depreciation deduction.

***Planning point:***

One can avoid the capture of excess depreciation by making a like-kind exchange instead of a taxable disposition.

**Example:** In December 2010, X, a calendar-year taxpayer, purchased and placed in service for use in its business a new passenger automobile that cost \$20,000. The passenger automobile is not a truck or van, is five-year property under §168(e), and is eligible for the 100-percent additional first-year depreciation deduction. X does not claim any §179 deduction for the passenger automobile. For 2010, X deducts \$11,060 for the 100-percent additional first-year depreciation for this property, which is the depreciation limitation for 2010 under §280F(a)(1)(A)(i) (see Table 7 in Rev. Proc. 2011-21). X adopts the safe-harbor method of accounting provided in §3.03(5)(c)(ii) of this revenue procedure.

Under the safe-harbor method of accounting, X is deemed to have claimed the 50-percent additional first-year depreciation deduction for purposes of determining the unrecovered basis and the remaining adjusted depreciable basis of the passenger automobile. Accordingly, for 2010, the total depreciation allowable for the passenger automobile is deemed to be \$12,000 [(50 percent multiplied by unadjusted depreciable basis of \$20,000) + (20 percent multiplied by the remaining adjusted depreciable basis of \$10,000)]. Thus, the unrecovered basis for the passenger automobile for 2010 is \$940 (\$12,000 deemed depreciation allowable less the \$11,060 depreciation deduction for 2010) and that amount is recovered by X beginning in the 2016 taxable year, subject to the limitation under §280F(a)(1)(B)(ii).

For 2011, the total depreciation allowable for the passenger automobile is deemed to be \$3,200 (32 percent multiplied by the remaining adjusted depreciable basis of \$10,000). Because this amount is less than the depreciation limitation of \$4,900 for 2011 (see Table 7 in Rev. Proc. 2011-21), X deducts \$3,200 as depreciation on its federal income tax return for the 2011 taxable year.

**Example:** The facts are the same as in the preceding **Example**, except the cost of the passenger automobile is \$18,400. For 2010, X deducts \$11,060 for the 100-percent additional first-year depreciation for this property, which is the depreciation limitation for 2010 under §280F(a)(1)(A)(i) (see Table 7 in Rev. Proc. 2011-21).

Under the safe-harbor method of accounting, X is deemed to have claimed the 50-percent additional first-year depreciation deduction for purposes of determining the unrecovered basis and the remaining adjusted depreciable basis of the passenger automobile. As a result, for 2010, the total depreciation allowable for the passenger automobile is deemed to be \$11,040 [(50 percent multiplied by unadjusted depreciable basis of \$18,400) + (20 percent multiplied by the remaining adjusted depreciable basis of \$9,200)]. Thus, there is no unrecovered basis for the passenger automobile for 2010 because the 2010 deemed depreciation allowable of \$11,040 is less than the 2010 depreciation deduction of \$11,060.

Pursuant to §3.03(5)(c)(ii)(D) of this revenue procedure, X must not use the optional depreciation tables for computing the depreciation deductions for the passenger automobile for the taxable years subsequent to the placed-in-service year. Therefore, assuming the applicable depreciation method and convention for the passenger automobile is the 200-percent declining balance method and the half-year convention, respectively, the total depreciation allowable for the passenger automobile for 2011 is \$2,936 (40 percent multiplied by the adjusted depreciable basis of \$7,340 [unadjusted depreciable basis of \$18,400 less the total depreciation allowable for prior taxable years of \$11,060]). Because this amount is less than the depreciation limitation of \$4,900 for 2011 (see Table 7 in Rev. Proc. 2011-21), X deducts \$2,936 as depreciation on its federal income tax return for the 2011 taxable year.

## 11. SUVs

One way to avoid the limitations on passenger automobiles was for a taxpayer to purchase a vehicle that was not a passenger automobile. Vehicles having a gross weight of over 6,000 pounds are not passenger automobiles and not subject to the limitations applied to them. The SUV became the vehicle of choice for the tax-savvy, permitting annual depreciation deductions far in excess of the annual dollar limitations on passenger automobiles. The Congress finally took action on the SUV by limiting the amount of the §179 expense to \$25,000 (and bonus depreciation, if available, would be applied against the remaining depreciable basis, and regular depreciation against the further reduced basis). But no such limitation applies with respect to bonus depreciation. Under the law that applies in 2011, taxpayers may fully write off the cost of an SUV used in a trade or business without resort to §179. Businesses purchasing new vehicles can now either first take the §179 deduction first and depreciate the remaining cost basis or simply expense the full cost in the first year using only the new 100-percent bonus depreciation provision. Taxpayers may be expected to browse the showrooms of their local Cadillac Escalade, Porsche Cayenne, Land Rover LR4, and BMW X5 M dealers.

**Example:**

(Assume for these purposes that all placed-in-service dates do not affect the taxpayer's ability to use the mid-year convention.) Compare Taxpayer A who purchases an \$80,000 new Land Rover Range Rover and Taxpayer B who purchases an \$80,000 new Mercedes Class C (with gross weight under 6,000 pounds) in 2011. A deducts the entire \$80,000 in 2011; B deducts \$11,060 in 2011, \$4,900 in 2012, \$2,950 in 2013, and \$1,775 in every year thereafter until 2048.

Taxpayer C purchases a used \$80,000 Land Rover Range Rover in 2011. C can write off \$25,000 under §179 and then deduct \$11,000 ( $.2 \times \$55,000$ ) of depreciation in 2011, deduct \$17,600 in 2012, \$10,560 in 2013, \$6,336 in 2014 and 2015, and \$3,168 in 2016.

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ABCs of Compilation and Review Reports .....	8/18 .....	1-3 p.m.
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The Monthly Tax Reporter with Jack Surgent and Mike Tucker .....	9/8 .....	1-3 p.m.
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Ethics for Tax Professionals .....	9/9 .....	1-3 p.m.
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The Monthly Tax Reporter with Jack Surgent and Mike Tucker .....	9/20 .....	1-3 p.m.
Individual Tax Planning Ideas that Save Clients Money .....	9/21 .....	1-3 p.m.
Strategies in the New War Against Higher Individual Taxes .....	9/21 .....	9 a.m.-5 p.m.
LLCs & Partnerships: Dealing with Special Allocations of Income & Contributed Property Issues .....	9/22 .....	1-3 p.m.
Schedule K-1s for Hedge Funds .....	9/22 .....	1-3 p.m.
Defined Contribution Plan Update .....	9/23 .....	1-3 p.m.
Revenue Recognition .....	9/23 .....	9 a.m.-5 p.m.
Fiduciary Income Tax Returns – Form 1041 Workshop .....	9/26 .....	9 a.m.-5 p.m.
Risk Management: Internal Controls and Fraud Prevention .....	9/26 .....	9 a.m.-5 p.m.
Gift Tax Return Preparation Issues .....	9/27 .....	1-3 p.m.
Accounting for Income Taxes .....	9/28 .....	9 a.m.-5 p.m.
Compilations and Review Engagements .....	9/29 .....	9 a.m.-5 p.m.
Ins and Outs of Self-Directed IRAs .....	9/29 .....	1-3 p.m.
Contingencies: Accounting and Disclosure Requirements .....	9/30 .....	1-3 p.m.
IFRS and U.S. GAAP: Examining Major Differences .....	9/30 .....	9 a.m.-5 p.m.
Section 754 Step-Up in Basis: Understanding the Tax Issues for Partnerships and LLCs .....	9/30 .....	1-3 p.m.

## Visit [www.surgentmccoy.com](http://www.surgentmccoy.com) for our complete 2011 seminar schedule!

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### TAX UPDATE COURSES

BCPE	THE BEST S CORPORATION, LLC, AND PARTNERSHIP UPDATE COURSE BY SURGENT McCOY
BFTU	THE BEST FEDERAL TAX UPDATE COURSE BY SURGENT McCOY
BITU	THE BEST INDIVIDUAL INCOME-TAX UPDATE COURSE BY SURGENT McCOY
SATC	SURGENT McCOY'S TAX CAMP
STTT	SURGENT McCOY'S 2011 TOP TEN TAX TOPICS

### INDIVIDUAL TAX COURSES

ATFI	ADVANCED TECHNICAL TAX FORMS TRAINING – FORM 1040 ISSUES
ERTW	EFFECTIVELY AND EFFICIENTLY REVIEWING TAX RETURNS IN BUSY SEASON
EXIB	HOT IRS TAX EXAMINATION ISSUES FOR INDIVIDUALS AND BUSINESSES
INBB	THE TOP 50 MISTAKES PRACTITIONERS MAKE AND HOW TO FIX THEM: INDIVIDUAL TAX AND FINANCIAL PLANNING
IWAR	STRATEGIES AND TACTICS IN THE NEW WAR AGAINST HIGHER INDIVIDUAL TAXES
PITR	PREPARING INDIVIDUAL TAX RETURNS FOR NEW STAFF AND PARA-PROFESSIONALS
STRI	SURGENT McCOY'S ADVANCED INDIVIDUAL INCOME TAX RETURN ISSUES
TSSG	SURGENT McCOY'S 1040 TAX SEASON SURVIVAL GUIDE

### ESTATE PLANNING COURSES

1041	FIDUCIARY INCOME TAX RETURNS – FORM 1041 WORKSHOP
ACEP	ADVANCED CONCEPTS IN ESTATE PLANNING
AP41	ADVANCED FORM 1041 PRACTICE WORKSHOP
EPBB	THE TOP 50 MISTAKES PRACTITIONERS MAKE AND HOW TO FIX THEM: ESTATE PLANNING AND ADMINISTRATION
FACT	COMPREHENSIVE ACCOUNTING ISSUES OF ESTATES AND TRUSTS: FIDUCIARY ACCOUNTING AND TAX ISSUES
GATE	A COMPLETE GUIDE TO THE ADMINISTRATION OF TRUSTS AND ESTATES
GIFT	FEDERAL ESTATE AND GIFT TAX RETURNS – FORMS 706 AND 709 WORKSHOP
ITEB	ADVANCED SELECTED ISSUES FOR TRUSTS, ESTATES, AND THEIR BENEFICIARIES
MFEP	MASTERING THE FUNDAMENTALS OF ESTATE PLANNING
NLEP	WHAT YOU NEED TO DO NOW IN ESTATE PLANNING UNDER THE NEW TAX LAW
TCTW	THE COMPLETE TRUST WORKSHOP!

### LLC, PARTNERSHIP, S CORPORATION, AND C CORPORATION COURSES

ACTL	SURGENT McCOY'S ADVANCED CRITICAL TAX ISSUES FOR LLCs AND PARTNERSHIPS
ACTS	SURGENT McCOY'S ADVANCED CRITICAL TAX ISSUES FOR S CORPORATIONS
ADTS	ADVANCED TAX STRUCTURES: USING TIERED PARTNERSHIPS, MULTIPLE CORPORATIONS, SERIES LLCs, AND DISREGARDED ENTITIES
APLW	ADVANCED PARTNERSHIP/LLC WORKSHOP: HOW TO DO OPTIONAL STEP-UP IN BASIS UNDER §754 AND RELATED PROVISIONS
ATFB	ADVANCED TECHNICAL TAX FORMS TRAINING – LLCs, S CORPORATIONS, AND PARTNERSHIPS
BTBB	THE TOP 50 BUSINESS TAX MISTAKES PRACTITIONERS MAKE AND HOW TO FIX THEM
BTPS	MAKE MONEY FOR YOU AND YOUR CLIENTS: SURGENT McCOY'S TOP BUSINESS TAX PLANNING STRATEGIES
CBES	CHOOSING THE BEST ENTITY STRUCTURE UNDER THE NEW TAX LAW IN 2011
CFOG	CLEARING THE FOG IN ADVANCED LLC AND PARTNERSHIP STRUCTURING
CGLB	THE COMPLETE GUIDE TO LIQUIDATION OF BUSINESS ENTITIES
HMBI	SURGENT McCOY'S HANDBOOK FOR MASTERING BASIS, DISTRIBUTIONS, AND LOSS LIMITATION ISSUES FOR S CORPORATIONS, LLCs, AND PARTNERSHIPS
IEFP	THE BEST INCOME TAX, ESTATE TAX, AND FINANCIAL-PLANNING IDEAS OF 2011
IPSC	SURGENT McCOY'S GUIDE TO UNDERSTANDING THE KEY ISSUES IN PREPARING S CORPORATION TAX RETURNS
LLPW	SURGENT McCOY'S LLC AND PARTNERSHIP TAX RETURN PREPARATION WORKSHOP
LP10	SURGENT McCOY'S TOP TEN TAX ISSUES IN DEALING WITH LLCs AND PARTNERSHIPS
LWRK	LLC PRACTITIONER'S WORKSHOP: A CASE STUDIES APPROACH
PCTR	PREPARING C CORPORATION TAX RETURNS FOR NEW STAFF AND PARA-PROFESSIONALS
PLPS	THE COMPLETE GUIDE TO PREPARING LLC, PARTNERSHIP, AND S CORPORATION FEDERAL INCOME TAX RETURNS
SWRK	S CORPORATION PRACTITIONER'S WORKSHOP: A CASE STUDIES APPROACH
TPGS	SURGENT McCOY'S 2011 ANNUAL TAX PLANNING GUIDE FOR S CORPORATIONS, PARTNERSHIPS, AND LLCs

## **RETIREMENT AND PENSION PLANS, INVESTMENTS AND INSURANCE COURSES**

CIRA	COMPLETE STRATEGIES FOR MAXIMIZING CONTRIBUTIONS, ROLLOVERS, DISTRIBUTIONS, AND ESTATE PLANNING OF IRAs, ROTH IRAs, SIMPLEs, AND SEPs
DRMM	DETERMINING HOW MUCH MONEY YOU NEED TO RETIRE, AND TAX IDEAS AND MONEY MANAGEMENT IN RETIREMENT
SRPL	NEW CRITICAL DECISIONS IN SELECTING THE BEST RETIREMENT PLAN FOR SMALL BUSINESSES IN 2011
SSRB	SOCIAL SECURITY, MEDICARE, AND PRESCRIPTION DRUG RETIREMENT BENEFITS; WHAT EVERY BABY BOOMER NEEDS TO KNOW NOW
TERS	ADVANCED TIPS AND TRICKS OF INVESTMENT TAX MANAGEMENT TO ENHANCE CLIENT WEALTH ACCUMULATION AND RETIREMENT SECURITY

## **BUSINESS, INDUSTRY, AND SPECIAL PRACTICE AREA COURSES**

CGFB	THE COMPLETE GUIDE TO FRINGE BENEFITS
CGPT	THE COMPLETE GUIDE TO PAYROLL TAXES AND 1099 ISSUES
CWRS	CASE STUDIES IN IMPROVING WRITING AND RESEARCH SKILLS FOR TAX PROFESSIONALS
EIRE	THE COMPLETE GUIDE TO EMPLOYMENT ISSUES – REDUCING THE EMPLOYER'S RISK
IDIC	PROTECTING YOUR CLIENTS AGAINST IDENTITY THEFT, INVESTMENT FRAUD, AND CONSUMER FRAUD
IRSM	THE TOP 50 MISTAKES PRACTITIONERS MAKE AND HOW TO FIX THEM: DEALING WITH THE INTERNAL REVENUE SERVICE
LTBO	LEGAL TOOLKIT FOR BUSINESS OWNERS, CONTROLLERS, AND CPAs
MBAD	MBA IN A DAY!
NTAB	NEGOTIATIONS AND TAX ASPECTS OF BUYING AND SELLING A BUSINESS
REBB	THE TOP 50 TAX MISTAKES PRACTITIONERS MAKE IN REAL ESTATE INVESTMENTS AND HOW TO FIX THEM
TDAP	SURGENT McCOY'S COMPREHENSIVE GUIDE TO TAX DEPRECIATION, AMORTIZATION, AND PROPERTY TRANSACTIONS FROM ACQUISITION TO EXCHANGE OR DISPOSITION

## **MULTISTATE TAX COURSES**

MSTU	SURGENT McCOY'S MULTISTATE TAX UPDATE
NEXU	LEARN TO DO A NEXUS STUDY TO BUILD YOUR STATE AND LOCAL TAX PRACTICE

## **ACCOUNTING AND AUDITING COURSES**

ATKN	THE ESSENTIAL AUDIT TOOLKIT: BEST PRACTICES FOR SMALLER ENTITIES
CCCB	FRAUD: CATCHING THE CROOKS WHO COOK THE BOOKS
CDAAs	CURRENT DEVELOPMENTS IN ACCOUNTING, AUDITING, AND THE ACCOUNTING PROFESSION: AN OVERVIEW FOR 2011
CR19	COMPILATION AND REVIEW: SSARS 19 UPDATE
ERAW	EFFECTIVELY AND EFFICIENTLY REVIEWING AUDIT WORKPAPERS: THE LINE OF DEFENSE AGAINST DEFICIENT AUDITS
FSAI	ANALYZING AND INTERPRETING FINANCIAL STATEMENTS
GAP1	IS THERE A GAP IN YOUR GAAP? SERIES 1
GAP2	IS THERE A GAP IN YOUR GAAP? SERIES 2
ICFO	FINANCIAL DILEMMAS AND CALAMITIES – CFOs AND SENIOR FINANCIAL MANAGERS IN INDUSTRY AT THE FOREFRONT: A CASE-STUDY APPROACH
ISBG	IFRS FOR SMALLER ENTITIES VS. U.S. GAAP: A STUDY IN HOW THE FINANCIAL STATEMENTS LOOK AND FEEL DIFFERENT
NABB	THE TOP 50 NONPUBLIC AUDIT MISTAKES PRACTITIONERS MAKE AND HOW TO FIX THEM

## **YELLOW BOOK COURSES**

AWAC	SURGENT McCOY'S AUDIT WORKSHOP: BEST PRACTICES FOR AUDITS IN COMPLIANCE WITH GOVERNMENT AUDITING STANDARDS AND OMB CIRCULAR A-133
AWPD	SURGENT McCOY'S AUDIT WORKSHOP: BEST PRACTICES IN PLANNING AND DESIGNING A HIGH-QUALITY AND PROFITABLE AUDIT
CDEC	INTERNAL CONTROLS DESIGN, EVALUATION, AND COMMUNICATION FOR SMALLER ENTITIES
TAIC	SURGENT McCOY'S PRACTICAL GUIDE TO BETTER SUBSTANTIVE TESTING AND AUDITING OF INTERNAL CONTROLS

## **NONPROFIT TAX COURSES**

F990	THE COMPLETE GUIDE TO UNDERSTANDING CHALLENGING NONPROFIT TAX AND FORM 990 ISSUES
GIBB	THE TOP 50 MISTAKES PRACTITIONERS MAKE IN NONPROFIT TAXATION AND GOVERNANCE ISSUES AND HOW TO FIX THEM
PNPR	FUNDAMENTALS OF PREPARING THE NONPROFIT SERIES OF TAX RETURNS (FORMS 990-N, 990-EZ, 990, 990-T, AND 990-PF)

## **AUDIT STAFF-LEVEL TRAINING COURSES**

AST1	SURGENT McCOY'S BASIC AUDIT STAFF TRAINING – LEVEL I
AST2	SURGENT McCOY'S EXPERIENCED AUDIT STAFF TRAINING – LEVEL II
AST3	SURGENT McCOY'S BEGINNING IN-CHARGE TRAINING – LEVEL III
AST4	SURGENT McCOY'S EXPERIENCED IN-CHARGE TRAINING – LEVEL IV
AST5	SURGENT McCOY'S MANAGEMENT SKILLS TRAINING – LEVEL V