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MARCH 2016 NEWSLETTER

501 WEST BROADWAY, SUITE 700
SAN DIEGO, CALIFORNIA 92101-3563
TELEPHONE: (619) 239-7777
FAX NUMBER: (619) 238-8808

IN THIS ISSUE

TAX LEGISLATION TO WATCH FOR IN 2016

by DeEtte L. Loeffler, J.D., L.LM, Taxation

Usually, very few changes to the tax law happen in an election year. This year may be an exception to that rule, at least with regard to federal taxes on businesses engaged in the international arena.

For the last two years, Congress has looked at the issue of large US corporations leaving the US tax structure by moving their operations off shore ("inversions"). These moves include not only manufacturers, which have been leaving for many years now, but also headquarters for big corporations. Countries like Ireland, with its extremely low corporate tax rate of 12.5% for active business income (and 25% for passive income), are extremely tempting for US corporations subject to tax at 39.1% (although the effective US tax rate varies by industry from 26-39.1%).

According to House Ways and Means Committee Chairman Kevin Brady (R-TX), members of both parties agree there is a need for international tax reform, and it should be possible to adopt reforms this year which do not include controversial changes in tax rates. Major reforms that could be adopted this year include the adoption of a territorial tax for businesses to replace the world-wide tax, adopting laws to discourage further inversions by US companies, incentives for high-tech companies to develop their products in the US, and a one-time tax on accumulated foreign profits (which would effectively end the incentive of US companies to continue retaining their foreign profits off shore). The one-time tax has strong support from both major parties, although there is little agreement on how the tax proceeds should be spent.

The first bill to address this issue was introduced on February 23, 2016 by Sander Levin (D-MI), ranking member of the House Ways and Means Committee. This bill, appropriately named the "Stop Corporate Earnings Stripping Act of 2016," would reduce inversions by limiting the ability of companies to strip earnings out of US companies, and by reducing or denying expense carry forwards.

Tax reform in other areas is unlikely in 2016, given the election and significant differences of opinion over whom and what should be taxed and where tax revenues should be spent (for credits, infrastructure repairs, etc.). However, the Treasury Department released the 2017 Green Book on February 9th, setting forth the Administration's tax agenda. Of these proposals, the following agenda items are worth noting:

- Further Limit Itemized Deductions. High-income taxpayers in the 33%, 35% and 39.6% tax brackets would be permitted only limited deductions instead of exclusions from income for such things as income on state and local tax-exempt bonds, employer sponsored health insurance plans (and pre-tax plans paid by employees), health insurance costs (for self-employed individuals), contributions to retirement plans and IRAs, interest on education loans, contributions to health savings accounts and Archer MSAs, moving expenses, domestic production income, and certain trade or business deductions for employees. Tax would be imposed on such income at 28%.

- Capital Gains Tax Imposed on Gifts and at Death. This change would sharply limit the popular basis step-up rule. The top capital gains tax rate would increase from 20% plus the 3.8% net investment income tax ("NIIT"), to 24.2% plus the NIIT, resulting in a top rate of 28%. Exceptions would be permitted for tangible personal property other than collectibles, up to $250,000 for each residence (not just a primary residence) portable to the surviving spouse (for a maximum combined total of $500,000), and $100,000, indexed for inflation, for all other capital gains. The tax would be postponed for small family owned businesses and would not apply to small business stock.

- Fair Share Tax Imposed. The imposition of a new minimum tax would replace the Alternative Minimum Tax (AMT) for high income taxpayers, starting at adjusted gross income (AGI) of $500,000 for married couples filing separately. The tax would be imposed fully at AGI of $1 million for married couples filing separately and at $2 million for those filing jointly. The tax would be 30% of AGI, with a credit for charitable contributions equal to 28% of donations. The AMT would continue to apply to other taxpayers.

- Expand New Basis Reporting Requirements to Gifts. As of January 2016, Basis Reporting is required for transfers from an estate if an estate tax return is filed. This change would apply to lifetime gifts if a gift tax return is required to be filed. Currently, an IRS Form 8971 must be filed by the executor 30 days after an estate tax return is filed.

Further, some tax proposals which have returned this year include:

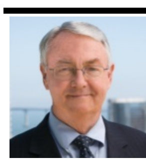
- Reducing the Basic Exclusion Amount for estates and gifts from $5 million (indexed for inflation) to $3.5 million (not indexed for inflation), imposing a 45% tax rate, and eliminating Portability of the exclusion (grandfathered estates would retain a more limited benefit);

- Placing limits on the term of Grantor Retained Annuity Trusts (GRATs), requiring a minimum ten-year term and a maximum term of the grantor's life expectancy plus ten (10) years;

- Limiting the maximum duration of Generation-Skipping Transfer (GST) trusts to 90 years, which would mostly impact trusts in states which have eliminated the Rule Against Perpetuities (such as Delaware, Alaska and Nevada); and

- Limiting to $50,000 per donor the value of all annual gifts (currently the limit is $14,000 per donee) that can be made using trusts or certain types of property, including interests in pass through entities (such as partnerships and LLCs), and interests the donee cannot immediately liquidate.

We will continue to watch these developments in 2016 and will let you know of any significant changes that may affect you or your business.



THE SEPARATE ACCOUNT RULE: HOW IT AFFECTS IRAS

by Bradford N. Dewan, J.D., MBA

Many questions are raised by clients and advisors regarding the distribution rules and issues that arise after an IRA owner's death. One of the questions most frequently asked is how the required minimum distribution ("RMD") amount is determined for each beneficiary when there is more than one primary beneficiary of the IRA.

If an IRA is inherited by more than one beneficiary, the general rule is that the RMDs may be stretched out over a period no longer than the single life expectancy of the oldest beneficiary. However, if certain requirements are met, each beneficiary may be allowed to receive his or her share of the IRA funds over his or her own single life expectancy. However, to do so, the decedent's IRA would have to be split into a separate inherited IRA for each beneficiary.

For example: Charles dies at age 55. His brother, Terry (age 60) and his niece, Betty (age 25) are co-primary beneficiaries of Charles' IRA. Terry and Betty may each choose to receive his or her share of the IRA funds by the end of the fifth year following the year Charles died, or they each may choose to stretch his or her share of the IRA funds over a life expectancy. However, to satisfy the "life expectancy rule," distributions must commence on or before the end of the calendar year immediately following the calendar year in which the IRA owner died. Then, applying the general rule for calculating the life expectancy payments, the RMDs for both of the beneficiaries, Terry and Betty, would be based solely on Terry's single life expectancy since he is the elder of the two beneficiaries.

However, if the IRA is split into separate inherited IRA accounts for Terry and Betty by the end of the calendar year after the calendar year in which the IRA owner died, the RMDs for Terry's inherited IRA will be based on Terry's single life expectancy and the RMDs for Betty's inherited IRA will be based on Betty's single life expectancy. This will result in obtaining the maximum stretch-out benefits for Betty. Under the Single Life Table, Terry's life expectancy is 25.2 years, but under this table, Betty's life expectancy is 58.2 years. Consequently, Betty will have the opportunity to realize tax deferred growth of the investments in her inherited IRA for thirty-three (33) more years than if she had to use Terry's single life expectancy.

Thus, to use each beneficiary's single life expectancy to determine the RMDs for his or her respective share, separate inherited IRAs must be established (and RMDs taken) by December 31 of the year following the year of the IRA owner's death. For example, if Charles, from the previous example, died in 2014, and the IRA was transferred to a single inherited IRA by December 31, 2015, the RMD amounts for both Terry's share and Betty's share (to be distributed by December 31, 2015) would be based on Terry's single life expectancy, because Terry is the beneficiary with the shorter life expectancy. But if both Terry and Betty formed and funded their respective inherited IRA by December 31, 2015 (and received their respective RMD by December 31, 2015), then Terry and, most importantly, Betty, would each be able to calculate his or her respective RMDs for 2015, and each succeeding year, based on his or her own life expectancy.

In conclusion, being aware and taking advantage of the "separate account rule" can result in the youngest IRA beneficiary realizing a significant financial benefit by being able to apply his or her own longer life expectancy, rather than that of the oldest beneficiary, in calculating the RMDs.

FEDERAL TAX NEWS

by DeEtte L. Loeffler, J.D., LL.M. Taxation

<u>2016 Tax Reform</u>. As promised, the House Ways and Means Committee has begun hearings on international tax reform, focusing on ways to slow or reverse inversions by US companies which are relocating off shore to obtain lower tax rates. Other tax reform options will be studied but are not expected to be brought to the House for discussion in 2016, given opposition by the White House. Meanwhile, Senator Orin Hatch, chairman of the Senate Finance Committee, has indicated he thinks international tax reform is too ambitious for 2016. He is in the process of proposing new

lower tax rates for US companies to draw them back to the United States.

Further complicating the current negotiations, the Treasury department has issued a letter to the European Union protesting its continuing investigations into whether special tax rate deals negotiated by several large US companies operating in the EU violate European law. If such findings are made, these US companies may be subject to significant retroactive taxes in Europe, which would reduce the amount of money that could be taxed by the US under the one-time repatriation tax currently favored by both major US parties. In addition, Doug Oberhelman, chairman of the Business Roundtable, has indicated that a "piecemeal" approach to tax reforms will be unacceptable to the US business community.

<u>IRS Dirty Dozen Published</u>. The IRS published its annual list of the dirty dozen tax scams for 2016. This list should not be surprising to anyone living in a digital world. It includes identity theft, phone and internet scams to get personal information or cash payments, and fake charities seeking money. According to the IRS, scams are up 400% in 2016. Taxpayers are encouraged to verify the identity of anyone seeking money from them or threatening criminal action if they do not make an immediate payment. The Dirty Dozen also includes such favorites as schemes to hide income or assets off shore, inflated claims for business expenses, inflated refund claims, tax preparer fraud, falsifying income or deductions to claim credits or reduce taxable income, abusive tax shelters, and tax protesters (those who claim the income tax itself is illegal). We recommend you hire a qualified CPA or enrolled agent to assist you with preparing your returns.

STATE TAX NEWS

by DeEtte L. Loeffler, J.D., LL.M. Taxation

<u>Local Sales Tax Rates Remain Unchanged</u>. The State Board of Equalization has released city and county sales and use tax rates which will go into effect on April 1, 2016. There are no changes to tax rates for local cities, which remain at 8.0% for most of San Diego County, with the exception of Vista and El Cajon (8.50%), La Mesa (8.75%), and National City (9.00%).

<u>Is the Proposed Professional Services Tax Dead?</u> The bill to impose a state tax on professional services (such as legal fees) failed to garner sufficient support in 2015 and has not yet been reintroduced in 2016. However, Senator Bob Hertzberg (D.), who introduced the bill in 2015, is undeterred and has suggested a possible ballot measure on the issue.

<u>Marijuana Tax Increase</u>. Under the proposed Marijuana Value Tax Act (<u>SB 987</u>), the tax on medical marijuana would increase to 15%. The authors estimate the change will result in increased revenues of over $100 million. The increased revenues would be used in part to implement 2015 regulations adopted by the legislature. Under the proposed bill, 30% of the funds would be diverted to the General Fund rather than spent on marijuana related matters.

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