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Should Your Company Join the Roth 401(k) Trend?

Roth 401(k) plans have been around for awhile but they have not caught on with the majority of employers or employees. However, the tide may be turning as Uncle Sam recently began making a Roth retirement plan available to civilian federal employees and members of the uniformed services. Is a Roth 401(k) a good option for your employees? This article gives a rundown of the plans.

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It's Still a Good Time for Roth IRA Conversions

You may think that the optimum time for Roth IRA conversions has passed. But for several reasons, it's *still* a great time to convert. That way, you can take tax-free withdrawals during retirement, provided you satisfy the requirements. This article explains the factors you need to assess in order to decide whether to convert a traditional IRA to a Roth account.

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Business Values and the 'Baby Boomer Effect'

If you own a business and want to sell it in the next 10 to 15 years, you need to plan ahead for the Baby Boomer Effect. Among the millions of people approaching retirement, or leaving the workforce, are Baby Boomer business owners who want to sell. With all of these businesses hitting the market, supply could exceed demand and values could be driven down. This article has five steps for owners to consider.

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IRS Issues Guidance for Healthcare FSAs

On January 1, 2013, the limit on contributions to healthcare flexible spending accounts (FSAs) is scheduled to become $2,500. It is important for employees to know about the new limit in order to decide whether to participate in their employers' FSAs next year. The IRS recently issued guidance on the $2,500 cap, which is explained in this article.

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IRS Issues New Proposed Regs on Passive Activity Losses

The tax rules for passive activity losses aren't overly friendly towards taxpayers. The rules may limit your ability to currently deduct losses sustained from certain activities. However, the IRS recently released taxpayer-friendly proposed regulations that may improve the situation for limited partners and LLC members. Here is a rundown of the proposed regulations, along with information about the passive


activity loss rules.

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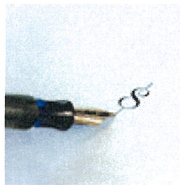
Court: IRS Can Reclassify S Corp Distributions as Wages



If you run your business as an S corporation, you know that it can reduce the amount of employment taxes paid over the years on your behalf. While S corp status can be an effective strategy, you should be aware of a recent court decision that ruled the IRS can reclassify distributions from the entity as wages subject to federal employment taxes. This article explains the tax rules, along with the details of the new case.

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It's hard to beat the Internet as a tool for sales and marketing, but you can't take full advantage of it until you build a database of e-mail addresses. Many businesses have their customers' home addresses but they still don't have e-mail addresses. Click "Full Article" for 10 pointers on how to keep your contact list up to date and under control.

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The Six Stages of World Class Customer Service

When it comes to customer satisfaction, it's sink or swim. Customers want service and they want it now. In addition, they will compare your service to what they get from the competition. To help come out ahead, here are the six stages of a more customer-friendly company.

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Should Your Company Join the Roth 401(k) Trend?

The Roth 401(k) plan -- a combination of popular 401(k) accounts for employees and the Roth IRA concept for individuals -- has been relatively slow to catch on in the workplace. But the federal government recently announced that it is offering this hybrid retirement savings option to its 3.3 million U.S. government workers.*

If it's good enough for Uncle Sam, does the setup make sense for your business operation? It may be time to take a closer look.

A recent survey indicates that 39 percent of employers with retirement plans offer a Roth 401(k) option, with 29 percent more likely to add it this year. Approximately 6 percent of the eligible workers are taking advantage of this feature.

Surprisingly, the Roth 401(k) has been around for awhile. It was initially authorized by the *Economic Growth and Tax Relief Reconciliation Act of 2001* (EGTRRA), but didn't officially become available until 2006. Under EGTRRA, this provision was scheduled to expire after 2010, but it was made permanent and enhanced by subsequent legislation. The IRS has also issued regulations governing its use. Most of the usual nondiscrimination requirements for regular 401(k) plans also apply to Roth 401(k)s.

The plan works pretty much like the name implies. As with a regular 401(k) plan, an eligible employee can elect to defer part of his or her salary to a separate account, subject to the generous annual limits in the law. The company may also provide matching contributions based on a percentage of salary.

For 2012, a participating employee can contribute up to $17,000 in elective deferrals, increased to $22,500 for someone age 50 or over. In comparison, contributions to a Roth IRA established outside the

Differences and Similarities

	**Roth 401(k)**	**401(k) Plan**	**Roth IRA**
Contributions made with	After-tax dollars	Pre-tax dollars	After-tax dollars
Withdrawals	If qualified, free from federal and possibly state tax	Taxed	If qualified, free from federal and possibly state tax
Contribution limits in 2012	Up to $17,000 ($22,500 for those age 50 or older at year-end)	Up to $17,000 ($22,500 for those age 50 or older at year-end)	Up to $5,000 ($6,000 for those age 50 or older at year-end)
Withdrawal requirements under the minimum distribution rules	Must start taking at age 70 1/2	Generally must start taking at age 70 1/2	None -- can leave account untouched and pass on to heirs.
Income limits	None to participate	None to participate	Cannot contribute if income is above certain limits (2012 phaseout begins at $173,000 AGI for married filing jointly and $110,000 for

workplace are limited to $5,000 in 2012; $6,000 for those age 50 or over. Also, the ability to contribute to a Roth IRA is phased out for high-income taxpayers.

			single and household head.

For 2012, the phase-out begins at $110,000 of modified adjusted gross income (MAGI); $173,000 of MAGI for joint filers.

But here's where the Roth 401(k) takes a marked departure from regular 401(k)s. The contributions to the employee's account are made with *after-tax dollars* rather than *pre-tax dollars*. Thus, an employee loses a key current tax benefit of 401(k)s.

On the plus side, when an employee withdraws funds from the account, "qualified distributions" are completely exempt from income tax, just like qualified distributions from a Roth IRA. In contrast, regular 401(k) distributions are taxed at ordinary income rates, which are scheduled to increase in 2013. The top tax rate on ordinary income in 2012 is 35 percent, slated to go up to 39.6 percent next year.

For this purpose, "qualified distributions" include distributions that are:

- Made after the participant has reached age 59 1/2;
- Paid on account of death or disability; or
- Used to pay for "first-time homebuyer expenses" (up to a lifetime limit of $10,000).

In other words, there's a trade-off. A participant in a Roth 401(k) gives up the ability to contribute to the account on a pre-tax basis in return for the lure of receiving tax-free payments in the future. For many workers, it's a good deal, especially if you are restricted from making Roth IRA contributions due to the annual income limits.

Of course, every situation is different. An employee must consider all the relevant factors, including his or her current and anticipated tax rates in retirement and the desire for current tax breaks. Switching from a traditional 401(k) plan to a Roth 401(k) means a cut in take-home pay.

Finally, under a tax law change, 401(k) participants can roll over pre-tax balances to a Roth account, effective as of September 27, 2010. This generally consists of the balance in a 401(k) account with elective deferrals, matching contributions and earnings. The rollover is taxable except to the extent it represents any after-tax contributions.

Is the Roth 401(k) option a good fit for you and your company? Consult with your tax and employee benefits advisers for more information.

*The "Roth TSP" (Thrift Savings Plan) is the equivalent of a Roth 401(k) for private sector employees, and is now available to federal civilian employees and members of the uniformed services.

It's Still a Good Time for Roth IRA Conversions

There was a time when 2010 was considered the year of perfect storm conditions for converting traditional IRAs (including SEP-IRAs and SIMPLE-IRAs) into Roth accounts. Previous income restrictions on Roth conversions were removed (even billionaires can convert under the current rules). On top of that, income triggered by conversions was taxed at relatively low rates that are still in effect for the rest of this year.

In 2012, the income restrictions are still removed and relatively low tax rates are still in effect. However, tax rates are scheduled to increase in 2013 unless Congress acts. So in 2012, we may once again be looking at perfect storm conditions for Roth conversions.

Here's what you need to know to assess the idea of converting before the end of this year.

Roth Conversion Basics

A Roth conversion is treated as a taxable distribution from your traditional IRA, because you're deemed to receive a taxable payout from your traditional account with the money then going into your new Roth account. So a conversion before year end will trigger a bigger federal income tax bill for this year (and maybe a bigger state income tax bill too).

However, three positive factors may outweigh the extra 2012 tax hit:

- Today's federal income tax rates are relatively low because the "Bush tax cuts" will remain in effect through December 31, 2012. However the tax cuts expire at year end, and rates will automatically increase for 2013 and beyond unless a new law is passed to extend them.

  So if you convert before year end, you are assured of paying today's relatively low rates on the extra income triggered by the conversion and you will completely avoid the risk of higher future tax rates on all post-conversion income that piles up in your new Roth account. That's because qualified Roth withdrawals are totally federal-income-tax-free. (In general, you can take qualified withdrawals after you've had at least one

Factors to Consider When Evaluating the Roth Conversion Strategy

While the Roth conversion strategy may be a good idea for you, there are several variables to consider before deciding to go forward. For instance, you should factor in:

- Expectations about future rates of return on your Roth IRA investments;
- Expectations about future tax rates;
- Expectations about whether -- and when -- you might need to withdraw money to pay for retirement; and
- Where you will get the cash to pay the conversion tax bill.

This is not necessarily a complete list of factors. Talk with your adviser about the Roth conversion opportunity, but don't wait until the last minute in 2012 to have the conversation.

Roth IRA open for over five years and reached age 59 1/2.)

- If you convert *this* year, you don't have to worry about the extra income from converting causing you to be hit with the new 3.8 percent Medicare surtax on investment income, which will take effect *next* year. While the extra income from a conversion next year would not itself count as investment income for purposes of the 3.8 percent surtax, it *would* raise next year's modified adjusted gross income (MAGI). Higher 2013 MAGI could, in turn, cause some or all of next year's investment income to be hit with the surtax, especially if you convert a traditional IRA with a big balance.

  In other words, while not everyone who converts in 2013 will be exposed to the surtax, *nobody* who converts this year will be exposed.)

- Roth IRAs are exempt from the required minimum distribution rules that require you to start taking withdrawals from traditional IRAs after you reach age 70 1/2 or pay a stiff penalty. So you can leave your Roth balance untouched for as long as you live and continue earning federal-income-tax-free money for as long as you live.

Don't Forget the 2012 Impact of 2010 Conversions

If you did a Roth conversion back in 2010 and chose to spread the resulting extra taxable income 50/50 over your 2011 and 2012 tax years (as allowed under the law), you already have some conversion income that must be reported on your 2012 return.

Therefore, if you do another conversion this year, you will have two layers of extra income to report on this year's return (from the 2010 conversion and from this year's conversion). Don't forget to take both layers into account when estimating the extra tax bill that would result from a 2012 conversion.

Consult with your tax adviser for help with running the numbers.

Roth Conversion Details

If you have several traditional IRAs, converting doesn't have to be an all-or-nothing proposition. You can convert some accounts and leave others alone. Similarly, you can convert only a proportion of the balances in one or more traditional IRAs.

If you've made some non-deductible traditional IRA contributions over the years, and then convert some of your traditional IRA balances to Roth status, the deemed distribution that takes place when you convert will be partly taxable and partly tax-free. The taxable and tax-free amounts will be based on the combined value of all your traditional IRAs (including any SEP-IRAs or SIMPLE-IRAs) on the conversion date and the combined amount of nondeductible contributions to all those accounts. So the taxable part and the nontaxable part of the deemed distribution will be the same regardless of which account you actually convert.

Example: You have two traditional IRAs worth $50,000 each. The $50,000 balance in IRA No. 1 is solely from deductible contributions and earnings. The $50,000 balance in IRA No. 2 consists of $15,000 of nondeductible contributions and $35,000 of deductible contributions and earnings. If you convert IRA No. 1 to Roth status, the resulting $50,000 deemed distribution will be 15 percent tax-free ($15,000/$100,000 equals .15) and 85 percent taxable ($85,000/$100,000 equals .85). If instead, you convert IRA No. 2, the results will be exactly the same.

Ill-Fated Conversions Can Be Reversed

Another nice thing about the Roth conversion strategy is you are allowed to change your mind well after the fact. Specifically, you have until October 15, 2013 to recharacterize (unwind) a 2012 conversion.

Example: You decide to convert a traditional IRA into Roth account this year. By the middle of 2013, the value of the converted account has plummeted due to poor investment performance.

In this bleak scenario, you would have to pay 2012 income tax on value that later disappeared. Bad idea! Thankfully, you have until October 15, 2013 to recharacterize the converted account back to traditional IRA status. After the recharacterization, it's as if the ill-fated conversion never happened. So you won't owe any income tax from the 2012 conversion that you later reversed.

Consider Splitting Up Large Accounts Before Converting

If you have a large-balance traditional IRA that you intend to convert into a Roth account this year, consider splitting it up into several smaller traditional IRAs. Then convert them into separate Roth accounts and follow different investment strategies for each one. If one of the new Roth accounts plummets in value next year due to poor investment performance, you can avoid an inflated 2012 conversion tax hit by recharacterizing that account back to traditional IRA status by October 15, 2013 (as explained immediately above). You can leave the better-performing accounts in Roth IRA status.

Today's Roth Equation

Relatively low current tax cost for converting plus the chance to avoid higher tax rates scheduled for 2013 and beyond on income that will accumulate in your Roth account equals another perfect storm for a Roth conversion strategy in 2012. Nevertheless, consult with your tax adviser before making a conversion move. With the complexity of taxes today, no-brainers are few and far between, and you want to make sure all the relevant variables are considered.

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Business Values and the 'Baby Boomer Effect'

It has been estimated that in the next five years or so, more than $5 trillion in value of small businesses will be changing hands. In the next 10 to 15 years, the estimate rises to $14 trillion. The main reason driving this is, of course, the aging of the Baby Boomer population in the United States.

As the Boomers hit their mid-sixties and beyond, they will begin retiring in droves. Many will want to transfer their businesses to family members while others will want to sell and use the funds to finance their retirement years.

The owners of those businesses want to maximize their value (if they are going to sell) or find the most cost efficient method of transferring the entities to their heirs. Either way, the value of a business being transferred is an important element for the owners to consider.

The recession that began in 2008, and the continuing malaise felt in some parts of the country, have certainly acted to reduce the value of many of these businesses. The lingering effects might also act to reduce values in the long-term. Additionally, the effect on the value of small companies when trillions of dollars worth of businesses hit the market in the next five to fifteen years is unknown.

One could speculate, as in other situations, supply will exceed demand and drive values even lower. The sheer number of businesses for sale and a diminished number of buyers could certainly lead to this conclusion.

Replacing the Aging Workforce

It's not just business owners who are going to feel a Baby Boomer effect. Employers at businesses, not-for-profit organizations and government agencies must plan to replace a large percentage of employees who are approaching retirement -- including managers and skilled workers.

The demographics of the aging workforce are illustrated in the chart below, which was released by the Bureau of Labor Statistics.

For example, in 1990, only 2.3 percent of the workforce was age 65 to 74. By the year 2020, it is projected that 6.1 percent of the workforce will be that age. *Note:* These are only people still working and does not reflect those who retired. Recent studies show that nearly half of 65-year-old Boomers have already fully retired.

Age	1990	2000	2010	2020* projected
35-44	25.5%	26.3%	21.7%	21.4%
45-54	16.1%	21.8%	23.4%	20.1%
55-64	9.2%	10.1%	15.1%	17.8%
65-74	2.3%	2.5%	3.5%	6.1%
75-up	0.4%	0.6%	0.8%	1.3%

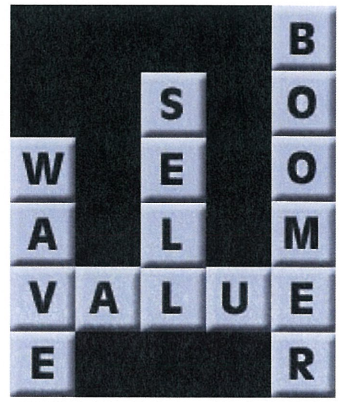
Given both the state of the economy and the eventual flood to the market from the Baby Boomer Effect, here are five steps for business owners to consider:

1. Monitor your business value on a regular basis, probably annually. It is also important for business owners to manage their operations for value. That means instituting management programs and taking actions that will maximize the business value.

2. Even if the business is going to be gifted to the next generation, it's important to maintain and increase the value so that the children and grandchildren inherit a strong operation they can improve upon further. With proper planning, a business can transfer the ownership to the next generation in a tax effective manner. Your CPA tax and valuation professionals can help to attain the best results.

3. When gifting interests to heirs, carefully consider the manner in which you are doing so. For example, if you have more than one child involved in the business, you need to be clear about the responsibilities each active individual will play when the next generation begins to run the operations. It is also responsible to clearly delineate which person ultimately is in control (and back it up with ownership and/or agreements). The last thing you want is a family deadlock somewhere in the future.

4. If you have some children active in the business and others who are not involved, it is wise to consider giving ownership in the business only to those active and taking care of the non-active children with other assets from your estate. If that is not possible, then you should consider devising some arrangement that will insure that the actively involved children are not hamstrung in operating the business and the non-active children will not be shut out of the benefits of future earnings of the business.



5. If you are planning to sell your business, put together the right team to help you. To be effective, it truly does take a team, made up of key members of your management, legal counsel, your CPA, and valuation analyst, and possibly a financial adviser if one is already in place. Some sellers also include family members, friends, and/or business associates to insure that they receive trustworthy advice. However, a note of caution on these latter potential team members. They can sometimes be detrimental to the process, if for example, they are given too much authority relative to their experience and competency.

There is no doubt that the Baby Boomer effect exists and it could have an impact on the exit strategy from your business. Your CPA, attorney and Valuation Analyst can be helpful in guiding you through this important transition not only in your business -- but in your life.

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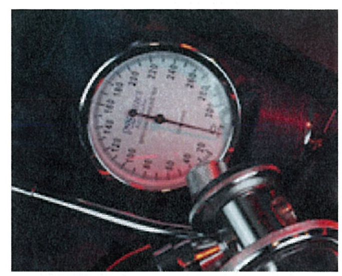
IRS Issues Guidance for Healthcare FSAs

The IRS recently issued guidance on the new $2,500 limit on contributions to flexible spending accounts (FSAs) used to pay for healthcare expenses.

The $2,500 limit, which becomes effective on January 1, 2013, was included in the *Patient Protection and Affordable Care Act of 2010* (PPACA). The U.S. Supreme Court upheld the constitutionality of the PPACA on June 28, 2012, so the FSA provision stays in place as scheduled.



Background: Under the tax law provisions covering "cafeteria plans," an employee participating in an FSA can choose to allocate a portion of his or her salary to the account on a pre-tax basis, thereby reducing tax liability. The employer also saves tax because the contributions aren't subject to employment taxes. These tax savings can usually offset part or all of the employer's administrative costs for the plan.

The most common type of FSA is used to pay for healthcare expenses. Another variation covers dependent care expenses. Previously, a $5,000 limit applied to dependent care FSAs, but there was no tax law limit on health care FSAs (although employers might self-impose a limit). Under the PPACA, a new $2,500 limit for healthcare expenses applies for tax years beginning after 2012. This limit will be indexed for inflation in subsequent years.

Here's how a healthcare FSA works: Typically, the employer allows employees to designate the amount to be contributed to the account at the beginning of the year. Then it deducts the amount from the paychecks of participating employers. For example, if an employee allocates $2,600 to the FSA for 2012 and he or she is paid bi-weekly, the payroll deduction is $100. Employees may tap into their accounts at any time to pay for qualified medical expenses.

However, any amount in the account that isn't used by the end of year is forfeited. This "use-it-or-lose-it" feature of FSAs has often been criticized as being unfair. Under a 2005 tax law change, an employer can make an election allowing a "grace period" of 2 1/2 months to give participants more time to empty out their accounts.

Conversely, qualified expenses are paid promptly, even if the account hasn't been fully funded through payroll deductions. If a participant quits or retires before funding catches up, the employer is responsible for the excess. In addition, the employer may incur extra costs if it allows employees to change contribution levels due to a change in family status during the year.

The new IRS Notice includes the following clarifications relating to the $2,500 limit on health care FSAs:

- The $2,500 limit is effective for plan years beginning after 2012.
- The term "tax year" refers to the cafeteria plan tax year, not the employer or employee's tax year.
- A plan can't change its tax year in order to delay application of the $2,500 limit.
- If a cafeteria plan has a short plan year beginning after 2014, the $2,500 limit must be pro-rated.
- The $2,500 limit on salary contributions to a health FSA applies on an individual basis. Thus, a married couple may contribute up to $5,000.
- All employers in a controlled or affiliated service group are treated as a single employer for purposes of the limit.
- The $2,500 limit doesn't apply to reimbursements under an FSA for dependent care expenses.
- In the event the employer uses the optional 2 1/2 month grace period for plan years beginning in 2012 or later, any amount carried over into the next year won't count against the $2,500 limit for the subsequent year.

Finally, the IRS is asking for comments regarding the use-it-or-lose-it rule. Keep an eye out for new developments.

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IRS Issues New Proposed Regs on Passive Activity Losses

The passive activity loss (PAL) rules can limit your ability to claim current federal tax deductions for losses thrown off by passive activities. This is because you can generally deduct passive losses only to the extent you have passive income from other sources. If you have little or no passive income, your passive losses are suspended until you have sufficient passive income -- or until you dispose of the loss-producing activities.

However if you *materially participate* in an activity for the tax year, you are exempt from the PAL limitations for the activity for that year. Therefore, you can deduct the loss from that activity unless another tax rule prevents it.

Question: What about losses incurred by limited partners? The PAL rules often make it difficult for limited partners to meet the material participation standard, while general partners usually have an easier time. So it's better to be classified as a general partner for PAL purposes than a limited partner.

Next question: Since LLC members have limited liability, must they be classified as limited partners for PAL purposes, which would be unfavorable, when an LLC is treated as a partnership or a sole proprietorship for federal income tax purposes? So far, the IRS has always said yes. However, the courts have repeatedly disagreed with the IRS. In apparent reaction to the losing streak, the IRS recently released taxpayer-friendly proposed regulations. But the rules in the proposed regulations will not take effect until they are issued in final form.

Before addressing the court decisions and the new proposed regulations, we'll first cover some background information on how the rules work.

Material Participation Tests in a Nutshell

IRS regulations prescribe seven tests to determine if a taxpayer can meet the material participation standard with respect to a particular business activity. (See right-hand box for a list of the seven tests.) If you can pass one or more of these tests for the tax year in question, you meet the material participation standard for that activity for that year, which means the unfavorable PAL rules are inapplicable to that activity for that year. General partners can take all seven tests in attempting to meet the material participation standard.

Here Are the Seven Material Participation Tests:

1. More-Than-500-Hours Test - You pass this test if you participate in the activity for more than 500 hours during the year.

2. Substantially-All Test - You pass if your participation in the activity during the year constitutes substantially all the participation by all individuals (including those who are not owners of interests in the activity) during that year.

3. More-Than-100-Hours Test - You pass if you participate in the activity for more than 100 hours during the year, and no other individual participates more than you during that year.

4. Significant Participation Activity (SPA) Test - You pass if the activity is a SPA (a term defined by IRS regulations) in which you participate for more than 100 hours during the year, and your total participation in all SPAs during the year exceeds 500 hours.

5. Prior-Year Material Participation Test - You pass if you materially participated in the activity for any five of the ten immediately preceding

Limited Partners Can Only Use Three Tests

When your interest in an activity is owned through a limited partnership interest, the seven material participation tests summarized in the right-hand box are unavailable. Instead, a limited partner can only use the first, fifth, and sixth tests in attempting to meet the material participation standard (the more-than-500-hours test, the prior-year material participation test, and the personal service activity test). These three tests are often much more difficult to pass than the other four.

years.

6. Personal Service Activity Test
- You pass if the activity is a personal service activity, and you materially participated in the activity for any three preceding years.

7. Facts and Circumstances Test
- You pass if consideration of relevant facts and circumstances dictate that you materially participate in the activity on a regular, continuous and substantial basis.

Courts: LLC Members Are General Partners for PAL Purposes

- In one decision, the Tax Court concluded that a member of a California multi-member LLC was allowed to use all seven of the PAL material participation tests that are available to general partners rather than just the three stricter tests that are available to limited partners. (*Lee Newell, 132 TC Memo 2010-23)*
- In another decision in 2009, the Tax Court said the Iowa LLC statute allowed the taxpayers (a married joint-filing couple) to actively participate in the Iowa LLCs in question when such active participation would not have been allowed for limited partners under applicable state law. This fact alone made the LLC interests closer to general partner interests than limited partner interests (even though the taxpayers did have limited liability with respect to the LLCs' activities). Therefore, the taxpayers could use all seven of the PAL material participation tests that are available to general partners. (*Paul D. Garnett, 132 TC 368)*
- The Court of Federal Claims agreed with a taxpayer's position that, even though he had limited liability with respect to the Texas LLC in question, he was not a limited partner for PAL purposes because: (1) the LLC was not a limited partnership under applicable Texas law and (2) he functioned as the manager of the business, which would not have been allowed for a limited partner under Texas law. Therefore, the taxpayer could use all seven of the PAL material participation tests that are available to general partners. (*James R. Thompson, 2009)*
- In a Summary Opinion, the Tax Court concluded that the husband and wife in this case should be treated as general partners for PAL purposes with respect to their interests in a Maryland LLC, which they used to operate a money-losing charter fishing business. This decision also stated that the government's argument that limited partner status should apply to LLC members was misplaced, which indicates the Tax Court was getting tired of hearing about the issue. (*Sean Hegarty, TC Summary Opinion 2009-153, 2009)*

Bottom Line for LLC Members

In effect, these decisions all state that LLC interests are general partner interests rather than limited partner interests for purposes of applying the PAL material participation rules. The common thread is the fact that LLC members are allowed to be heavily involved in LLC activities under applicable state LLC laws. In contrast, when a limited partner becomes too involved in a partnership's affairs, his limited partner status may be lost under some state partnership laws. (In some other states, limited partners are allowed to be involved in management without losing their limited partner status.)

According to the courts, this important distinction makes it impossible to conclude that LLC interests are equivalent to limited partner interests for purposes of applying the PAL material participation rules. Therefore, LLC members are general partners for PAL purposes even though LLC members have limited liability similar to what limited partners have.

The New Proposed Regulations

Recently issued proposed Treasury regulations (*1.469-5(e))* state that, for purposes of applying the PAL material participation rules, a limited partner interest is defined as an interest in an entity that is classified as a partnership for federal tax purposes. Also, the owner cannot have rights to manage the entity at any time during the tax year in question under applicable law in the state where the entity is organized and under the entity's governing agreement. The owner of such an interest is treated as a limited partner for purposes of applying the PAL material participation rules. As such, the owner must pass one of the three stricter limited partner tests to meet the material participation standard.

According to the Preamble to the proposed regulations, rights to manage include the right to legally bind the entity. Unfortunately, however, other examples of management rights are not provided.

Because LLC members typically have management rights, the proposed new rules are taxpayer-friendly. Such LLC members would be able to use all seven of the material participation tests. The same would be true for limited partners who have management rights.

Key Point: In stark contrast to the historical IRS position, the degree of limited liability offered by the entity to the owner is irrelevant under the proposed regulations.

Conclusion: While LLC members would be the prime beneficiaries of the liberalized rules in the proposed regulations, limited partners who are allowed under applicable state law to be involved in managing limited partnerships would also benefit. They too would be allowed to use all seven material participation tests in attempting to meet the material participation standard.

However, the new rules in the proposed regulations will not take effect unless and until they are issued in the form of final regulations. Meanwhile, consult your tax adviser for questions about how the PAL rules might affect you.

Note: The Preamble to the proposed regulations states that the proposed new rules would only apply in the context of applying the PAL material participation rules. The proposed new rules would not have any impact on other issues, such as determining the extent to which LLC members are exposed to the self-employment tax.

Feedback

Is this item worthy of implementation?	**Yes**	○	**No**	○	**Maybe**	○
Is this item worth sharing with other associates?	**Yes**	○	**No**	○	**Maybe**	○
Did this item present value to you and your business?	**Yes**	○	**No**	○	**Maybe**	○

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In Perspective

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Court: IRS Can Reclassify S Corp Distributions as Wages

If you run your business as an S corporation, you are probably both a shareholder and an employee. As such, the corporation pays you a salary that reflects the work you do for the business. The first $110,100 of any employee's 2012 salary (including yours) is subject to a 13.3 percent federal employment tax rate. Of that, 10.4 percent is for the Social Security tax and 2.9 percent is for the Medicare tax. The 10.4 percent Social Security tax cuts out above the $110,100 wage ceiling, but the 2.9 percent Medicare tax continues to hit wages up to infinity.

Note: For 2012 wages, the Social Security tax rate is reduced from the normal 12.4 percent to 10.4 percent (same as for 2011). However, the Social Security tax rate will return to the standard 12.4 percent in 2013 and beyond unless Congress takes further action.

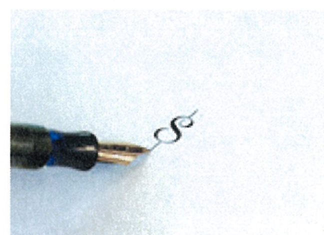
A portion of the Social Security and Medicare taxes are withheld from your paychecks and the remainder is paid directly to the government by the S corporation in its role as your employer. (You must, of course, pay income tax at your personal level on salary received from the corporation.)

On its annual federal income tax return (Form 1120S), the corporation deducts your salary and the employer's share of Social Security and Medicare taxes. These corporate-level write-offs reduce the taxable income passed through to you on the Schedule K-1 you receive from the corporation. Whatever amount of corporate-level taxable income is left after deducting your salary and related employment taxes can then be paid out to you as a cash distribution without any Social Security or Medicare taxes due.

S Corp Status Can Reduce Employment Taxes

As the following example illustrates, the federal employment tax rules leave an opening that can potentially save you major amounts of taxes over the years.

Example with a Modest S Corp Salary. Let's say you're trying to decide if you should establish a single-member LLC (SMLLC) or an S corporation for your solely-owned small business. Assume that for 2012, you expect the business to earn about $100,000 after paying all expenses but before paying any Social Security or Medicare taxes. Also assume that if you choose the S corporation option, a $40,000 salary would be reasonable for your work in the business, albeit on the low side of reasonable.



What's a Reasonable Salary?

The instructions to the Form 1120S, *U.S. Income Tax Return for an S Corporation*, state that "Distributions and other payments by an S corporation to a corporate officer must be treated as wages to the extent the amounts are reasonable compensation for services rendered to the corporation."

The amount of the compensation never exceeds the amount received by the shareholder either directly or indirectly. However, if cash or property (or the right to receive cash and property) did go to the shareholder, a salary amount must be determined and the salary level must be reasonable and appropriate.

There are no specific guidelines for reasonable compensation in the tax code or regulations. Various courts

- With an SMLLC, you would have to pay the 10.4 percent Social Security tax plus the 2.9 percent Medicare tax on all of your net self-employment income. The employment tax hit would be about $12,300.
- With an S corporation, you would only have to pay Social Security and Medicare taxes on the $40,000 amount taken out as salary. The employment tax hit would only be about $5,300.

You can expect to reap comparable federal employment tax savings year after year, assuming your business continues to generate about $100,000 of income adjusted for inflation.

Note: Setting a relatively low salary can also mean reduced deductible contributions to your tax-deferred retirement plan account. So if you place a premium on maximizing deductible retirement plan contributions, the modest salary approach illustrated in this example might not be right for you.

IRS Knows the Game

The IRS is aware of the strategy of using modest S corporation salaries to reduce federal employment taxes for shareholder-employees. The tax-saving advantage is lost if the government successfully asserts that S corporation cash distributions are actually disguised salary payments. Then, the corporation can be hit with back employment taxes, interest, and penalties.

Back in 2002, a Treasury Inspector General for Tax Administration report said IRS auditors should be devoting substantial attention to the issue of understated compensation for S corporation shareholder-employees. Therefore, be prepared to defend stated shareholder-employee salary amounts as being reasonable for the work performed.

that have ruled on this issue have based their determinations on the facts and circumstances of each case.

Factors considered in determining reasonable compensation include:

- Training and experience;
- Duties and responsibilities;
- Time and effort devoted to the business;
- Dividend history;
- Payments to non-shareholder employees;
- Timing and manner of paying bonuses to key people;
- What comparable businesses pay for similar services;
- Compensation agreements; and
- The use of a formula to determine compensation.

-- *Source:* The IRS

The Courts Have Weighed in, Including a Recent Decision

There have been several court decisions on the subject of paying minimal salaries to S corporation shareholder-employees in order to minimize federal employment taxes. These decisions make it clear that the IRS has the power to reclassify purported S corporation cash distributions as disguised shareholder-employee wages when stated compensation payments are unreasonably low. This means they are subject to federal employment taxes. (Cases include *Joseph Radtke, S.C.,* 7th Circuit, 1990, and *Veterinary Surgical Consultants, P.C.,* 3rd Circuit, 2004.)

These cases may not be very illuminating because they involve obvious compensation understatements where stated salaries for shareholder-employees were zero or next to nothing. A recent decision was more informative.

Facts of the new case: An individual replaced his partnership interest (the net income from which was subject to the Social Security and Medicare taxes in the form of the self-employment tax) with a 100 percent owned S corporation. The individual then functioned as an employee of the S corporation. For the two years in question, the S corporation paid him annual salaries of $24,000 and also paid him cash distributions of about $203,000 and $175,000, respectively. Upon audit, the IRS reclassified a portion of the cash distributions as wages subject to federal employment taxes. An Iowa District Court agreed. The shareholder-employee appealed to the Eighth Circuit, which agreed with the District Court. An IRS expert estimated that the shareholder-employee's services were worth an annual salary of about $91,000. Therefore, both courts concluded that the IRS was justified in reclassifying about $67,000 ($91,000 minus $24,000) of the purported cash distributions paid in each of the two years in question as additional wages that were subject to federal employment taxes. (*David Watson, P.C.,* 8th Circuit, 2012).

Conclusion: Because of the risk of assessments for back federal employment taxes, penalties, and interest, S corporation shareholder-employees should be sensitive to the issue of understated compensation paid to them. This is especially true for professional service S corporations. Gathering evidence to demonstrate that outsiders could be hired to perform the same work for salaries equal to the stated (modest) salaries paid to shareholder employees is a good idea. Contact your tax adviser if you have questions or want more information on this issue.

Feedback

Is this item worthy of implementation?	**Yes**	**No**	**Maybe**
Is this item worth sharing with other associates?	**Yes**	**No**	**Maybe**
Did this item present value to you and your business?	**Yes**	**No**	**Maybe**

Comments:

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