

Tax Talk

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Dear Clients and Friends,

Do the “rich” pay their fair share of taxes? Too little? Or too much? That is a topic that has been much in the press recently as Congress and the White House debate how to pay for our ever increasing deficit. President Obama believes the “rich” do not pay their share, and Warren Buffet has famously stated that his personal tax rate is lower than that of his receptionist. Meanwhile, we are frequently reminded by others that the top 1% of taxpayers pay more than 1/3 of all Federal income tax, while the bottom 50% pay almost no Federal income tax. And, I can tell you that most of our clients (who would by most definitions be considered to be part of “the rich”) feel they pay their fair share or more. So who is right? In part, it may depend on how you define the rate of tax. Are we referring to marginal rate or effective rate? Basing it as a percentage of “taxable income?” Or as a percentage of all economic income? Federal income tax only? Or all taxes (including e.g. FICA)? When Warren Buffet said that his receptionist paid taxes at a higher rate than him did he consider his proportionate share of the corporate tax paid by his company Berkshire

Hathaway?

We won’t try to address the issue of “fairness” in this newsletter (that’s not our role), but we will address marginal rate versus effective rate and how these factor into our tax planning. We will also discuss an extremely important upcoming deadline for those with foreign bank accounts, the new 3.8% Medicare tax on net investment income, a late election opportunity for real estate professionals, the recent increase in the debt ceiling and what that may portend in terms of future tax increases, and, as always, highlight a member of our firm and one of our clients.

We hope that you will enjoy this issue and gain from it some useful information.

Sincerely,

Kent Bridges



Kent Bridges,
Managing Partner

Marginal and Effective Tax Rates and Their Importance in Tax Planning

When discussing tax planning with our clients, we often use the terms “marginal tax rate” and “effective tax rate”. Marginal tax rate generally refers to the rate of tax to be incurred on the next dollar of income (or the value of the next incremental dollar of deduction), whereas effective rate generally refers to the amount of your overall tax as a percentage of your overall income. While different, both are important to understand for optimal tax planning.

Range of rates – The highest marginal Federal income tax rate is currently 35%, the highest state income tax rate is 11% (Hawaii and Oregon), and self-employment tax or FICA can be as high as 15.3%. Accordingly, in the right (or shall we say “wrong”) situation your marginal tax rate could be higher than 60%.

Planning at the margin - Marginal tax rates are what we tend to focus most on in tax planning, since that is where the real permanent tax savings can be derived. Most people don’t really understand the concept of marginal tax rate. The general thought is that the higher your income the higher your marginal rate. While that is sometimes true, it is not always the case. For example, if in the year of sale of your business you have \$10,000,000 of long-term capital gain and \$500,000 of ordinary

income, you might automatically assume that you would be in the 35% Federal marginal rate bracket. However, if you also have \$1,000,000 of charitable donations in that year, then your marginal Federal rate is actually only 15% (since the charitable donations would first offset the ordinary income and then the long-term capital gain).

AMT - Clients tend to think it is a terrible thing when they are in the alternative minimum tax (AMT) posture. While it does mean that you are losing the Federal benefit of certain deductions (e.g. real estate taxes and state income taxes), it also means that you are paying tax at a maximum Federal rate of 28% (versus the highest rate of 35%), because the AMT caps out at 28%; and it may mean you are paying tax at a maximum Federal rate of 15% (the maximum AMT rate on long-term capital gain and qualified dividends).

Phase-outs – Many exemptions, exclusions, deductions and credits are subject to being phased out, based on your income level. These “silent tax increases” can have a significant impact on your marginal tax rate as your income moves through the

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Kyle K. Bartleson, CPA

Member in the Spotlight – Kyle Bartleson

Kyle Bartleson's broad range of work experience includes, in addition to 15 years in public accounting, 4 years in the U.S. Army as an Intelligence Analyst, and 5 years with the Internal Revenue Service. From an educational standpoint, he holds an undergraduate degree from Western Kentucky University and a Masters in Taxation from Georgia State University.

Kyle and his wife, Carole, are now empty nesters, with three young adult children, two of whom have

followed in dad's footsteps and are serving in the U.S. military. Kyle and Carole are active in Bethesda United Methodist Church, and he enjoys playing both classical and electric guitar.

Bridges & Dunn-Rankin is proud to have Kyle Bartleson as a member of our firm.

Marginal and Effective Tax Rates and Their Importance in Tax Planning – continued

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phase-out range.

Deferral/acceleration strategies and rate arbitrage - In an era of very low short-term interest rates, we do not get too excited about short-term deferral strategies. Long-term deferral strategies like 1031 exchanges or the continuing year after year deferral from adoption of cash method are another story. True *permanent* tax savings, however, tend to come when you can get rate arbitrage (e.g. take a deduction in a high marginal rate year and the related income in a low marginal rate year). Qualified retirement plans are one way to work this. For example, you make retirement plan contributions in high marginal rate years and take the related distribution or do a Roth conversion in low rate years.

Avoid negative rate arbitrage - You should avoid deferring income from a low marginal rate year into a high marginal rate year. Sometimes when we pick up a new client we find that (due to lack of proactive advice) they have had years in which they felt good about having paid little or no tax, but in reality they wasted itemized deductions, exemptions, and low rate brackets that could have been used to capture income at a zero or low tax cost. Or they took losses that produced a benefit of maybe 20 cents on the dollar which will effectively be recaptured in a later year at 40 cents on the dollar. This type of cost is not readily apparent, until you analyze your tax situation over many years.

Impact of state income tax - State income taxes on individuals can range from 0% in states like Florida up to 11% in states like Hawaii and Oregon. It is important to factor that into your tax planning; especially if you may be contemplating a move to or from a high tax state. Accelerating the recognition of income into a year in which you are a resident of Florida (a no tax state) ahead of your relocation to California (a high tax state) could result in a significant permanent tax savings.

Impact of self-employment tax or FICA - Self-employment tax or FICA is 15.3% of the first \$106,800 of "earned income" for the

year, and 2.9% thereafter. For W-2 employees, the employer pays ½ of this amount. This tax is in addition to the income tax, so the marginal tax impact on earned income can be quite substantial. Knowing where you are relative to the hurdle (i.e. over or under the \$106,800) is important in your planning. Itemized deductions and exemptions do not reduce the income subject to self-employment tax, so your effective tax rate (as defined relative to taxable income) can appear quite dramatic if you are paying self-employment tax.

NOL considerations - Net operating losses (NOLs) can generally be carried back 2 years or forward 20 years. Unless you make an election with your return for the year of the loss to waive the carryback period, you have, by default, made an irrevocable election to carry the loss back. Accordingly, it is important before filing your return for the year of the loss to carefully analyze the effective tax benefit of carrying the loss back (as a percentage of the loss) versus the probable effective benefit of electing to carry the loss forward instead. Doing this sort of analysis before the end of the loss year, can guide you as to whether you should accelerate deductions into the loss year (e.g. where the loss has a very substantial effective tax benefit in the carryback year).

Cash flow considerations - There are times when, even though accelerating income into a low-rate bracket year makes the most sense from a long-term perspective, the client may not be in a position cash-flow wise to incur the incremental tax. Similarly, there are times when a client's need to maximize a tax refund for cash flow purposes may dictate accelerating losses or deductions, even though a greater percentage benefit might be derived in some future year.

A multi-year, long-term process - Tax planning is a multi-year, long-term process. We feel really good about the job we have done for a client when we can analyze their situation over many years and see that, in spite of generating tremendous wealth over that period of time, they have incurred a very low effective tax cost.

An Extension of Time to Comply with Foreign Bank Account Reporting Rules

If there is any chance that you may have or may have had in the past any ownership interest in or signature authority over a foreign bank or financial account, then you need to be sure to read this article. This can include any corporate executive who

may have had signature authority over a foreign bank account by virtue of his or her position with a company which has foreign bank accounts.

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An Extension of Time to Comply with Foreign Bank Account Reporting Rules – continued

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There has for many years been a requirement that any US person with a financial interest in or signature or other authority over a foreign financial account file with the Treasury Department each year by June 30 a Form TD F 90-22.1, disclosing the details with respect to such accounts, if the aggregate balance of such accounts at any time during the prior calendar year exceeded \$10,000. Until a few years ago, the only penalties for failure to file a Form TD F 90-22.1 were for a *willful* failure to file. However, current law provides for a penalty of up to \$10,000 per violation in the case of a *nonwillful* failure to file, and the civil penalty for a *willful* failure to file can be up to the greater of \$100,000 or 50% of the account balance.

The IRS has become increasingly concerned that US taxpayers

are using offshore financial accounts to evade US taxes and has stepped up its enforcement in this area. As part of its stepped-up enforcement initiative, the IRS recently provided guidelines for those taxpayers who have failed to report income from foreign accounts to make voluntary disclosure of such in exchange for leniency. Further, the IRS has recently announced that taxpayers who have properly reported their income but inadvertently failed to file the TD F 90-22.1 have until August 31, 2011 to do so, without penalty. For those with signature authority over but no financial interest in foreign accounts the deadline is later.

For those who have failed to report income from a foreign account, the rules, procedures and potential penalty relief are different, but immediate action is required.

A 3.8% Tax on the Sale of Your Home?

One of our clients recently forwarded us an e-mail (apparently originated by an attorney) warning that under new tax rules you will incur a tax of 3.8% on the sales price of your home if you sell it. The e-mail included an example of your incurring a tax of \$11,400 on the sale of your home for \$300,000. Several other clients have asked about this, so apparently this e-mail (or similar ones) has been circulated quite a bit.

So, would you really incur a tax of \$11,400 on the sale of your home for \$300,000? Well, theoretically that is possible. But, it is highly unlikely.

The e-mail is apparently referring to the 3.8% unearned income Medicare tax which was included as part of the very controversial health care legislation which was enacted in March 2010. This 3.8% tax (which is scheduled to take effect in 2013, but could potentially be repealed before then) applies to “net investment income”. “Net investment income” for these purposes includes capital gains, but only to the extent the gain is included in taxable income. In computing the gain from the sale

of a home, you get to reduce the proceeds by your basis (i.e. generally cost). Also, current tax law permits a married couple to exclude from taxable income up to \$500,000 of gain from the sale of their primary residence. Accordingly, a married couple would generally have to have at least an \$800,000 *gain* on the sale of their primary residence in order to incur \$11,400 of tax under this new provision. Also, this tax does not apply at all unless you have at least \$250,000 of adjusted gross income for the year (\$200,000 in the case of a single person).

So, to answer the earlier question, you could theoretically incur a tax of \$11,400 on the sale of a home for \$300,000, but only if your cost basis in the home were zero and the home did not qualify for the residence gain exclusion. The reality is that the new 3.8% Medicare tax on net investment income is not likely to have much of an impact on the sale of primary residences. However, we do need to keep it in mind in our tax planning; especially from the standpoint of potentially accelerating capital gains into 2012 in order to get out in front of this and other tax increases which may take effect for 2013.

Client in the Spotlight – Bonner Custom Homes

Jerry Bonner was only 12 years old when he began working with his uncle, a commercial contractor in Griffin, who taught Jerry about taking pride in his work by focusing on quality and relationships. It was 1957, and a vision was beginning to form for his future profession, with a passion for building driven by the reality that building is about helping other people fulfill their dreams.

In 1969, after earning his degree in Engineering and serving in the U.S. Army (where he built barracks in Vietnam), Jerry returned to the business. Then in 1978, he moved to Atlanta where he founded Bonner Custom Homes. Today, this family-owned business, which includes wife Julie and son Rhett, is one of the most respected custom residential construction companies in the country.

Bonner Custom Homes

With a passion for building and an atmosphere of historical architectural integrity, true craftsmanship, personal integrity and trust, Bonner Custom Homes helps its clients go *From Vision to Reality*.

Bridges & Dunn-Rankin is proud to be associated with Bonner Custom Homes.

Late Election Opportunity for Real Estate Professionals

In 1986, concerned with the erosion of the tax base from the proliferation of tax shelters, Congress enacted the “passive loss rules” which provide, in general, that the losses from rental activities or from businesses in which you do not “materially participate” (generally defined as at least 500 hours per year) cannot be used to offset income from other sources like W-2 wages, interest, dividends, capital gains or businesses in which you do materially participate.

Generally, any rental activity is automatically considered to be passive, regardless of the number of hours spent on it. An exception to this general rule, however, exists for “real estate professionals”. Under the exception, a real estate professional is not subject to the passive loss rules with respect to rental activities in which he otherwise meets the material participation standards. A “real estate professional” for purposes of this exception is one who spends at least 750 hours during the year on real estate activities and more than ½ his or her working hours on real estate. For purposes of the 500-hour rule (and other material

participation standards), each rental activity is generally viewed separately. However, a real estate professional may make an election to aggregate all rental activities (which makes it easier to meet the 500-hours test or another one of the material participation standards).

The election to aggregate rental activities is made by filing a statement with the taxpayer’s original return for the year in which he or she wishes the election to take effect.

In a recent Revenue Procedure (2011-34), the IRS has provided a procedure whereby taxpayers who failed to file an aggregation election statement with their returns can now do so with an amended return, provided they otherwise took the aggregation position on their original timely-filed returns and had reasonable cause for failure to attach the election statement. This relief procedure could be very beneficial to a real estate professional who has deducted rental losses which would otherwise be suspended under the passive loss rules.

Debt Ceiling Increased Without Any (Immediate) Tax Increases

On August 2nd, Congress passed and the President signed into law the *Budget Control Act of 2011*. This legislation increases the debt ceiling by up to \$2.4 trillion in order to avoid a theoretical potential default by the U.S. government on its obligations. The legislation does not include any tax increases, but the need for deficit reduction beyond that provided by spending cuts may well portend tax increases down the road. Some *possible* future tax increases include:

- Allowing the “Bush tax cuts” to expire at the end of 2012. This could mean an increase in the top individual rate to 39.6%, an increase in the tax rate on qualified dividends to 39.6%, and an increase in the long-term capital gains rate to 20%. It could also mean an increase in the estate tax rate to 55%.
- Expiration of the very favorable fixed asset expensing rules (e.g. 100% of the cost of most new depreciable assets other than buildings placed in service during 2011 can be expensed immediately).

- Repeal of the production activities deduction.
- Repeal of the LIFO inventory accounting method.
- Repeal of oil & gas industry tax preferences.
- A repatriation holiday to induce multinational corporations to bring home overseas profits on which taxes have been deferred (not really a “tax increase”, but rather a tax break to encourage acceleration of deferred taxes).
- Treatment of “carried interests” as ordinary income.
- Reducing or limiting the benefit of the mortgage interest deduction for individuals.

Revenue increasing provisions like the above will likely be considered not only because of the need for deficit reduction, but also to help offset the cost of potential desired tax reductions like elimination of the alternative minimum tax and a reduction in the top corporate tax rate (currently 35% and considered anti-competitive on a global basis).

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Quick Notes

- Effective July 1, 2011, the allowable business mileage rate has been increased to 55.5 cents per mile.
- The very unpopular expanded 1099 reporting rules which were included as part of the 2010 healthcare legislation and scheduled to take effect in 2012 have been repealed.

The information provided in this newsletter is presented for educational and informational purposes only, and is not intended to constitute legal, tax or accounting advice. The articles provide only a very general summary of complex rules. For advice on how these rules may apply to your specific situation, contact a professional tax advisor.