September/October 2015

tax IMPACT

The PAL rules and estate planning
Can you reduce your trust's tax bill?

Pumping up
retirement contributions
Cash balance plans

The ins and outs of tax breaks
for getting to and from work

Tax Tips
Supreme Court decision, phone calls "from the IRS" and the accumulated earnings tax

Can you reduce your trust's tax bill?

Trusts can accomplish a variety of estate planning goals, including wealth distribution, asset protection, estate and gift tax reduction, and probate avoidance. But don't overlook their income tax treatment. By reducing a trust's income tax bill, you can preserve more wealth for your heirs.

Last year, in *Frank Aragona Trust v. Commissioner*, the U.S. Tax Court held that a trust can "materially participate" in a business for purposes of the passive activity loss (PAL) rules. The decision creates new tax-saving opportunities for many trusts.

A PAL primer

The PAL rules prohibit taxpayers from deducting losses generated by "passive" business activities from "nonpassive" income, such as wages, interest and dividends. Passive activities are those in which a taxpayer doesn't "materially participate." They include rental real estate activities, regardless of participation level, unless the taxpayer qualifies as a real estate professional. (See "'Real estate professional' defined" on page 3.) Taxpayers who aren't real estate professionals may deduct up to $25,000 in rental real estate losses from nonpassive income.

The word "material" — defined as "regular, continuous and substantial" — is somewhat subjective. But the tax rules include several objective "safe harbors" you can use to establish material participation. They include participating in an activity for more than 500 hours during a tax year, performing substantially all of the work involved in an activity, and participating in an activity for more than 100 hours and as much as or more than any other participant.

The ability of a trust to be a material participant in a business activity or to qualify as a real estate professional has significant income tax consequences. Nongrantor trusts are taxed at the highest marginal rate (currently, 39.6%) to the extent their income exceeds $12,300 (in 2015). They're also subject to the 3.8% net investment income tax (NIIT) to the extent their net investment income exceeds the same threshold.

If a trust materially participates in businesses it owns — and, in the case of rental real estate holdings, qualifies as a real estate professional — it can deduct losses generated by these activities from its nonpassive income, potentially reducing its income tax bill substantially. In addition, the trust's income from these activities is exempt from the NIIT, which doesn't apply to income from a nonpassive trade or business.

The Tax Court's ruling

In *Aragona*, the Tax Court rejected the IRS's argument that a trust can't materially participate in a business or qualify as a real estate professional. This case involved a trust that the

taxpayer established for the benefit of his five children. The taxpayer served as trustee, and after he died, was succeeded by six trustees: his five children plus one independent trustee.

The trust's assets included rental real estate properties. The trust managed most of its rental real estate through a wholly owned limited liability company (LLC). It also managed some of the properties directly or through majority-owned entities. Three of the children worked for the LLC full time.

The IRS disallowed the trust's deduction of its rental real estate losses from its nonpassive income, arguing that 1) trusts can't perform "personal services" or otherwise materially participate, and 2) even if they can, the trustees' activities as *employees of the LLC* didn't count toward the material participation thresholds.

The Tax Court disagreed, finding that the trust materially participated in the rental real estate businesses and qualified as a real estate professional by virtue of its trustees' activities — even though some of the trustees were employed by the LLC.

It's possible that the activities of a trust's *non-trustee* employees are sufficient to establish material participation or real estate professional status, but the court didn't address this issue. Also, the outcome might have been different had the trust owned minority rather than majority interests in its rental real estate businesses.

Review your estate plan

In light of the Tax Court's decision, it's a good idea to review your estate plan. If your plan includes trusts that own rental real estate or other passive business interests, determine whether your trusts materially participate in these businesses or qualify as real estate professionals based on the trustees' activities. If they don't, consider naming one or more trust employees as trustees to help ensure that the trust can deduct passive losses from its nonpassive income and minimize NIIT liability. ◎

"Real estate professional" defined

As noted in the main article, taxpayers who qualify as real estate professionals may fully deduct rental real estate losses from their nonpassive income. Real estate professionals are those who, during the year, spend more than half of their working hours, and at least 750 hours, on real estate businesses in which they materially participate. This doesn't include activities performed as an employee, unless the taxpayer owns at least 5% of the business.

Keep in mind that, even if a taxpayer qualifies as a real estate professional, it's still necessary to materially participate in a rental activity in order to deduct losses from nonpassive income. Taxpayers involved with multiple rental properties may elect to treat all of these properties as a single activity in order to satisfy the material participation requirements.

Pumping up retirement contributions

Cash balance plans

With individual income tax rates at their highest levels in years, maximizing contributions to tax-deferred retirement vehicles is an important strategy. For business owners who got a late start saving for retirement, a cash balance plan can help turbocharge their contributions while they enjoy substantial current tax deductions.

Defined contribution vs. defined benefit plans

Today, defined contribution plans — such as 401(k) and profit sharing plans — remain the most popular tax-advantaged retirement plans for businesses. But one disadvantage of these plans, particularly for highly paid business owners approaching retirement, is their relatively low contribution limits. For 2015, the combined limit on employer contributions and employee deferrals is $53,000 ($59,000 for employees age 50 or older).

Defined benefit plans, including traditional pension plans, aren't subject to these contribution limits. Rather, there's a cap on the annual payouts that an employee may receive during retirement (currently, $210,000). These plans enable a business to make substantial contributions on behalf of older owner-employees — often three or four times as much as defined contribution plans.

The contribution amount depends on several factors, including an owner-employee's age and the number of years until retirement. Generally, employees must also be included in the plan if they work enough hours and meet other qualification requirements. But contributions on behalf of younger employees, who have more time until retirement, are significantly lower than those for older owner-employees. This discrepancy in contribution levels doesn't violate nondiscrimination requirements, so long as contributions are designed to generate comparable benefits at retirement.

Typically, business owners fund their retirement contributions by accepting lower salaries. If contributions are large, this can substantially reduce their current tax bills.

Cash balance plans: The best of both worlds?

A cash balance plan is a defined benefit plan that enables business owners to significantly boost their retirement contributions while still enjoying many of the advantages of defined contribution plans.

Traditional pension benefits are calculated based on years of service and the final level of compensation. As a result, they tend to be

heavily "back-loaded" — that is, the bulk of these benefits are earned in an employee's last years before retirement. This makes it more difficult to estimate benefit payouts with any certainty, especially for younger employees.

Typically, business owners fund their retirement contributions by accepting lower salaries. If contributions are large, this can substantially reduce their current tax bills.

Cash balance plans, on the other hand, determine benefits by allocating annual pay credits and interest credits to hypothetical accounts, similar to 401(k) plan accounts (although plan assets are held in one pooled account). Pay credits are based on a percentage of compensation or a fixed dollar amount. Interest credits are typically based on a conservative fixed rate or on an indexed rate, such as the 30-year Treasury rate.

This approach offers several advantages. For example, benefits are earned more uniformly over an employee's career, and the ability to check one's account "balance" provides greater certainty over benefit payouts. Also, unlike traditional pension plans, cash balance plan benefits are "portable." That is, an employee (or owner-employee) who leaves the company before reaching retirement age can take his or her benefits as a lump sum and roll it over into an IRA or another employer's plan.

A balanced approach

For business owners who are behind on their retirement contributions, a cash balance plan can be a powerful tool for accelerating retirement savings while also reducing current tax liability. It can be used alone, or as a supplement to a 401(k) or profit-sharing plan. ◎

The ins and outs of tax breaks for getting to and from work

As you're probably already aware, you generally can't deduct costs related to commuting between home and work. The IRS considers commuting to be a nondeductible "personal expense" instead. But there are some instances when commuting costs are considered deductible "transportation" expenses. And you might be eligible for tax-advantaged transportation fringe benefit programs through your employer. Let's take a closer look at tax breaks that are available related to getting to and from work.

Deducting the expense between work and home

IRS Revenue Ruling 99-7 allows you to deduct the expense of traveling between your home and a work location under certain circumstances. One is if you travel between your home and a temporary work location that's outside your metropolitan area. The IRS recognizes that it would be unreasonable to expect a worker to relocate his or her principal residence for just a short-term job.

Another instance when you can deduct what might seem like a commuting expense is if you travel between your home and a temporary work location — regardless of distance — and you have one or more regular work locations away from your home. This exception might apply if, for example, you're a consultant who sometimes travels directly from your home to a client's worksite.

Qualified transportation fringe benefit programs offer tax benefits for both employers and employees.

Still another instance when commuting-like costs may be deductible is if you travel between your home and a temporary or regular work location, but your home qualifies as your principal place of business. For example, perhaps you work out of your home and travel to a client's temporary worksite, while also renting conference space away from home (a regular location).

Indefinite job assignments

A key consideration for the first two exceptions is the meaning of "temporary work location." Notably, a job assignment of *indefinite* duration isn't considered temporary.

According to IRS Revenue Ruling 99-7, absent facts and circumstances that indicate otherwise, a worksite is temporary if employment there "is realistically expected to last (and does in fact last) for one year or less." However, if a job is initially expected to last one year or less but that expectation changes during the course of the job, it's treated as temporary only until the date it becomes evident that the job will last more than one year.

Other transportation benefits

Qualified transportation fringe benefit programs offer tax benefits for both employers and employees. Employers that provide workers with transit passes, vanpool services or parking at or near the office or a mass-transit facility can deduct the expense while excluding the benefits from employees' wages (subject to the limits discussed below). Or the programs can simply allow employees to pay these costs with pretax dollars.

Qualified parking benefits can be provided in the form of a noncash benefit (such as the free use of a pay parking lot) or a cash reimbursement of up to $250 per month for 2015. A cash reimbursement also can be provided for vanpool services or mass transit (or a combination of the two), but unless Congress extends transit benefit parity for 2015 (contact your tax advisor for the latest information), the limit is only $130 per month this year. These same limits apply when your employer pays these costs with pretax dollars.

You're eligible to take advantage of both the parking and mass-transit/vanpool benefits, which would be applicable if, for instance, you had to pay to park at a commuter train station and also had to pay for the cost of taking the commuter train. If you don't participate in either of the benefits and use your bicycle to commute, you may be eligible for a $20 monthly benefit.

Bottom line

As you know, every little bit of savings can help. So work with your tax advisor to ensure you're taking advantage of all the transportation-related tax breaks you're eligible for. Moreover, your advisor can help you make sure you comply with any additional rules and restrictions that might apply. ◎

tax TIPS

Supreme Court decision may open door for refund claims

If you earn income in multiple states, a recent U.S. Supreme Court decision may provide an opportunity for a tax refund. *Comptroller of the Treasury of Maryland v. Wynne* involved Maryland taxpayers who owned stock in an S corporation that did business in several states and, therefore, paid taxes on income apportioned to those states.

Like most states, Maryland offered its residents a tax credit for taxes paid to other states. But it allowed the credit to offset only the state portion, *not* the county portion, of its income tax. The Supreme Court found this unconstitutional.

If you live in a state with a similar income tax regime, consider filing a protective refund claim for open tax years to preserve your right to a refund in the event that *Wynne* is applied in your state. ◎

Watch out for phone calls "from the IRS"

If you receive a phone call from someone claiming to be with the IRS, be very skeptical. The IRS has warned taxpayers of an aggressive, sophisticated phone scam. Callers sound convincing, know a lot about their victims, and often provide fake IRS identification badge numbers. They may even alter the caller ID so it looks like the call is coming from the IRS.

The scammers tell victims that they owe money to the IRS and demand prompt payment through a wire transfer or preloaded debit card. If victims don't cooperate, the scammers threaten arrest, deportation or suspension of a business or driver's license.

Always keep in mind that the IRS will never call you about a tax bill without first communicating by mail, will never demand immediate payment without an opportunity to ask questions or file an appeal, and will never require you to use a specific payment method. And the IRS will never ask you for credit or debit card numbers over the phone or threaten you with arrest. ◎

Beware of the accumulated earnings tax

Ever since the 2008 financial crisis, many businesses have held higher levels of cash to cushion the blow of future economic downturns. But if your business is structured as a C corporation, watch out for the accumulated earnings tax. This 20% penalty applies to corporations the IRS perceives to be retaining unreasonably high levels of earnings in order to avoid or defer taxes on dividends paid to shareholders.

There's no bright-line test for determining whether accumulated earnings are reasonable, so it's important to establish and document the company's reasonable need to retain earnings for working capital, business expansion, equipment purchases or other purposes. ◎

This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting or other professional advice or opinions on specific facts or matters, and, accordingly, assume no liability whatsoever in connection with its use. ©2015 TXIso15