Top tax issues and planning ideas for 2015

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The end of the year is quickly approaching, so it is important to ensure you are informed of the latest tax-related issues to begin planning your tax strategies. The following tax issues, among others, will be the topic of discussion at our upcoming Business Hour event – Top tax issues and planning ideas for 2015 – this Wednesday at 12:00 pm ET. Join us for a discussion on the latest tax updates, strategies, and insights by registering to attend our Business Hour or to watch the live webcast so you can start planning for taxes now.

SIGNIFICANT CHANGE TO PARTNERSHIP AUDITS

The budget bill signed by President Barack Obama on Nov. 2 includes a significant change in the way partnership audits are handled. Partnership audits are increasingly an issue for the IRS as more businesses are set up as partnerships (including LLCs), and more partnerships and LLCs have hundreds or even thousands of partners.

BACKGROUND

Under the current audit rules (which are generally still effective until 2018), there are basically three different types of partnership audits. Electing Large Partnerships (ELPs) have audits done at the partnership level, and any adjustments are reflected on the partners' current year return (as opposed to amending prior year returns). An ELP must have more than 100 partners and elect to be treated as such. Partnerships with more than 10 partners are audited under the unified partnership audit rules, and the results of the audit are binding on the partners. After the audit, the IRS recalculates the tax liability of each partner and makes an assessment. Although the IRS audits the partnership and not the partners under the unified rules, any assessment must be made (and collected from) the individual partners. A partnership with fewer than 10 partners is generally audited by auditing the individual partners. Rules regarding who gets notice of the audit vary among the different types of partnership audit. A Government Accounting Office report issued last year determined (and the IRS has long complained) that these rules make it difficult to audit partnerships and LLCs, especially those with large numbers of partners.

SINGLE SET OF RULES

The budget bill eliminates these distinctions and provides for a single set of rules governing partnership audits. After the effective date of these rules, the IRS will examine the partnership's return, and the partnership will (with a number of exceptions) be responsible for any adjustments in the year that the audit was completed, or in the year that any judicial proceeding relating to the audit becomes final. The partnership will generally pay tax at the highest individual or corporate tax rate, although procedures will be available for a partnership to show that this rate is not appropriate because, for instance, income is allocable to partners with a lower rate. Although prior proposals had included "joint and several" liability of partners with respect to these taxes, this provision is not included in the final bill.

There are a number of ways that a partnership can essentially opt out of these rules. An election will be available whereby the partnership can issue adjusted information returns to its partners instead of having the partnership pay the tax liability. Partnerships with 100 or fewer partners that have only certain types of partners (essentially individuals and corporations) would be allowed to opt out of these rules and have audits performed at the individual partner level.

$9 BILLION TO BE RAISED

While the new rules are applicable to tax years beginning after 2017, some partnerships can elect to have these rules effective as of Jan. 1, 2016. Existing partnerships should review their agreements to determine what, if any impact the new rules will have on them. The fact that these provisions were designed to raise $9 billion over the next 10 years is a clear sign that more partnership and LLC audits are coming soon.

IRS EYEING EXCESS ACCUMULATED EARNINGS

Businesses taxed as C corporations can expect the IRS to be taking a very close look at the level of accumulated earnings over the next several years.

There are many reasons corporations decide to not pay dividends to shareholders. Uncertain economic conditions have led many businesses to conserve cash over the last decade. Higher dividend rates have provided an additional incentive for corporations to hold on to cash because a distribution of earnings via a dividend is not deductible by the corporation and, therefore, represents the classic "double tax" scenario to which C corporations are subject.

The IRS, however, can effectively compel C corporations to make nondeductible dividend distributions. If a determination is made that the business is accumulating earnings to avoid the tax payable on dividends, the IRS can impose an "accumulated earnings tax" on the corporation, at the same rate imposed on dividend income. Once the IRS examiner asserts that there is an unreasonable accumulation of earnings, the burden is generally on the taxpayer to show that such accumulation was reasonable given the needs of the business.

The tax can be avoided if the corporation can show that the accumulation is not to avoid paying dividends, but to prepare and provide for legitimate business reasons such as the expansion of a facility, acquisition of another business, or debt retirement, among other reasons. It is therefore important to document these needs each year, ideally in the minutes of the shareholders' or directors' meeting.

The company is also allowed to retain a sufficient amount of earnings to provide working capital to the business as determined by a formula known as the "Bardhal Formula." This formula takes into account the capital needed for the business by looking at the business operating cycle and the cash needed to operate the business for a taxable year.

Because of the many factors that go into the analysis, it is important to have a comprehensive plan that takes into account (and documents) the needs of the business, from both a working capital and a future needs basis, along with establishing a dividend paying policy. The amount of IRS attention to this issue has varied over the years. This was a significant issue in prior years when capital gains were taxed at a rate that was lower (and in some cases much lower) than dividend rates. It seems as though the IRS was less likely to focus on this issue in more recent years when dividend rates were very low. With the recent increase in dividend rates, this issue will be coming up more frequently in audits and should therefore again be an important planning item for corporations.

YOU COULD BE ON THE HOOK FOR YOUR COMPANY'S TAX LIABILITY

Business owners typically operate their businesses as corporations or other separate business entities to protect their personal assets from liabilities of the business. The IRS can, however hold business owners responsible for tax liabilities of the business under certain circumstances.

A Tax Court case this year found that several minority shareholders who had nothing to do with the financial fraud relating to the unpaid tax debts were liable for the taxes. In this case, a corporation failed to file tax returns or pay taxes for a number of years, even though the corporation had been very profitable. During this time, the majority shareholders were essentially embezzling funds from the corporation, unbeknownst to several minority shareholders. The minority shareholders (who were also employees of the corporation) did, however, receive transfers of money from the corporation, including loans that were made in lieu of normal bonuses, and dividends that were paid by the corporation in other years based on their percentage of stock ownership.

Upon audit, the IRS determined that the corporation owed over $120,000,000 in taxes, penalties, and interest. Although the corporation entered into an agreement to pay this liability over time, it was determined that it would take over 150 years to complete the payment program! So the IRS turned to the minority shareholders to recover a portion of these taxes, asserting that all of the amounts transferred by the corporation to the shareholders (other than salaries) were fraudulent transfers and could therefore be recovered by the IRS.

The Tax Court decided that the loans – which were effectively treated as advances of bonuses because no loan documentation was ever prepared – were actually compensation and could not be recovered. The dividends paid to the minority shareholders, however, were found to be fraudulent transfers under state law and, therefore, recoverable.

The ability of the IRS to recover taxes from a transferee such as a shareholder in a corporation is dependent on state law. Under most state laws, a transfer is fraudulent if the corporation did not receive a reasonably equivalent benefit in exchange for the payments to the shareholders and the corporation was insolvent at the time of or as a result of the payments. Dividends are generally not a transfer in exchange for reasonably equivalent value, and so a dividend by an insolvent corporation (including one that is insolvent because it cannot pay its taxes) are recoverable by the IRS.

While normally a corporation provides complete protection of shareholders against liabilities of the corporation, where the corporation is not adequately capitalized, the IRS as well as other creditors can pursue shareholders for funds transferred to them. It is therefore important to consider the corporation's financial solvency before paying dividends to shareholders or large bonuses to shareholders who are also employees.

VALUATION DISCOUNTING: FOR A LIMITED TIME ONLY

Estate planning attorneys have been using discounting techniques as an important part of wealth transfer planning for many years. This past year there were several indications that regulations would be issued soon by the Treasury Department that will significantly curtail this practice.

Generally speaking, discounting involves the use of planning techniques that facilitate an estate and/or wealth transfer plan that makes assets less valuable for gift and estate tax purposes. Discounting in its simplest form is often times achieved by transferring the assets to an entity (such as a limited partnership) that imposes restrictions on the ability of the owners to convert the assets into cash. Gifts of an interest in the limited partnership would be valued at less than the underlying assets in the partnership because there would be significant restrictions. For example, typically, there is no way to convert the partnership interest to cash and no way to control the investment decisions or the decision to sell the assets. The actual value of the gift would be determined by an appraiser, but even a modest discount from the fair market value of the underlying assets could save a considerable amount of gift and/or estate taxes.

The IRS has, over the years, fought this type of planning, especially where the assets consisted of marketable securities. There have been many cases in Tax Court where the IRS has challenged this type of discounting strategy, and it has had some success. Most of the taxpayer losses have been in situations where the partnership or LLC was not set up properly, or the gifting was not executed properly.

There has been a fair amount of press this summer on the IRS plan to curtail this estate planning technique in a more formal and permanent way. Treasury already has been given broad authority to issue regulations limiting situations where discounts can be taken. Existing regulations provide that an "Applicable Restriction" is ignored when determining the value of an asset. An "Applicable Restriction" is one that limits the ability of a corporation or partnership to liquidate, if the restriction lapses or could be changed in the future by family members. A limit provided under state or federal law is NOT considered an applicable restriction, so these types of restrictions are permitted and can provide the basis for a discount on the value of an interest.

All indications were that these regulations would be released by the end of summer, but we have heard little on the subject in the last few months. While most practitioners feel that an outright prohibition on marketability discounts would be beyond the power of the Treasury, there may be some room for Treasury to scale back the use of this technique. The scope of the changes is unclear, as is the timing of the effective date of the regulations. Although these regulations would likely be issued as proposed regulations, these types of regulations are oftentimes made effective as of the date of initial publication, meaning there would be little or no advance notice that the changes were coming.

CATCH-22: NET INVESTMENT INCOME TAX PLANNING

For many business owners, the additional 3.8 percent additional tax on net investment income (the "NII Tax") is yet another layer of tax to contend with. Since this tax is imposed only on certain types of income, it does present some planning opportunities.

The NII Tax is a 3.8 percent tax on investment income to the extent that the taxpayer's adjusted gross income (with some modifications) exceeds $250,000 (for married couples filing jointly). The term "investment income" for purposes of the NII Tax includes almost any income derived from passive business activities, including allocations of business income from S corporations, LLCs, and partnerships. Some advisors have recommended to their passive investor clients that they may want to become active in their business in order to avoid the NII Tax.

Although active owners of partnerships and LLCs will not be subject to the NII tax, they will most likely be subject to a Medicare tax that is also at a 3.8 percent rate. In general, allocations of partnership and LLC income to persons who are active in the business are subject to self-employment taxes, which include a Medicare component at 3.8 percent for taxpayers with income above the thresholds noted above. LLC and partnership owners will, therefore, in most cases pay the 3.8 percent NII tax if they are inactive in the business, or the 3.8 percent self-employment tax rate if they are active.

Given this conundrum, many business owners who are active in their business or who can become active have considered converting their C corporation or LLC to an S corporation. This conversion can usually be done on a tax-free basis, and can at least partially mitigate the issue with the NII/Medicare tax.

If the business is operated as an S corporation, salary payments to the owner would still be subject to the 3.8 percent Medicare tax (assuming the income thresholds were met), but allocations of business income to an owner who is active in the business would not be subject to either the Medicare or NII Tax. Care must be taken, however, in implementing this structure since the IRS will challenge compensation that is too low.

Although converting to an S corporation is normally tax-free, gain can be recognized under certain circumstances, so the conversion itself must be analyzed carefully. The benefits of the conversion relative to the NII and Medicare tax should also be weighed against other tax benefits that may be enjoyed by a business and its owners as an LLC or even a C corporation. All things being equal, however, the S corporation can be considered as a way to mitigate the business owner's exposure to the NII Tax if the owner is active and expects distributions in excess of compensation for services.

For additional information, please contact one of the attorneys listed below.

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I have extensive experience helping business owners and executives negotiate compensation and ownership agreements and develop retirement and estate plans. I understand that they do not want problems; they want it done.

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