Lally & Co.
CPAs and Business Advisors

The EVERGREEN

Quarterly Journal for Clients & Friends

Spring 2013 – Volume VI

This Issue:

The Evergreen. Always Growing.

Why a leaf-bearing tree? For *The Evergreen* we've chosen the image of a live oak tree to represent the strength, stability, and resourcefulness of our clients. The name "live oak" comes from the fact that evergreen oaks remain green throughout the winter, when other oaks are dormant, leafless, and "dead"-looking. The live oak has been a living symbol of strength and durability for centuries. The southern live oak is the official state tree of Georgia.

At Lally & Co., we strive to offer solid solutions that ensure our clients' financial strength and protection. We are always looking for ways to better serve you.

Contact our office or visit our website for more information.

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Dear Clients and Friends,

Spring has arrived and with that comes the end of another "busy" season. We would like to extend our sincere gratitude for the trust you have invested in us. Our clients and referral sources are the reason we had one of our busiest and most successful tax seasons. It would not have happened without each of you.

We continue to service our clients throughout the calendar year. As you read through *The Evergreen*, please do not hesitate to contact us at any time. We would be happy to hear from you! This and past issues of *The Evergreen* are available on our website at http://lallycpas.com/newsletters/.

Small Business Tax Reform

Many small business benefits incorporated into the Tax Code are complicated and arguably in need of reform. House Ways and Means Committee chair Dave Camp, R-Mich. recently released a draft proposal containing numerous tax reform measures specifically designed to simplify taxation of small businesses and partnerships. According to a report by the National Federation of Independent Business, small business owners spend approximately $18 to $19 billion every year in tax compliance costs. Camp's proposal addresses this and other issues by recommending lower tax rates, permanent Code Sec. 179 expensing, expansion of the cash accounting method, unification of tax filing rules for S corps and partnerships, and more.

Camp's dedications to tax reform, if not his specific proposals, carry credibility on both sides of the aisle on Capitol Hill. If the momentum toward tax reform continues to grow, Camp's current efforts will likely shape at least a portion of its overall framework.

Proposed reforms

Code Sec. 179 expensing - The *American Taxpayer Relief Act of 2012* (ATRA) extended the $500,000 expensing limit and $2 million dollar limit through the end of 2013. Camp's proposal would make permanent Code Sec. 179 expensing for certain depreciable business property for businesses, but would lower the limits allowed for costs of qualifying property placed in service after 2013. A business would be allowed to deduct the costs of up to $250,000 in qualifying property placed in service during a tax year after 2013 (down from $500,000 in 2013). The allowance would be subject to a dollar limit threshold of $800,000 under the proposal (down from $2 million in 2013). The proposal would also

(continued on page 2)

Important Dates:

May 15, 2013 - 2012 Foundation Tax Returns Due

June 15, 2013 - 2013 2nd Quarter Estimated Payments Due

June 30, 2013 - Form 90-22.1, Report of Foreign Bank and Financial Accounts Due

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Firm Announcements:

Anna Sella successfully completed the Uniform CPA Exam in February 2013

Elinor Avigad joined our A&A Department in April 2013 as a Staff Accountant

Jorden Kraus joined our Tax Department in February 2013 as a Staff Accountant

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provide for an annual adjustment of the limits for inflation.

Cash method of accounting - Camp's proposal would expand availability of the cash method of accounting for certain business entities that do not currently have the option to use the simpler cash method under which items of income accrue when received and expenses are counted when actually paid.

Uniform capitalization rules - Camp's proposal would expand the number of business taxpayers exempt from the Code Sec. 263A uniform capitalization rules (UNICAP) that require businesses to capitalize certain direct and indirect costs for items such as materials, labor, or production that are allocable to real or tangible personal property that the taxpayer produced for certain trade, business, or resale purposes.

Current law provides an exception for small businesses that have average annual gross receipts of less than $10 million and acquire property for resale. Camp's draft proposal would expand the exception to also cover small business producers of real or tangible property.

Start-up expenses - Camp's proposal would simplify the Tax Code's current treatment of the $5,000 deduction for start-up expenses by consolidating the provisions of Code Secs. 248 and 709, which govern organizational expenditures for corporations and partnerships, under the start-up expense deduction provisions of Code Sec. 195. The draft proposal would also increase the current Code Sec. 195 deduction limit from $5,000 to $10,000, subject to a phase-out limit of $60,000 (up from $50,000).

Business tax return deadlines - Camp's proposal would shift due dates for Form 1065, U.S. Return of Partnership Income, Form 1120S, U.S. Income Tax Return for an S Corporation, and, with respect to C Corporations, Form 1120, U.S. Corporation Income Tax Return. The deadlines would change from April 15 (Form 1065) and March 15 (Forms 1120 and 1120S) to March 15 (Form 1065), April 15 (Form 1120) and April 1 (Form 1120S). The proposal would also provide an option to file six-month extensions for all three forms.

Pass-through reform

Pass-through entities such as S Corps and partnerships are stymied by the Tax Code's complexity, according to Camp. Because an estimated 65 percent of new jobs over the past 17 years were created by small businesses formed as unincorporated pass-through entities, Camp's proposal set forth several recommendations for drastic reform of the current pass-through regime such as enacting a shorter recognition period for a newly elected S Corp's built-in gains under Code Sec. 1374 and increasing the threshold at which an S corporation's net passive income becomes subject to the highest corporate tax rate.

Alternatively, Camp has also proposed a drastic rewrite of current Subchapters K and S, which govern taxation of partnerships and S Corps. The Tax Code would contain one unified set of rules under a new Subchapter K for taxation of partnerships and pass-through corporations. The new Subchapter K would expand eligibility of most pass-through corporations to elect S Corp treatment, loosen current restrictions on who may be an S Corp shareholder, impose a withholding requirement on a pass-through with respect to certain amounts of each pass-through owner's distributive share, and more.

The New 3.8 Percent Net Investment Tax Continues to Challenge

Questions over the operation of the new 3.8 percent Medicare tax on net investment income (the NII Tax) continue to be placed on the IRS's doorstep as it tries to better explain the operation of the new tax. Proposed "reliance regulations" issued at the end of 2012 "are insufficient in many respects," tax experts complain, as the IRS struggles to turn its earlier guidance into final rules.
A public hearing on the existing regulations in early April 2013 confirmed how the application of the NII Tax to certain categories of income—particularly income arising from "passive activities"—is challenging even the experts.

Nevertheless, taxpayers are not getting a reprieve from the immediate application of this new tax. The 3.8 percent Medicare surtax on net investment income (NII) became effective January 1, 2013. Current confusion over exactly how the 3.8 percent operates can impact on tax strategies that should be put into motion in 2013. Any misinterpretation can also bear on 2013 estimated tax that may be due to cover any 3.8 percent NII Tax liability.

NII Tax Thresholds
For tax years beginning after December 31, 2012, the NII surtax on individuals equals 3.8 percent of the *lesser of:* net investment income for the tax year, *or* the excess, if any, of:

- the individual's modified adjusted gross income (MAGI) for the tax year, *over*
- the threshold amount.

The threshold amount in turn is equal to:

- $250,000 in the case of a taxpayer making a joint return or a surviving spouse,
- $125,000 in the case of a married taxpayer filing a separate return, and
- $200,000 in any other case.

Trusts and estates are also subject to the NII surtax, to the extent of the *lesser of: (i)* undistributed net investment income, *or (ii)* the excess of adjusted gross income *over* the dollar amount at which the highest tax bracket begins (which, for 2013, is $11,950).

Net Investment Income
The primary confusion over application of the 3.8 percent NII Tax revolves around finding a precise definition of "net investment income" as enacted by Congress. To appreciate the complexity of the task, just look at the applicable Internal Revenue Code provision. Code Sec. 1411(c)(1) defines net investment income as the sum of:
Category (i) income: Gross income from interest, dividends, annuities, royalties, and rents, other than such income which is derived in the ordinary course of a trade or business not described in Code Sec. 1411(c)(2);
Category (ii) income: Other gross income derived from a trade or business described in Code Sec. 1411(c)(2); and
Category (iii) income: Net gain attributable to the disposition of property, other than property held in a trade or business not described in Code Sec. 1411(c)(2); *over*

Deductions properly allocable to such gross income or net gain.

Complexity
The IRS has stated that the principal purpose of Code Sec. 1411 is "to impose a tax on unearned income or investments of certain individuals, estates, and trusts." Unfortunately, Code Sec. 1411 is not so direct and simple, with its three categories of income (that is, (i), (ii) and (iii), above), complicating matters, albeit in an effort to close every door to those who try to "game the system."

Application of the 3.8 percent NII Tax to capital gains and dividends from a personal stock portfolio is clear under this rule of thumb. But clarity breaks down when a "trade or business" is thrown into the mix and the concept of "passive activity" is added to it.

If gain or other income is the result of an active business activity, it generally escapes NII Tax. However, when the "active" business is a passive activity (for example, a rental business), it may be deemed to generate income that is subject to the NII Tax. Furthermore, when a passive activity is not merely incidental to a business however otherwise active that business should be, the NII Tax also becomes an issue.

Passive Activity
Any revised or additional rules from the IRS on the application of the NII Tax on passive activities should be made more user friendly to the broad middle range of taxpayers and their advisors, one expert at the hearing recommended. The IRS should err on the side of explaining things clearly and simply, even at the expense of not covering every possible nuance of interpretation.

At the same time, however, other experts are asking for more detail, at least in the way of clarification. For example, the IRS has stated that passive activity for NII Tax purposes should be applied within a narrower scope than the passive activity loss rules under Code 469 ("passive loss" rules). Experts want the IRS to explain exactly what they mean by a "narrower scope."

(continued on page 4)

Self-Rental Activities/Grouping
The self-rental recharacterization rule under Code Sec. 469 affects taxpayers who rent property to a trade or business in which they materially participate. Concern has been expressed over the possibility of interpreting net investment income under Code Sec. 1411 to include rental income from a self-rental activity grouped with a trade or business activity in which the taxpayer materially participates.

The material participation and trade or business requirements should be tested on the grouped activity as a whole rather than on a component basis, one expert in particular stressed at the hearing. If that test is passed, he argued, the trade or business income and rental income from the grouped activity should be excluded from the reach of the NII Tax. For example, the owners of self-rental properties should not have that rent considered as separate from their overall business activity and subject to the net investment tax simply because properties are held in a separate LLC to avoid tort liability.

Regrouping deadline
The proposed regulations permit businesses subject to the NII Tax to elect to regroup their activities for passive-loss purposes in 2013 or 2014. This regrouping election allows taxpayers with a fresh start to accommodate the new NII surtax. Without permitting regroupings, taxpayers would be bound by their original grouping decisions, some of which may have been made as many as 20 years ago, only for purpose of Code Sec. 469 passive loss rules and not the NII Tax. Some small business representatives are also concerned that, because of the complexity of the rules, the final regulations should extend the deadline for a regrouping election through 2015.
Application of the net investment income tax is particularly difficult to get a handle on in a variety of situations. Unfortunately, however, at 3.8 percent, it is costly enough not to be ignored.

Updated Form 941, Employer's Quarterly Federal Tax Return

The IRS recently announced the availability of updated Form 941, Employer's Quarterly Federal Tax Return for 2013 and its instructions. Revised Form 941 and its instructions reflect the January 1, 2013 effective date of the 0.9 percent Additional Medicare Tax, expiration of the payroll tax holiday and other changes. In addition to imposing new obligations on employers, the Additional Medicare Tax presents under-withholding and over-withholding pitfalls for impacted employees.

The 0.9 Percent Additional Medicare Tax
The IRS reminded employers that the Additional Medicare Tax, enacted by the *Patient Protection and Affordable Care Act* (PPACA) applies effective January 1, 2013. The Additional Medicare Tax is imposed to the extent covered wages; compensation and/or self-employment income exceed threshold amounts ($200,000 for single individuals, $250,000 for married couples filing joint returns and $125,000 for married couples filing separately). Employers, however, must withhold Additional Medicare Tax from wages paid to an individual in excess of $200,000 in a calendar year, without regard to the individual employee's filing status or other wages/compensation.

It is up to the employee to make adjustments to account for any shortfall (if subject to the $125,000 threshold or if the combined wages of a married couple exceed $250,000) or overage (if subject to the $250,000 threshold). Employees cannot request additional withholding specifically for

Additional Medicare Tax but can request a change in overall income taxes withheld by their employer. Taxpayers anticipating they will owe Additional Medicare Tax, and who did not request additional income tax withholding, may need to make estimated tax payments.

The standard Medicare tax equals 1.45 percent of covered wages. The 1.45 percent employee-share of Medicare tax is matched by the employer. There is no employer match for the Additional Medicare Tax.

The IRS further explained that an employer must begin withholding the 0.9 percent Additional Medicare Tax in the pay period in which they pay wages in excess of $200,000 to an employee and continue to withhold it each pay period until the end of the calendar year. All wages that are subject to Medicare tax are subject to Additional Medicare Tax withholding if paid in excess of the $200,000 withholding threshold. The IRS has added line 5d, Taxable wages & tips subject to Additional Medicare Tax withholding, to Form 941.

Payroll Tax Holiday Ends
The IRS also has reminded taxpayers that the OASDI tax rate is 6.2 percent for both employers and employees for calendar year 2013. The payroll tax holiday, effective for calendar years 2011 and 2012, was not renewed by the *American Taxpayer Relief Act of 2012 (ATRA)* or other legislation and has expired. The Social Security wage base for calendar year 2013 is $113,700, up from $110,100 for calendar year 2012. The payroll tax holiday had reduced the employee-share of OASDI taxes from 6.2 percent to 4.2 percent (with a comparable benefit for self-employed individuals).

Record Retention Guide

Throughout the year, our clients ask us how long they should retain certain records. Below is a quick guide of some common documents and the suggested retention period.

Document	Suggested Retention Period
Alimony, Custody, or Prenuptial Agreements	Permanent
Annual Reports	Permanent
Articles of Incorporation	Permanent
Audit Reports	Permanent
Bank Reconciliations	7 Years
Bank Statements	7 Years
BOD Minute Book	Permanent
Canceled Checks	10 Years
Check Register	Permanent
Depreciation Schedules	Permanent
Financial Statements	Permanent
Forms 1099	7 Years
Forms W-2	Permanent
General Ledger	Permanent
Inventory Records	Permanent
Loan Records	7 Years
Inventory Records	Permanent
Medical Receipts	7 Years
Partnership Agreements	Permanent
Payroll Register	4 Years
Property Appraisals	Permanent
Retirement Statements	7 Years
Tax Returns	Permanent
Trust Agreements	Permanent

www.cpa.net/resources/retende.pdf

How Do I Get the Most From My Inherited IRA?

Individual Retirement Accounts (IRAs) are popular retirement savings vehicles that enable taxpayers to build their nest egg slowly over the years and enjoy tax benefits as well. But what happens to that nest egg when the IRA owner passes away?

The answer to that question depends on who inherits the IRA. Surviving spouses are subject to different rules than other beneficiaries. And if there are multiple beneficiaries (for example if the owner left the IRA assets to several children), the rules can be complicated.

Spouses
Upon the IRA owner's death, his (or her) surviving spouse may elect to treat the IRA account as his or her own. That means that the surviving spouse could name a beneficiary for the assets, continue to contribute to the IRA, and would also avoid having to take distributions. This might be a good option for surviving spouses who are not yet near retirement age and who wish to avoid the extra 10-percent tax on early distributions from an IRA.

A surviving spouse may also rollover the IRA funds into another plan, such as a qualified employer plan, qualified employee annuity plan (section 403(a) plan), or other deferred compensation plan and take distributions as a beneficiary. Distributions would be determined by the required minimum distribution (RMD) rules based on the surviving spouse's life expectancy.

In the alternative, a spouse could disclaim up to 100 percent of the IRA assets. Some surviving spouses might choose this latter option so that their children could inherit the IRA assets and/or to avoid extra taxable income.

Finally, the surviving spouse could take all of the IRA assets out in one lump-sum. However, lump-sum withdrawals (even from a Roth IRA) can subject a spouse to federal taxes if he or she does not carefully check and meet the requirements.

Non-spousal inherited IRAs
Different rules apply to an individual beneficiary, who is not a surviving spouse. First of all, the beneficiary may not elect to treat the IRA has his or her own. That means the beneficiary cannot continue to make contributions.

The beneficiary may, however, elect to take out the assets in a lump-sum cash distribution. However, this may subject the beneficiary to federal taxes that could take away a significant portion of the assets. Conversely, beneficiaries may also disclaim all or part of the assets in the IRA for up to nine months after the IRA owner's death.

The beneficiary may also take distributions from the account based on the beneficiary's age. If the beneficiary is older than the IRA owner, then the beneficiary may take distributions based on the IRA owner's age.

If there are multiple beneficiaries, the distribution amounts are based on the oldest beneficiary's age. Or, in the alternative, multiple beneficiaries can split the inherited IRA into separate accounts, and the RMD rules will apply separately to each separate account.

Did you know?

- Todd Sacco has been named a 2013 Five Star Wealth Manager in the Taxation category by *Pittsburgh Magazine*. This award is the result of an extensive survey of high-net worth families in the Pittsburgh area, and reflects Todd's dedication to providing high quality tax and financial advice to his clients. The Five Star Wealth Manager award is given to less than 7% of the financial planners, accountants, estate planning attorneys, investment advisors, and other professional financial advisors in the Pittsburgh area.

- You can find helpful financial tools on our website www.lallycpas.com/financial-calculator/

- This and past issues of *The Evergreen* are available on our website. www.lallycpas.com/newsletter

How Are LLCs Taxed?

An LLC (limited liability company) is not a federal tax entity. LLCs are organized under state law. LLCs are not specifically mentioned in the Tax Code, and there are no special IRS regulations governing the taxation of LLCs comparable to the regulations for C corporations, S corporations, and partnerships. Instead, LLCs make an election to be taxed as a particular entity (or to be disregarded for tax purposes) by following the check-the-box business entity classification regulations. The election is filed on Form 8832, Entity Classification Election. The IRS will assign an entity classification by default if no election is made. A taxpayer who accepts the IRS default entity classification does not need to file Form 8832.

"Check-the-Box" Election

An LLC with **only one member** can elect:

- Disregarded entity (Schedule C on the members Form 1040)
- C corporation
- S corporation (accomplished by electing to be taxed as a C corporation, then filing an S corporation election)

An LLC with **more than one member** can elect:

- Partnership
- C corporation
- S corporation (accomplished by electing to be taxed as a C corporation, then filing an S corporation election)

The IRS will assign these classifications **if no entity election is filed** for an LLC (the default rules):

- wholly-owned by a single person will be disregarded as an entity separate from its owner (taxed as a sole proprietorship on Schedule C)
- owned by two or more members is classified as a partnership

In Fond Memory of John M. Erdely
1960 - 2013

We started 2013 with heavy hearts as we mourned the loss of our good friend and colleague, John Erdely. On January 15, 2013, John lost a courageous three-year battle with melanoma cancer.

John was a 1982 graduate of Saint Vincent College. He started his career in public accounting where he passed the CPA exam. He then spent 10 + years working for privately-held businesses and the last eight years with us. He had loads of experience and the patience of Job when dealing with clients and fellow workers.

John was truly a nice person and will be greatly missed by all who had the opportunity to know him. John was 52 years old and is survived by his wife Jackie, daughters Alexandra and Victoria, and stepchildren Dillon and Elizabeth.

God bless John and his family.