HOW RECENT TAX LEGISLATION AFFECTS CLOSELY-HELD BUSINESSES

William C. Staley, Attorney

USC Gould School of Law

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William C. Staley,

Business and Tax Attorney

Law Office of William C. Staley

818 936-3490

www.staleylaw.com

This presentation should be viewed only as a summary of the law and not as a substitute for tax or legal consultation in a particular case. Your comments and questions are always welcome.

The Big Issues

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The Big U.S. Domestic Issues

- Jobs
  - ⇒ 9.4% unemployment rate in12-10
- Growth
  - ⇒ 2.6% annual rate of GDP in 3Q-2010

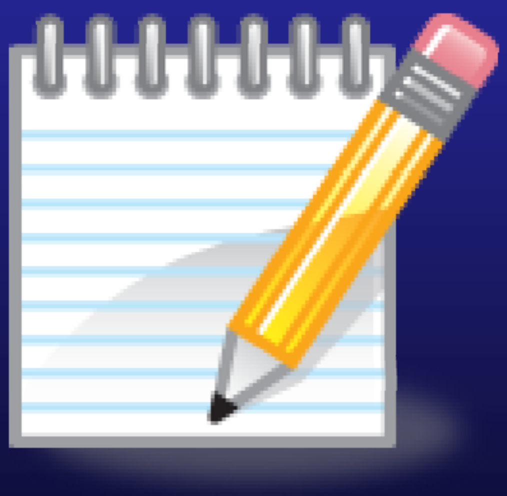
The Big U.S. Domestic Issues

- Deficit reduction
  - ⇒ U.S. national debt per taxpayer - $127,000
  - ⇒ Unfunded liability per taxpayer - $1,014,000
    - ❖ Medicare – 70%
    - ❖ Prescription Drug program – 20%
    - ❖ Social Security – 10%
  - ⇒ www.usdebtclock.org

The Big Tax Issues for Closely-Held Businesses

- Marginal income tax rates
- Certainty
- Ability to comply and cost of compliance

Key Marginal Tax Rates



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Key Marginal Tax Rates

Ordinary income tax rate (Federal maximum)	
2010-2012	2013
35%	**45%** On net investment income over $250,000 and taxable income over $288,000

- Includes 3.8% Medicare tax and effective 1.2% rate increase for itemized deduction cutback

- Also an 0.9% Medicare tax on wages and SET over $250,000, not deductible

Key Marginal Tax Rates

Ordinary income tax rate (highest effective combined Federal and California)	
2010-2012	2013
42% On CA taxable income over $1M **43%** through an S corp	**51%** On net investment income over $250,000 and CA taxable income over $1M **52%** through an S corp as net investment income

Key Marginal Tax Rates

Tax rate on qualified dividends (highest Federal rate, non-corporate taxpayer)	
2010-2012	2013
15%	**41%** On net investment income *under* $250,000 **45%** On net investment income *over* $250,000

Key Marginal Tax Rates

Tax rate on qualified dividends (highest effective combined Federal and California rate, non-corporate taxpayer)	
2010-2012	2013
22% On CA taxable income over $1M	**47%** On CA taxable income over $1M and net investment income *under* $250,000 **51%** On net investment income *over* $250,000

Key Marginal Tax Rates

Tax rate on net long-term capital gain (highest Federal rate, non-corporate taxpayer)	
2010-2012	2013
15%	**21%** On net investment income *under* $250,000, held over 5 years **25%** On net investment income *over* $250,000

Key Marginal Tax Rates

Tax rate on net long-term capital gain (highest effective combined Federal and California rate, non-corporate taxpayer, *no AMT*)	
2010-2012	2013
22% CA taxable income over $1M **23%** through an S corp	**29%** On net investment income *over* $250,000, held *over* 5 years **31%** Same, held under 5 years **32%** Same, through an S corp

Key Marginal Tax Rates

Tax rate on net long-term capital gain (max effective combined Federal and California rate, non-corporate taxpayer, *with AMT*)	
2010-2012	2013
26% CA taxable income over $1M **28%** through an S corp	**35%** On net investment income *over* $250,000, held *over* 5 years **36%** Same, through an S corp 1992 AMT exemption amounts

Key Marginal Tax Rates

C corp income or gain distributed as a *dividend* to non-corporate shareholders (max effective combined Federal and CA income tax rate)	
2010-2012	2013
53% at 34% Fed corp rate) **54%** at 35%Fed corp rate	**71%** On net investment income *over* $250,000 and a Fed corp tax rate of 34% or 35%

Key Marginal Tax Rates

C corp income or gain distributed as *long-term capital gain* to non-corporate shareholders (max effective combined Federal and California income tax rate)	
2010-2012	2013
53% at 34% Fed corp rate) **54%** at 35%Fed corp rate	**57%** On net investment income *over* $250,000 and a Fed corp tax rate of 34% **58%** at a 35% Fed corp rate

Other Federal
Business Tax Legislation in 2010

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Federal Business Tax Legislation

- 100% bonus depreciation
  - ⇒ Placed in service after 9-8-10 and before 2012
- Extended 50% bonus depreciation
  - ⇒ Placed in service in 2012
- Or, accelerated AMT and R&D credits with no bonus depreciation
  - ⇒ Through 2012

Federal Business Tax Legislation

- 15-year depreciation (vs. 39 years) for leasehold, restaurant and retail improvements
  - ⇒ Placed in service before 2012
- Extended special amortization of film and TV costs up to $15M
  - ⇒ Incurred before 2012
- Election to deduct environmental remediation costs incurred before 2012

Federal Business Tax Legislation

Section 179 expensing – amount per year that can be expensed			
2009	2010-11	2012	2013
$250,000	$500,000	$125,000	$25,000

Section 179 expensing – Phase-out starts at buys of		
2009	2010-11	2012
$800,000	$2M	$500,000

- Extended inclusion of computer software through 2012

Federal Business Tax Legislation

Recognition period for S corp built-in gains		
2010	2011	2012
7 years	5 years	10 years

- California has not conformed

Federal Business Tax Legislation

- Forms 1099
  - ⇒ 2011: Reporting by passive owners of rental properties for services provided by non-corporate providers
  - ⇒ 2012:
    - ❖ Reporting for payments for property and services
    - ❖ Reporting for payments to corporations
  - ⇒ Increased penalties for failing to file info returns due after 2010

Federal Business Tax Legislation

Extension of AMT exemption amount			
	2010	2011	2012
Married, joint	$72,000	$74,000	$45,000
Single	$47,000	$48,000	$24,000

AMT exemption phase-out			
	2010	2011	2012
Married, joint	$150,000- $440,000	$150,000 to $448,000	$150,000 to $330,000
Single	$112,000- $302,000	$112,000 to $306,000	$112,000 to $249,000

Federal Business Tax Legislation

- Economic substance doctrine
  - ⇒ Unifies application of doctrine by courts
  - ⇒ Concern about “meaningless steps” in intentional step transactions
  - ⇒ LMSB Director of Field Operations must approve application of penalty
    - ❖ 20% accuracy penalty
    - ❖ Special 40% penalty for not disclosing the transaction

Federal Business Tax Legislation

- Other extenders – thru 2011 only
  - ⇒ Empowerment zones
  - ⇒ R&D credit
  - ⇒ New Markets credit
  - ⇒ Charitable contribution deduction limits:
    - ❖ Inventory of food or books
    - ❖ Computer technology and equipment
    - ❖ S corp stock basis adjusted down by basis (not value) of S corp's property contribution

California Business Tax Legislation 2010

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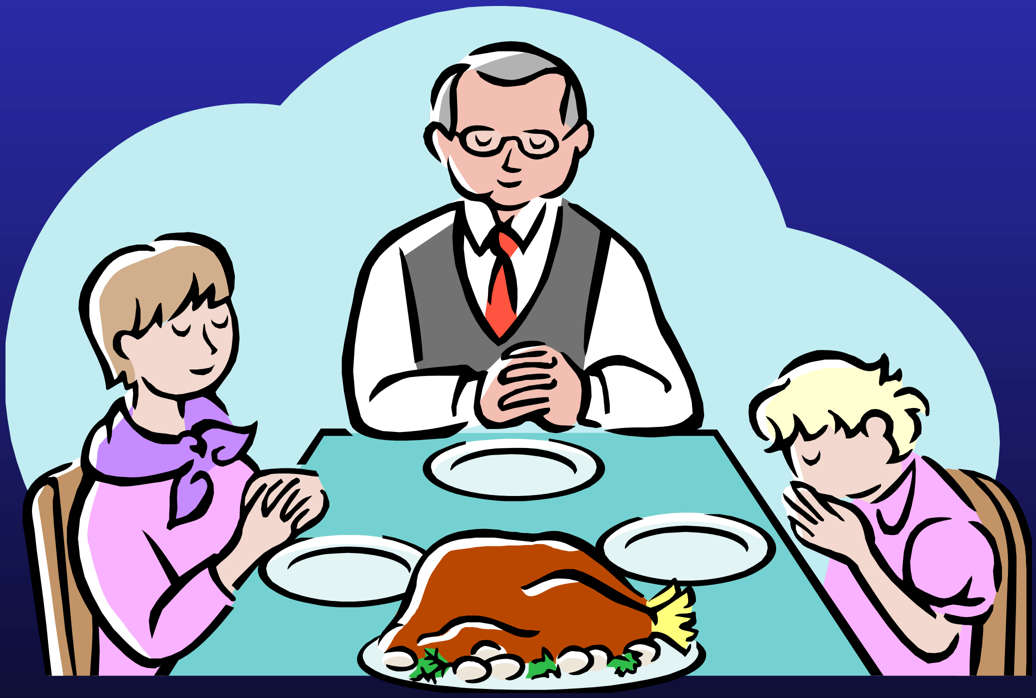
CA Business Tax Legislation

- NOLs
  - ⇒ 20-year carryforward (after 2007)
  - ⇒ Old law: No carryback for 2008 or 2009, but can carry back up to 2 years starting in 2010
  - ⇒ Old law: If NOLs in 2010 or after exceed $500,000, no carryback to 2008 or 2009, but tack up to 2 years on carry-forward period
  - ⇒ New law: No carrybacks for 2010 or 2011 if California income exceeds $300,000, limited carryback in all cases in which it is allowed

Federal Estate and Gift Taxes



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Federal Estate and Gift Taxes

Gift tax rate (Federal maximum)	
2010-12	2013
35%	**55%**

- Gift tax exclusion - $13,000 per donor per donee per year
  - ⇒ Unchanged by 2010 legislation, no pending sunset
  - ⇒ Subject to inflation adjustments

Federal Estate and Gift Taxes

Gift tax "applicable exemption amount" per donor (Federal)		
2010	2011-12	2013
$1M ***not*** unified with the default estate tax	**$5M** unified with estate tax	**$1M** unified with estate tax

Federal Estate and Gift Taxes

Estate tax rate (Federal maximum)		
2010	2011-12	2013
35% Or executor can elect no estate tax and modified carryover basis	**35%**	**55%**

Federal Estate and Gift Taxes

Estate tax "applicable exemption amount" per donor (Federal)		
2010	2011-12	2013
$5M ***not*** unified with the gift tax	**$5M** unified with gift tax	**$1M** unified with gift tax

- "Portability" introduced
- Does not eliminate need for living trust

Federal Estate and Gift Taxes

Income tax basis of inherited assets (Federal)		
2010	2011-12	2013
Basis adjusted to FMV at date of death Option: no estate tax and modified carryover basis	Basis adjusted to FMV at date of death	Basis adjusted to FMV at date of death

Proposed but not Enacted

Proposed but not Enacted

- Repeal of 2010 Patient Protection and Health Care Acts (HR 2)
  - ⇒ Passed by House 1-19-11 by 245-189 vote
  - ⇒ Not likely to be subject to Senate vote
  - ⇒ Would eliminate 3.8% Medicare tax on net investment income over $250,000 after 2012
  - ⇒ Would eliminate 0.9% Medicare tax on wages and SET over $250,000 after 2012
  - ⇒ Would eliminate the most onerous Form 1099 reporting

Proposed but not Enacted

- Carried interest – Proposed IRC § 710
  - ⇒ Recharacterizes as ordinary income 75% of certain capital gain of an investment fund manager in an investment fund
  - ⇒ Turns off all nonrecognition provisions for such interests
  - ⇒ Attempts to leave in place capital gain treatment for invested capital

Proposed but not Enacted

- Carried interest – Proposed IRC § 710
  - ⇒ Passed as HR 4213 by House in June 2010
  - ⇒ Failed Senate cloture vote 6-25-10
  - ⇒ A big issue was unfunded extension of unemployment benefits

Proposed but not Enacted

- Synthetic interests – Proposed IRC § 710(e)
  - ⇒ Passed House as part of carried interest bill, failed in Senate cloture vote
  - ⇒ Recharacterizes as ordinary income all of the gain on a synthetic interest held by a person who performed investment services for the entity
  - ⇒ Targets interests that change in value or payout based on changes in the value of the managed assets, whether or not gain is realized

Proposed but not Enacted

- Carried and Synthetic interest rules – Proposed IRC § 710
  - ⇒ 40% penalty for underpayments
  - ⇒ Expected to raise $19B over 10 years

Proposed but not Enacted

- Self-employment taxes for professional firms ($11B over 10 years, in HR 4213)
  - ⇒ All flow-though income would be self-employment income for SET purposes
    - ❖ Targets S corp engaged in a professional service business AND three or fewer principal shareholders
    - ❖ Targets S corp that is a partner in a professional service business
  - ⇒ Would remove SET exclusion for active limited partners in professional service firms

Proposed but not Enacted

- Section 83 and partnership interests (in HR 4213)
  - ⇒ Method of valuing a partnership interest that is transferred in connection with the performance of services
    - ❖ As if there was a deemed sale, all creditors paid and the balance distributed
  - ⇒ A deemed Section 83(b) election is made at the time of the transfer
    - ❖ The service provider can “unmake” the deemed election

Proposed but not Enacted

- GRATs would be required to last for at least 10 years (in HR 4213)

Proposed but not Enacted

- Income tax rate increase for incomes over $250,000, pre-2001 EGT regime (12-1-10 version of HR 4853), passed the House on 12-2-10 by 234-188 vote
- $3.5M/45% estate tax regime ; otherwise, same as 2010 Tax Relief Act (House amendment) , failed House vote by 194-233 on 12-16-10
- Extension of current tax rates and extenders past current sunset dates?
- Permanence?

Broad Tax Reform

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Broad Tax Reform

- Milton Friedman (1999):

"The real cost of government -- the total tax burden -- equals what government spends plus the cost to the public of complying with government mandates and regulations and of calculating, paying, and taking measures to avoid taxes.

"Anything that reduces that real cost -- lower government spending, elimination of costly regulations on individuals or businesses, simplification of explicit taxes -- is a tax reform."

Broad Tax Reform

- President's Economic Recovery Advisory Board chaired by Paul Volker
  - REPORT ON TAX REFORM OPTIONS: SIMPLIFICATION, ENFORCEMENT AND CORPORATE TAXATION, 8-27-10

Broad Tax Reform

- Volker Report (8-27-10):

"The tax code has become more complex and more unstable over the last two decades, in part because legislators have increasingly used targeted tax provisions to achieve social policy objectives normally achieved by spending programs.

"There have been more than 15,000 changes to the tax code since 1986, and a current JCT pamphlet lists 42 pages of expiring provisions."

Broad Tax Reform

- Volker Report:

"Beyond these direct costs that can be measured in time, money, and revenue lost to noncompliance, the complexity of the tax system is a tremendous source of frustration to American taxpayers, reduces the system's transparency, and undermines trust in its fairness."

Broad Tax Reform

- Bipartisan National Commission on Fiscal Responsibility and Reform co-chaired by Alan Simpson and Erskine Bowles
  - THE MOMENT OF TRUTH, 12-1-10

Broad Tax Reform

- Simpson-Bowles Report (12-1-10):

"America's tax code is broken and must be reformed. In the quarter century since the last comprehensive tax reform, Washington has riddled the system with countless tax expenditures, which are simply spending by another name. These tax [expenditures]– amounting to $1.1 trillion a year of spending in the tax code – not only increase the deficit, but cause tax rates to be too high. Instead of promoting economic growth and competitiveness, our current code drives up health care costs and provides special treatment to special interests."

Broad Tax Reform

- Simpson-Bowles Report (12-1-10):

"The code presents individuals and businesses with perverse economic incentives instead of a level playing field.

"The current individual income tax system is hopelessly confusing and complicated.

"The corporate income tax, meanwhile, hurts America's ability to compete."

Broad Tax Reform

- Simpson-Bowles Report (12-1-10):

"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. Rather than tinker around the edges of the existing tax code, the Commission proposes fundamental and comprehensive tax reform that achieves these basic goals…."

Thank you

Bill Staley

Attorney

Woodland Hills, California

818 936-3490

www.staleylaw.com