tax IMPACT

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Material participation key to deducting LLC and LLP losses

Tax Tips
The IRS Fast Track Settlement program, real estate reconveyance, and more

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Could the NIIT apply to the sale of your home?

The 3.8% net investment income tax (NIIT), which went into effect in 2013 under the Affordable Care Act, continues to create confusion. One aspect of the NIIT (also known as the Medicare contribution tax) that's widely misunderstood is its impact on the sale of a home. It doesn't help that chain e-mails and other unreliable sources would have you believe that the NIIT is a "sales tax" on the gross proceeds of all home sales.

The NIIT is *not* a sales tax. It applies, if at all, only to *profits* from a home sale, not to gross proceeds. And it doesn't apply to profits eligible for the Internal Revenue Code Section 121 home sale exclusion. The exclusion applies to the first $250,000 ($500,000 for joint filers) of gain from the sale of a principal residence. Certain home sales are subject to the NIIT, however.

How the NIIT works

For NIIT purposes, net investment income includes interest, dividends, annuities, rents and royalties, net capital gains, and other investment income, reduced by certain expenses that can be allocated to that income. Several types of income are excluded, including (with certain exceptions) income from an active trade or business.

The tax applies to your net investment income or the excess of your MAGI over the threshold, whichever is less.

Not everyone is subject to the tax, though. It's limited to taxpayers whose modified adjusted gross income (MAGI) exceeds the following thresholds:

Single or head of household	$200,000
Married filing jointly	$250,000
Married filing separately	$125,000

Generally, MAGI is equal to adjusted gross income (AGI). But if you live and work abroad, you'll need to add back the foreign earned income exclusion to determine your MAGI.

The tax applies to your net investment income or the excess of your MAGI over the threshold, *whichever is less*. So, for example, if a married couple has MAGI of $300,000, including $75,000 of net investment income, the tax is 3.8% of $50,000, the amount by which the couple's MAGI exceeds the $250,000 threshold.

Application to home sales

Home sales can trigger the NIIT in two ways: First, a net capital gain is investment income that's potentially subject to the tax. Second, if you're not otherwise subject to the tax, a large gain can push your MAGI above the threshold.

Recently, the IRS created the publication *Questions and Answers on the Net Investment Income Tax*, clarifying that the NIIT doesn't apply to gains that qualify for the Sec. 121 exclusion for regular tax purposes. The tax does apply, however, to the extent gain exceeds the exclusion as well as to gains on sales that don't qualify for the exclusion.

For a home to qualify for the exclusion, you must own and use it as your principal residence for at least two years during the five-year period preceding the sale. And you can't use the exclusion more than once every two years. If the home is a nonprincipal residence (a vacation home, for example) or you don't meet the two-year requirement, the entire gain will be subject to capital gains taxes and, depending on your MAGI, NIIT.

There's one exception to the two-year requirement: If you're forced to sell your principal residence in less than two years due to job loss, health issues or certain other unforeseen circumstances, you may be entitled to a prorated exclusion. For example, if you're laid off and have to sell your home after only one year, you can claim a 50% exclusion ($125,000; $250,000 if you're married).

Planning opportunities

If a home sale will trigger the NIIT — either because the gain will exceed the exclusion amount or because the home isn't your principal residence — there may be strategies you can use to reduce or even eliminate the tax. They include:

Harvesting losses. If you own stocks or other investments that have declined in value, consider selling them to generate capital losses you can use to offset the gain.

Converting a second home into a principal residence. If you're selling a nonprincipal residence, it may be possible to convert it into a principal residence. The rules for these conversions are complex, however, and in many cases provide only a partial exclusion.

Keeping track of improvements. Remember, the NIIT applies to profit, not gross proceeds. Improvement costs generally increase your basis, reducing your profit. So it's important to track and document those costs.

Not only do these strategies reduce your net investment income, but they also reduce your MAGI, potentially eliminating NIIT. (See "Home sale example" above.)

Consult an advisor

If you're preparing to sell a home, consult your tax advisor to determine whether the sale will generate NIIT and to discuss tax-saving strategies.

Home sale example

Bill and Judy, a married couple filing jointly, sell their principal residence for $1.3 million. They bought the home 20 years ago for $500,000 and made no improvements, so their basis is $500,000, for an $800,000 gain. Of that amount, $300,000 is taxable ($800,000 less the $500,000 Section 121 exclusion).

The $300,000 is net investment income. Bill and Judy have additional net investment income of $50,000, for a total of $350,000. Their MAGI for the year is $525,000, which exceeds the $250,000 net investment income tax (NIIT) threshold by $275,000. Bill and Judy are subject to NIIT on the lesser of $350,000 (their net investment income) or $275,000 (the amount by which their MAGI exceeds the threshold). In this case, the NIIT is $10,450 ($275,000 × 3.8%).

Suppose, instead, that Bill and Judy had spent $300,000 on improvements to the home. That would increase their basis to $800,000, reducing their gain to $500,000 and eliminating taxes on the sale. It would also eliminate NIIT by reducing their MAGI to $225,000, which is below the NIIT threshold.

Why a private annuity is a powerful estate planning tool

Affluent families looking for ways to reduce their gift and estate tax exposure should consider private annuities. Under the right circumstances, a private annuity can generate significant tax savings. A 2013 U.S. Tax Court decision that approved the use of a *deferred* private annuity for estate planning purposes has potentially made this tool even more powerful.

Many benefits

To take advantage of a private annuity, you simply transfer property — such as securities, family business interests, real estate or other assets — to your children or other beneficiaries in exchange for their promise to make periodic payments, usually for the rest of your life.

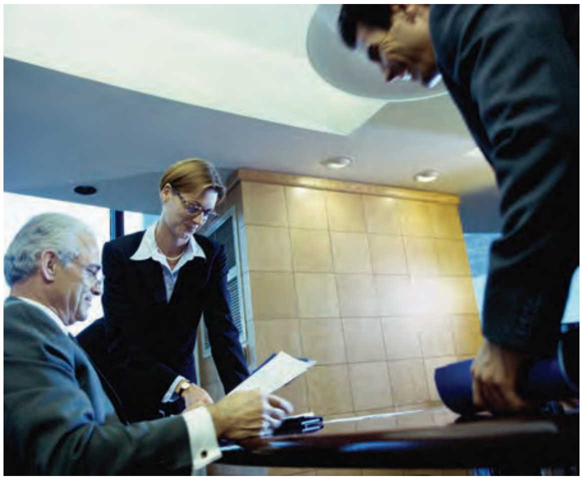
This technique offers several benefits. It gives you a source of fixed income for life, often taxable (at least in part) at favorable capital gains rates. Once you complete the transfer, the property's value — plus all future appreciation — is removed from your taxable estate. And there's no gift tax on the transaction, so long as the present value of the annuity is roughly equal to the property's current fair market value.

Understandably, the IRS isn't a big fan of the deferred annuity technique. But in a 2013 case, Estate of Kite v. Commissioner, *the U.S. Tax Court approved its use — at least in one set of circumstances.*

Another benefit of a private annuity is that, if you fail to reach your life expectancy, your beneficiaries will receive a windfall. Typically, the transaction is structured so that the present value of annuity payments over your actuarial life expectancy (according to IRS tables) equals the property's value. After you die, your beneficiaries are no longer obligated to make annuity payments. So if you don't reach your life expectancy, they'll acquire the property at a substantial discount.

Advantages of deferral

A *deferred* annuity provides for payments to commence at some date in the future. Structured properly, it increases the chances that the transferor will die before the annuity payments are complete — or, in some cases, before they begin. Understandably, the IRS isn't a big fan of this technique. But in a 2013 case, *Estate of Kite v. Commissioner*, the U.S. Tax Court approved its use — at least in one set of circumstances.



In 2001, at age 74, the taxpayer sold her interests in a family limited partnership to her three children in exchange for three private annuity agreements. The agreements called for annuity payments to begin 10 years later, in 2011. The taxpayer died in 2004, so her children never had to make any payments. The tax benefits of the private annuity transaction were substantial: In challenging it, the IRS sought to collect more than $11 million in federal gift and estate taxes.

The IRS claimed that the transaction was a disguised gift. It argued that there was no real expectation of payment and, therefore, the annuities didn't constitute adequate consideration for the transfer.

The Tax Court disagreed, finding that the family was justified in relying on IRS life expectancy tables because the taxpayer wasn't terminally ill (and presented a physician's letter to that effect). In light of the taxpayer's 12.5-year life expectancy, her children's financial independence, and other evidence, the court concluded that her children expected to make annuity payments and were prepared to do so.

A calculated risk

Private annuities aren't risk-free: If you surpass your life expectancy, the beneficiaries will end up overpaying (and the payments will be part of your taxable estate). Also, if your beneficiaries default on the payments, the strategy may unravel. But, given the potential benefits, these may be risks worth taking. ◎

Material participation key to deducting LLC and LLP losses

If your business is a limited liability company (LLC) or a limited liability partnership (LLP), you know that these structures offer liability protection and flexibility as well as tax advantages. But, until recently, they also had a significant tax *dis*advantage: The IRS used to treat all LLC and LLP owners as *limited* partners for purposes of the passive activity loss (PAL) rules, limiting the owners' ability to deduct losses in the current year.

Now, however, LLC and LLP owners can be treated as *general* partners. This makes it easier for them to deduct losses, because they can meet any one of seven "material participation" tests to avoid passive treatment.

The PAL rules

Congress established the PAL rules in 1986 to discourage abusive tax shelters. The rules prohibit taxpayers from offsetting losses from passive business activities (such as limited partnerships or rental properties) against nonpassive income (such as wages, interest, dividends and capital gains). Disallowed losses may be carried forward to future years and deducted from passive income or recovered when the passive business interest is sold.

There are two types of passive activities: 1) trade or business activities in which you *don't* materially participate during the year, and 2) rental activities, even if you do materially participate (unless you're a qualified real estate professional).

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The 7 tests

Material participation in this context means participation on a "regular, continuous and substantial" basis. Under the tax regulations, unless you're a limited partner, you're deemed to materially participate in a business activity if you meet just *one* of seven tests:

1. You participate in the activity at least 500 hours during the year.

2. Your participation constitutes substantially all of the participation for the year by anyone, including nonowners.

3. You participate more than 100 hours and as much or more than any other person.

4. The activity is a "significant participation activity" — that is, you participate more than 100 hours — but you participate less than one or more other people yet your participation in all of your significant participation activities for the year totals more than 500 hours.

5. You materially participated in the activity for any five of the preceding 10 tax years.

6. The activity is a personal service activity in which you materially participated in any three previous tax years.

7. Regardless of the number of hours, based on all the facts and circumstances, you participate in the activity on a regular, continuous and substantial basis.

The rules are more restrictive for limited partners, who can establish material participation only by satisfying tests 1, 5 or 6.

Avoiding passive losses

If you're an owner of an LLC or LLP and want to avoid passive losses, make sure you take the steps necessary to meet one of the material participation tests. In many cases, that will mean diligently tracking every hour spent on your activities associated with that business. ◎

tax TIPS

Rescission doctrine and real estate reconveyance

In IRS Revenue Ruling 80-58, a seller of real estate had agreed to accept reconveyance of the property and return the buyer's funds if the buyer couldn't get the property rezoned for business purposes within a specified period. Applying the "rescission doctrine," the IRS ruled that a seller need not recognize taxable gain if the transaction is rescinded during the same tax year as the original sale and the parties are returned to their original positions.

But if the rescission occurs in a *later* year, the seller must recognize gain in the year of sale. When the property is reconveyed, the seller acquires a new basis, equal to the funds paid to the buyer.

In private letter rulings (PLRs) over the years, the IRS appeared to be expanding the rescission doctrine, but in a 2012 Revenue Procedure, it announced that it would no longer issue PLRs on the subject. Until there's guidance on this issue, apply the rescission doctrine conservatively and follow Rev. Rul. 80-58 to the letter. ◎

Contract work: Who claims the manufacturers' deduction?

The manufacturers' deduction (also commonly referred to as the domestic production activities deduction or the Section 199 deduction) allows many businesses to deduct as much as 9% of their income from qualified production activities, including manufacturing, construction, architecture and engineering, and software development.

But what if a business contracts with third parties to perform these activities? Which party claims the deduction? The U.S. Tax Court addressed this issue in *Advo, Inc. v. Commissioner*, a case involving a contract manufacturing arrangement.

Identifying the party entitled to claim the deduction is complex, but essentially it boils down to which party has the benefits and burdens of ownership. To make this determination, the court looks at several factors, including who holds legal title to property during production, who has control over the property and the process, who pays property taxes, who bears the risk of loss or damage, and who receives profits from the property's sale.

Businesses involved in contract production agreements should review their arrangements carefully to ensure that they obtain the desired tax treatment. ◎

Get on the fast track

The IRS has expanded its Fast Track Settlement (FTS) program to small businesses and self-employed individuals. The program, previously available only to businesses with more than $10 million in assets, streamlines the dispute resolution process by using mediation rather than litigation or other formal proceedings. The goal is to complete cases within 60 days. If you're involved in a dispute with the IRS, ask your tax advisor about applying for FTS. ◎

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Card, Palmer, Sibbison & Co. has been serving as a trusted advisor and management consultant to owners and businesses in Northeast Ohio since 1920. We have expertise in both the privately held company and not-for-profit area. As certified public accountants we perform the traditional financial and tax services but also provide a wide array of other business services.

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