

*Washington National Tax quarterly update*

# Hot tax topics to think about now

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# Today's presenters



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# Agenda

## Topic

Capitol Hill update: recent tax-related discussions that may affect your company

Managing IRS compliance failures

Identity theft and changes to M-3 filing requirements

State tax legislation: Q1/Q2 2013

Executive compensation and the .9 percent Medicare tax

# Capitol Hill update: Where are we going?

## The fiscal challenges

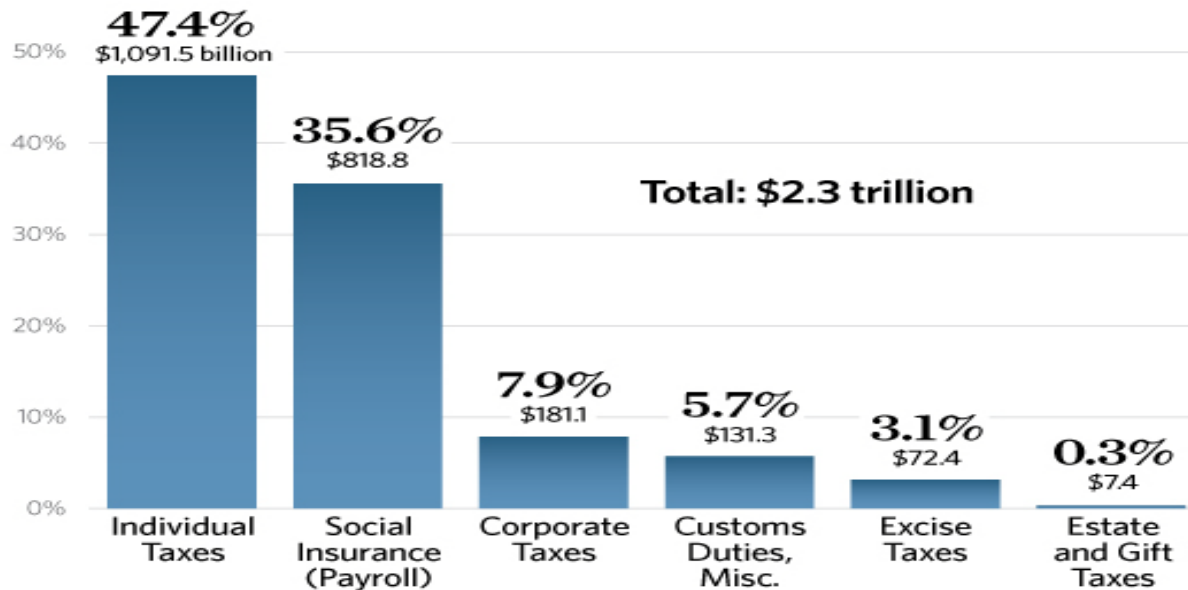
- 2011 federal government revenues
- 2011 federal government expenditures

# Capitol Hill update: Where are we going? (cont.)

## Federal Revenues by Source

Most federal revenues come from individual taxpayers. Personal income taxes are the largest portion of total tax revenues. Social Security and Medicare payroll taxes are the second-largest source.

PERCENTAGE OF TOTAL FEDERAL REVENUE (2011)



Source: Congressional Budget Office.

Federal Revenue Chart 3 • Federal Budget in Pictures 2012 heritage.org

# Capitol Hill update: Where are we going? (cont.)

2011:

- Spending: Approximately \$3.6 trillion
- Deficit: Approximately \$1.3 trillion

2012 estimates:

- Revenues: \$2.5 trillion
- Spending: \$3.8 trillion
- Deficit: \$1.3 trillion

# Managing IRS compliance failures

# Scenarios

- Unfiled returns
  - Information returns
  - Tax returns
- Misclassified workers
  - Employee versus independent contractor
- Withholding taxes
  - Form 1042 and 1042-S
  - Tipped employee reporting



# Goals

- Penalty-free compliance agreement
- Reduced income or specialty tax
- Protection for prior non-compliant years
- Protection for third parties (workers, beneficiaries, etc.)
- Focus areas: tax rates, tax years, covered taxpayers

# Example: IRS program

- Misclassified workers
  - Voluntary classification settlement program (VCSP)
    - Employer pays reduced payroll tax for most recent years
    - Penalty-free and interest-free
    - Audit protection for all prior years
    - Future compliance

# Example: Taxpayer initiated agreement

- Failure to file generation skipping transfer tax (GSTT) returns for 20+ years
  - Six years of filings
  - No penalties
  - Trust paid the tax
  - Protection for beneficiaries

# Other information

- Important time frames
  - Compliance agreement discussions occur before the IRS discovers the compliance failure
  - Potential compliance filing periods
    - Six to seven years
    - Shorter period depending on compliance issue
      1. VCSP requires no filings, but information is provided to IRS about one year
      2. Other compliance issues

# Identity theft

# Identity theft

- Subject is federal tax identity theft
- Typical example
  - Social Security Number (SSN) thief creates fake Form W-2 showing withheld income tax, SSN thief files Form 1040 claiming refund due, IRS filtering fails, and refund issued to SSN thief
  - Then, actual SSN owner, taxpayer, files real return, IRS cannot process return, IRS sends notice to taxpayer that return was previously filed, and taxpayer must begin process to sort out the matter

# Identity theft (cont.)

- Economic and emotional difficulties for taxpayers include:
  - Return not processed until actual identification is verified
  - Refund, if one is due, delayed until return is processed
  - Takes several months, partly due to IRS resource constraints, to correct and clear accounts and issue refund
  - Stress, usually a lot of it
  - Hardship if refund planned for (e.g., spring break vacation) or important financial transactions delayed (e.g., home mortgage financing needing refund cash and/or tax clearance for closing)

# Identity theft (cont.)

- Size of problem
  - Nina Olson, National Taxpayer Advocate, 2012 annual report to Congress
    - IRS has nearly 650,000 such cases in its servicewide inventory and may take six months or longer to resolve them. The Taxpayer Advocate Service (TAS) identity theft caseload has soared more than 650 percent since fiscal 2008, with TAS providing relief to 88 percent of the affected taxpayers in fiscal 2012.
  - IRS Oversight Board, 2012 Annual Report to Congress
    - One of the biggest risks the IRS faced in fiscal 2012 was tax refund fraud. While progress is being made through the use of new filters and processes to detect and handle fraudulent returns, it is unclear how large this problem is.



# Identity theft (cont.)

## Tax Related Identity Theft: Incidence, Assistance, and IRS Efforts to Combat <sup>1,3</sup>

Description	2011	2012
Identity theft incidents identified by IRS	247,000	1,245,000
Number of IP PINs <sup>2</sup> issued by the IRS to identity theft victims for use in the next filing season	252,000	600,000
Number of confirmed identity theft returns stopped	1,084,000	1,840,000
Value of fraudulent identity theft refunds prevented	\$7.58 billion	\$12.11 billion

SOURCE: IRS and GAO

<sup>1</sup> Some counts reflect partial year tallies.

<sup>2</sup> Identity Protection Personal Identification Numbers (IP PIN)

<sup>3</sup> Numbers have been rounded.

\*From IRS Oversight Board 2012 Annual Report to Congress

# Identity theft (cont.)

- IRS efforts to combat fraudulent refund returns
  - By late 2012, the IRS had assigned more than 3,000 personnel to work on identity theft.
  - In 2013, the IRS significantly increased the number of quality identity theft screening filters to spot fraudulent tax returns before refunds are issued.
    - The IRS Criminal Investigation division tripled the number of identity theft investigations in fiscal 2012, starting 900 investigations. Nearly 500 people have been indicted across the country.
    - More than 670 criminal identity theft investigations opened from October 2012 through March 2013.
    - Criminals spending an average of four years in custody with sentences as long as 20 years.
  - Collaborating with more than 130 financial institutions to identify identity theft fraud schemes and block refunds from reaching the hands of identity thieves.

# Identity theft (cont.)

- Issuing Identity Protection PINs (IP PINs) to taxpayers whose federal tax records are affected
- Taxpayer process when tax account is compromised
  - List of actions to be taken on IRS website
    - <http://www.irs.gov/uac/Taxpayer-Guide-to-Identity-Theft>
  - Initiate process by filing Form 14039, Identity Theft Affidavit
    - If a victim of identity theft affecting federal tax records, or
    - If suffered an event of identity theft that may affect federal tax records in the future
  - Tax accounts of IP PIN recipients are flagged as subject to identity theft

# Identity theft (cont.)

- Taxpayers use their IP PINs on their Forms 1040 to validate that the return they are filing is really their return and not that of an identity thief
- New IP PIN is issued each year to affected taxpayers
- Identity theft flag removed from tax account when no more threat
- IRS Identity Protection Specialized Unit, 800-908-4490
- Proactive acquisition of IP PIN to pre-empt fraudulent return
- AICPA to propose extending existing IP PIN process for user fee
- User fee to help with IRS identity theft resource constraints
- May be worth the user fee in exchange for avoidance of hassles with IRS tax account

# Identity theft (cont.)

- How SSNs are stolen
  - Misplacing a wallet, smartphone or other personal information
  - Sophisticated schemes perpetrated by experienced fraud artists
  - Pickpockets, widespread email phishing, thieves posing as someone needing information on the phone or via email, people going through victims' trash, or thieves accessing information through unsecure websites
  - Patient medical records, now prime targets of identity thieves since the patients are often tracked by SSN

# Changes to Schedule M-3 filing requirements

# Changes to Schedule M-3 filing requirements


- IRS is changing Schedule M-3 filing requirements for the following taxpayers:
  - Filers of Forms 1120, 1120-C, 1120-F, 1120S, 1065 and 1065-B
  - Total assets of at least \$10 million but less than \$50 million on return balance sheet
- Changes in requirements
  - May file Schedule M-1 in place of the Schedule M-3 parts II and III
  - Schedule M-3, part I, lines 1-12 continue to be required
  - Will not be required to file Form 1120 (Schedule B), Form 1065 (Schedule C), or Form 8916-A
- Effective for tax years ending on or after Dec. 31, 2014

# Changes to Schedule M-3 filing requirements (cont.)

- No changes currently planned in requirements for Forms 1120-L or 1120-PC, or for Form 1120 mixed group taxpayers
- Reason for changes – to reduce the filing burden and simplify reporting
- IRS continues to consider changes to Schedule M-3 requirements for other taxpayers

Reference: [http://www.irs.gov/Businesses/Corporations/Schedule-M-3-for-Large-Business-&-International-\(LB&I\)](http://www.irs.gov/Businesses/Corporations/Schedule-M-3-for-Large-Business-&-International-(LB&I))





# State Tax Topics Q1 and Q2 2013



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# Overview

- State legislation
- Marketplace Fairness Act
- Multistate Tax Compact (MTC)

# State legislation

A number of states have enacted, or are highly likely to enact, tax legislation during this legislative session that hit on some significant issues in state taxation, including:

- Arizona
- Arkansas
- Idaho
- Kansas
- Kentucky
- Mississippi
- Missouri
- Nebraska
- New Mexico
- New York
- North Dakota
- Virginia

# Arizona–intercompany transactions

- HB2324
  - Effective on the 91st day after the close of the 2013 legislative session
  - Leasing of real property between affiliated companies, businesses, persons or reciprocal insurers will be excluded from the commercial leasing classification
    - “Affiliated companies, businesses, persons or reciprocal insurers” includes any situation in which a lessor holds a controlling interest in the lessee, a lessee holds a controlling interest in the lessor, an affiliated entity holds a controlling interest in both the lessor and the lessee, or an unrelated person holds a controlling interest in both the lessor and lessee

# Arizona–intercompany transactions (cont.)

- “Controlling interest” is defined as direct or indirect ownership of at least 80 percent of the voting shares of a corporation or of the interests in a company, business or person other than a corporation
- Under prior law, the related-party exclusion applied only to circumstances where a corporation leased real property to an affiliated corporation
- 80 percent vote test still leaves situations in which entities commonly understood to be affiliated (e.g., 80 percent shared value but not vote) would not benefit from the exclusion

# Arkansas—rate reduction and a whole lot more

- Arkansas has enacted a number of rate reduction measures, credits, and other changes, including:
  - HB 1585: Reduces the state individual income tax by .1 percent across all tax brackets. Cut for the lowest tax bracket will go into effect on July 1, 2013. The cut for the rest of the tax brackets will go into effect in FY 2015.
  - HB 1832: Effective in FY 2016, creates an investment incentive program under which insurance companies can purchase premium tax credits from entities that would invest the proceeds in businesses in economically depressed areas of the state (similar in nature to the federal New Markets Tax Credit).

# Arkansas—rate reduction and a whole lot more

- HB 1966: Effective July 1, 2013, increases the capital gains tax threshold to 50 percent of gains, along with an exemption for capital gains that exceed \$10 million.
- SB 791: Starting in FY 2015, gradually reduces the sales tax on utilities sold to manufacturers to .625 percent. The tax rate is currently 2.75 percent but is scheduled to increase to 3.25 percent as of July 1 because of a .5 percent sales tax increase approved by voters for state highway needs.
- SB 899: Effective April 11, 2013, moves up the due date for filing corporate franchise tax returns and remitting the full amount of tax due from June 1 to May 1 (e.g., corporate franchise tax returns for tax year 2012, previously due on June 1, 2013, were due on May 1, 2013). Taxpayers that failed to file a return and remit the full amount of tax due on or before the due date will be subject to a \$25.00 penalty and interest at the rate of 10 percent of the tax due per year.

# Idaho—exemptions and cloud computing

## ■ H 0315

- Effective retroactive to Jan. 1, 2013
- Provides two broadly applicable personal property tax exemptions that stack together
  - First exemption applies to any item of taxable personal property that is purchased on or after Jan. 1, 2013 and has an acquisition cost of \$3,000 or less
    - “Acquisition cost” is defined as all costs required to put an item of taxable personal property into service and includes the purchase price of a new or used item, the cost of freight, shipping, installation, engineering, erection, and assembly, and the amount of sales and use taxes on the item



# Idaho—exemptions and cloud computing

- “Item of taxable personal property” is defined as equipment, machinery, furniture or other personal property that is functioning at its highest and best use for the purpose it was designed and constructed and is generally capable of performing that function without being combined with other items of personal property.
- Second exemption applies to the first \$100,000 of a taxpayer's personal property that is located in the taxing county and is not otherwise exempt from taxation, not including vehicles, recreational vehicles, aircraft, and boats that are not registered with Idaho and for which required registration fees have not been paid. A taxpayer must file an application to claim this exemption.

# Idaho

- HB 243
  - Effective April 3, 2013
  - Provides that software accessed through the internet, commonly referred to as “cloud computing,” is not tangible personal property for sales and use tax purposes and that, therefore, sales of such software are exempt from sales tax and the use of such software in Idaho is exempt from use tax
  - State Tax Commission had previously taken the position that software accessed through the internet was tangible personal property because it was functionally equivalent to software purchased on a tangible medium and that the sale of such property was subject to sales tax

# Kansas—click-through nexus

- H Sub SB 83
  - Enacted on April 16, 2013
  - Establishes click-through nexus provisions for sales tax purposes that expand the definition of a retailer doing business in the state for purposes of sales and use tax collection to include any retailer who enters into an agreement with a Kansas resident under which the resident directly or indirectly refers potential customers from Kansas to the retailer in exchange for some consideration and the total gross receipts stemming from these references exceed \$10,000 during the preceding 12 months.
  - Repeals 2012 statutory changes that required partners or S corporation shareholders to compute a different adjusted basis for their partnership interests or S corporation stock for Kansas income tax purposes than the adjusted basis for federal income tax purposes.

# Kansas–click-through nexus

- Provides that any ruling, agreement, or contract between a retailer and the state executive branch concerning a sales and use tax exemption is null and void unless approved by each chamber of the legislature

# Kentucky–management fees

- HB 440
  - Enacted on April 4, 2013
  - Eliminates the deduction for intercompany management fees, under which a company could deduct from its corporate income tax base payments made to a related party for management services (e.g., accounting, payroll, insurance, data processing, etc.).

# Mississippi–energy exemption

- HB 844
  - Enacted on April 23, 2013 and effective July 1, 2014
  - Creates a sales tax exemption for sales of electricity, current, power, steam, coal, natural gas, liquefied petroleum gas or other fuel to:
    - A manufacturer, custom processor, technology intensive enterprise, or public service company for industrial purposes
    - A producer or processor for use directly in the production of poultry or poultry products, the production of livestock and livestock products, the production of domesticated fish and domesticated fish products, the production of marine aquaculture products, the production of plants or food by commercial horticulturists, the processing of milk and milk products, the processing of poultry and livestock feed, and the irrigation of farm crops
    - A commercial fisherman, shrimper or oysterman.

# Mississippi–energy exemption (cont.)

- “Processing for industrial purposes” includes the generation of electricity, the operation of an electrical distribution or transmission system, the operation of pipeline compressor or pumping stations, and the operation of railroad locomotives

# Missouri—rate reductions, deductions, and amnesty

## ■ HB 253

- Passed by Missouri General Assembly on May 9, 2013
- Gradual reduction of the state's corporate tax rate from 6.25 percent to 3.25 percent and the top individual tax rate from 6 percent to 5.5 percent, contingent on Missouri's annual year-over-year revenue increasing by \$100 million over a five-year period ending in 2018
- Phase-in of a 50 percent deduction for business income reported on individual tax returns and an increase in the personal deduction on income taxes for individuals making \$20,000 or less
- Create a general tax amnesty running from August through October of 2013, which provides for waiver of all penalties
- Unclear whether Governor Nixon will sign HB 253; however, there appear to be enough votes in the General Assembly to override a veto



# Nebraska—moving up deadlines

- LB 28
  - Enacted on Mar. 7, 2013
  - Effective Jan. 1, 2014, personal property tax returns filed after June 30 will be subject to a 10 percent penalty and returns filed after July 1 will be subject to a 25 percent penalty
  - Penalty amount is calculated based on the tax due in relation to property value added in the reporting year
  - In prior years, the 10 percent penalty was applied after July 31 and the 25 percent penalty was applied after Aug. 1

# New Mexico—rate reductions, combined reporting, and manufacturer apportionment

- HB 641
  - Effective June 14, 2013
  - Changes to be implemented by HB 641 include:
    - The top corporate income tax rate of 7.6 percent will be reduced to 5.9 percent over a period of five years.
    - Retailers making retail sales of goods in a facility of more than 30,000 square feet under one roof in the state will be required to file on a unitary combined basis beginning in 2014. Mandatory unitary combination will not apply to taxpayers that operate non-retail facilities in the state that employ at least 750 employees.
    - Elective single sales factor apportionment will phase in over five years for manufacturers. A manufacturer will be bound by this election for at least three years, and making the election will block the application of the throwback rule for years covered by the election.
    - The gross receipts tax deduction for sales of consumables to manufacturers will be modified to include repair parts and spares in the definition of deductible “consumables.”

# New York—a mixed bag

- SB 2609 and AB 3009
  - Extends the sunset date for the 8.82 percent top personal income tax rate for individuals earning more than \$1 million and married couples earning more than \$2 million from Dec. 31, 2014 to Dec. 31, 2017
  - Extends the limitation on charitable deductions for taxpayers earning more than \$1 million by three years
  - Further restricts the deductibility of related-party royalty payments
  - Extends the personal income tax rate reduction for those earning between \$40,000 and \$300,000 per year
  - Reduces the corporate income tax rate for qualified manufacturers from 3.25 percent to 2.4 percent over three years

# New York—a mixed bag (cont.)

- Creates a tax exemption equal to 3 percent of income in FY 2014-15, 3.75 percent in FY 2015-16, and 5 percent in FY 2016-17 for small businesses that have annual income of less than \$250,000
- Phases out the 2 percent assessment on the sale of electricity and gas by New York utilities
- Provides two new employment tax credits for employers that hire veterans and youths

# North Dakota—personal liability for business taxes

- HB 1106
  - Enacted on April 18, 2013
  - Expands the parties that can be held responsible for unpaid entity-level taxes
  - Provides an option for such responsible parties to elect out of personal liability by making a cash deposit or executing a surety bond in an amount equal to the entity's annual estimated tax liability

# Virginia—sales tax increases and remote seller taxation

## ■ H 2313

- Increases state's sales and use tax rate from 4 percent to 4.3 percent in general and 5 percent on purchases other than food in planning districts
- Increases rate of use tax on imported motor vehicles as follows:
  - 3 percent through midnight on June 30, 2013
  - 4 percent beginning July 1, 2013, through midnight on June 30, 2014
  - 4.05 percent beginning July 1, 2014, through midnight on June 30, 2015
  - 4.1 percent beginning July 1, 2015, through midnight on June 30, 2016
  - 4.15 percent beginning on and after July 1, 2016

# Virginia—sales tax increases and remote seller taxation (cont.)

- In Hampton Roads, imposes a 2.1 percent state tax on wholesale distributors of motor fuels
- In Northern Virginia, imposes a 3.0 percent state transient occupancy tax and an additional state recordation fee equal to \$0.25 per \$100 of the value of the real property for which the deed, instrument, or writing is being recorded
- Repeals the exemption for out-of-state mail-order catalog purchases totaling \$100 or less during a calendar year
- In the event that the federal government passes legislation allowing the states to impose sales tax collection responsibility on remote sellers (e.g., the Marketplace Fairness Act), authorizes the Virginia Tax Commissioner to take all administrative actions necessary to facilitate state compliance with any federally mandated minimum simplification requirements

# Marketplace Fairness Act–status

- On May 6, 2013, the Senate voted 69-27 in favor of the Marketplace Fairness Act (MFA) of 2013
  - Intended to achieve sales tax collection and remittance parity between remote sellers and local retailers
  - Grants qualifying states the authority to compel remote sellers to collect and remit sales tax on all sales, regardless of whether they have nexus in the state to which the goods are delivered
  - States must enact one of two alternative sales tax “simplification” packages
  - Does not cause a remote seller to have nexus in a state into which it makes sales
- The Act will now go to the House, where passage without change appears unlikely



# Marketplace Fairness Act—simplification alternatives

- Pursuant to the first alternative, a state will be able to compel remote sellers to collect and remit sales tax if the state:
  - Provides a single entity within the state with responsibility for all sales and use tax administration, return processing and audits;
  - Provides a uniform sales and use tax base for all jurisdictions within the state;
  - Sources all interstate sales based upon destination;
  - Provides taxability information, sales tax compliance software free of charge, and certification procedures for software providers;
  - Holds remote sellers harmless for errors or omissions resulting from the use of certified software;

# Marketplace Fairness Act—simplification alternatives (cont.)

- Holds certified software providers harmless for errors or omissions resulting from misleading or inaccurate information provided by a remote seller;
  - Holds remote sellers and certified software providers harmless for errors or omissions resulting from incorrect information or software provided by the state; and
  - Provides remote sellers and certified software providers with 90 days notice of a state or local rate change.
- Pursuant to the second alternative, a state will be able to compel remote sellers to collect and remit sales tax if the state adopts the Streamlined Sales and Use Tax Agreement (SSUTA) and the SSUTA contains all the provisions discussed above.
  - The MFA operates to simplify the collection and remission of sales tax on a national scale, it does nothing to simplify or promote uniformity in the determination of what, and to what extent, transactions are taxable.

# Marketplace Fairness Act—small business exception

- Remote sellers with annual gross receipts from remote sales in the U.S. in the preceding calendar year at or below \$1 million cannot be compelled to collect and remit sales tax absent a finding of nexus.
- Is \$1 million a high enough threshold?
  - A remote seller will still have the burden of analyzing transactions in every state into which it make sales to determine whether the sales are taxable.
  - Additionally, remote sellers may be burdened with a number of miscellaneous costs, including those related to registration, return preparation and filing, consulting services for software configuration, and audit defense.
  - Studies suggest that businesses with gross revenue ranging from \$1 million to \$50 million will incur costs between 1.5 percent to 2.0 percent of gross revenue.

# Marketplace Fairness Act—next steps

- The Act is now being considered by the House
- Passage is uncertain because of significant partisan opposition
- Main causes for concern:
  - Small business threshold
  - Is this a “new tax”?
- Other potential problems:
  - Privilege tax versus sales tax
  - Due Process clause
  - Enforcement without nexus

# MTC Article IV revisions—impact of *Gillette*

- MTC apportionment election
  - *Gillette Co. & Subsidiaries v. Franchise Tax Bd.*, No. A130803 (Cal. App. 1st Dist. Oct. 2, 2012).
  - Oregon, Michigan, Texas cases
  - Waiting for a decision...
- States move to repeal MTC
  - Minnesota (SF 1617)
  - Oregon (SB 307)
  - South Dakota (L. 2013 SB 239)
  - Utah (L. 2013 SB 247)
- Movement on MTC apportionment reform

# MTC Article IV revisions—proposed changes

- Proposed major changes to MTC Article IV:
  - Definitions of business and non-business income would shift to an amorphous “Constitutional” standard, establish the independence of the transactional and functional tests, and replace “and” with “or” in the functional test. Potential problem: new standard is nebulous and will lead to litigation.
  - Apportionment formula would double-weight the sales factor. Potential problem: standard formula is still focused on manufacturing and mercantile, and special formulas would be required to make the system work, thus sacrificing uniformity.

# MTC Article IV revisions—proposed changes (cont.)

- Definition of receipts for sales factor purposes would include all apportionable gross receipts other than those that (1) would not meet the transactional test or (2) are treasury receipts. Potential problem: occasional sales of fixed assets would automatically be excluded under this approach.
- Sourcing of sales of services based on market and not cost of performance. Market-sourcing rule based on location of delivery, which is undefined. Potential problem: failure to define delivery using some kind of cascading method would lead to uncertainty and multiple taxation.

# MTC Article IV revisions—proposed changes (cont.)

- Sourcing of licensing/sales of intangibles based on use. Potential problem: rules are written broadly enough to come to the conclusion that a taxpayer would be required to source based on the ultimate consumer's location, requiring a seller or licensor of intangibles to (1) determine whether the direct licensor or purchaser is the user or an indirect licensor or purchaser is the ultimate user, and (2) run out to the final user to determine source.
- General throwout rule applicable to sales of intangibles would apply to taxpayers in the business of selling some intangibles. Potential problem: a company that only derives receipts from the sale of such intangibles could, and generally would, have a zero sales factor.
- Changes to the alternative apportionment rules would allow each state to create industry-specific alternative apportionment formulas via regulation. Potential problem: ad hoc apportionment applied to groups with certain common facts could become the norm, when it should really only be applied on a taxpayer-specific basis.



# MTC Article IV revisions—next steps

- Hearing held on March 28, 2013
- Period to submit written commentary closed
- MTC considering commentary

# Executive compensation update



# Utilizing profits interests in LLCs

- Limited liability companies (LLCs) are becoming an increasingly popular business structure
  - Provide limited liability
  - If taxed as a partnership, no double taxation
  - Greater flexibility than S corporations
- Grants of profits interests are a means for providing incentive compensation to LLC management executives
  - Not applicable to corporations
  - Not taxable at time of grant
  - May be unvested and subject to vesting schedule
  - Can result in capital gains tax treatment

# Utilizing profits interests in LLCs (cont.)

What is a “profits interest”?

- An interest limited to participation in *future* profits of the LLC—profits participation may be broad or limited (e.g., participation in gain on sale of specific assets or upon a change in control event)
- Generally represented by a grant of a special class of LLC units—different than other equity units
- Has no initial capital value
- If the LLC was liquidated immediately after the grant of profits units—no value would be allocated to the profits units
- For income tax purposes, considered “property” having a zero value if certain conditions are met

# Utilizing profits interests in LLCs (cont.)

- Safe harbor income tax treatment—Rev Proc 2001-43 (see also Rev Proc 93-27)
- No income tax is recognized if these conditions are satisfied:
  - The individual is treated as a partner from the date of grant
  - Forms K-1 are issued, and the partner reports his distributive share
  - No compensation deduction is taken by LLC
  - Profits interest—held for two years or more

# Utilizing profits interests in LLCs (cont.)

- The safe harbor does not apply if the LLC is a publicly traded partnership or if the profits interest relates to a substantially certain and predictable stream of income from partnership assets (e.g. high-quality net lease or debt securities)
- Section 83(b) election is available within 30 days of grant date—but is it needed? May not be necessary if the safe harbor is satisfied, but a protective election may be helpful (e.g., possible disposition within two years)

# Utilizing profits interests in LLCs (cont.)

- **WARNING:** Possible future “carried interest” legislation could result in some portion or all of the gain upon disposition of the profits units being taxed as ordinary income rather than long-term capital gain

# The .9 percent additional Medicare tax

- Enacted as part of the Affordable Care Act (ACA)
- Effective commencing in 2013
- To raise revenue to pay for the broadened medical coverage and elimination of pre-existing conditions under the ACA
- Not to be confused with the separate new 3.8 percent income tax on high earners' investment income



# The .9 percent additional Medicare tax (cont.)

- Differs from the basic Medicare tax that applies to all wages paid to an employee
- Is not applied until wages, compensation and self employment income exceed a threshold amount based on the taxpayer's tax filing status
- Threshold is:
  - \$250,000 (married filing jointly)
  - \$125,000 (married filing separately)
  - \$200,000 (all other filers)
- The .9 percent tax is imposed only on the individual (no employer matching tax)

# The .9 percent additional Medicare tax (cont.)

- Employer must withhold the tax commencing in the pay period that the employee's wages exceed \$200,000
- Employer is not required to notify employee of the additional tax withholding
- The employer must withhold regardless of whether the employee is ultimately liable for the tax
- The employer will report the .9 percent Medicare tax withheld as a separate item on the employee's W-2

# The .9 percent additional Medicare tax (cont.)

- The tax withheld is treated as a tax payment by the employee and is aggregated with all other taxes paid during the year and applied against the overall tax liability on the employee's Form 1040
- Excess of tax payments over the taxpayer's tax liability is eligible for a refund upon filing the Form 1040
- Self-employed individuals are subject to the .9 percent Medicare tax when self-employment income exceeds the threshold and should consider this in making their estimated tax payments

# Income tax withholding on supplemental wages

- Supplemental wages—wage payments to an employee that are not regular wages
- Examples include (but are not limited to) bonuses, commissions, stock option income, overtime pay, accumulated sick leave and severance pay
- There are special tax withholding rules that apply once supplemental wages paid during the year exceed \$1 million

# Income tax withholding on supplemental wages (cont.)

- Supplemental wages paid during a calendar year exceed \$1 million
  - Mandatory flat rate withholding at 39.6 percent
  - No option to apply Form W-4 withholding
  - This is an increase to the 35 percent rate (2012)
  - Employer cannot withhold at a higher or lower rate even if requested to do so by the employee
  - If the employee wanted more withheld—can file a new Form W-4 to increase withholding on regular wages

# Income tax withholding on supplemental wages (cont.)

- Supplemental wages paid during a calendar year do not exceed \$1 million
  - Employer may withhold flat rate of 25 percent (no other flat rate is allowed)
  - Note: This may result in a shortfall of tax paid if the employee is in a higher tax bracket such that the employee may need to pay estimated tax
  - Employer may withhold in accordance with Form W-4

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