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High Net Worth Family TAX REPORT

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Remember to file your gift tax return and other follow-up related to 2012 gifts

Many of our clients made gifts during 2012 to utilize the $5,120,000 lifetime exemption from gift tax that was scheduled to be reduced to $1 million after December 31, 2012. If you made gifts in excess of $13,000 per donee, you are required to file a gift tax return on Form 709 even if no gift tax is due because the gifts were within the available exemptions. Gift tax returns are due April 15, 2013, although the filing date (but not the payment of gift tax if due) may be extended up to October 15, 2013. You can obtain an extension of time to file your gift tax return by filing Form 8892 on or before April 15, 2013. You can also obtain an automatic extension of time to file your gift tax return if you obtain an extension of time to file your 2012 federal income tax return, by filing form 4868 on or before April 15, 2013.

If you made gifts of property other than money and marketable securities, you must have the property appraised and include a copy of the appraisal when filing the gift tax return. If you don't attach the appraisal to the gift tax return, your likelihood of audit increases because the Internal Revenue Service has no way of knowing on what basis the value was reported. If you attach an appraisal, the person reviewing the gift tax return on behalf of the IRS may conclude that the reported value is reasonable based on the appraisal and not audit the return. In any event, the burden is on you, the taxpayer, to prove the value, so whether you attach the appraisal or not, you should have an appraisal to back up the reported value. The appraisal should be a "qualified appraisal," an appraisal prepared by an independent person who is in the business of appraising assets. Other technical requirements exist for a qualified appraisal, but any reputable appraiser should know the rules for preparing an appraisal that qualifies for submission to the IRS. We suggest that you check with your accountant well before April 15, 2013, so that he or she can tell you what documents must be obtained in order to file a complete gift tax return.

This publication may constitute "Attorney Advertising" under the New York Rules of Professional Conduct and under the law of other jurisdictions.

In order for a gift tax return to begin the running of the statute of limitations, you must adequately disclose the gift on Form 709 (or an attached statement) filed for the year of the gift. In general, a gift will be considered adequately disclosed if the return or statement includes the following: i) a full and complete Form 709; ii) a description of the transferred property and any consideration received by the donor; iii) the identity of, and relationship between, the donor and donee; iv) if the property was transferred to a trust, the trust's employer identification number (EIN) and a brief description of the terms of the trust (or a copy of the trust instrument in lieu of the description); and v) either a qualified appraisal or a detailed description of the method used to determine the fair market value of the property that was the subject of the gift. In most cases, an appraisal will be preferable.

If you made the transfer to a multigenerational trust, your gift tax return must also allocate a generation-skipping transfer tax exemption so that distributions from the trust in the future are not subject to this separate transfer tax.

You may need to complete other follow-up tasks for some kinds of gift transfers. For example, if you transferred any kind of insured property, such as real property or works of art, you should contact the insurance company to take the required steps to ensure that the new owner of the property will be covered by the insurance, including obtaining an appropriate endorsement for any title insurance policies for real property so there is no lapse in coverage.

Review estate plans in light of $5 million exemption becoming permanent

When the estate tax exemption first reached $3.5 million in 2009, we cautioned clients to review their estate plans to be sure the significantly larger exemption did not have unintended consequences, especially in light of the fact that many experienced material decreases in the value of their assets during 2008. Some people did nothing at the time because the $3.5 million exemption was originally intended to apply only during 2009.

Now that the exemption is permanent and at an even higher level of $5 million, adjusted for inflation to $5,250,000 in 2013, it is even more important to review your estate plan for unintended consequences. For example, if a 2013 decedent has a total estate of $6 million and has a will or trust that leaves the maximum amount that can be transferred free of estate tax to his children and the balance to his spouse, the children would receive $5,250,000 and the spouse $750,000. This result is likely not what the decedent intended if he prepared his will or trust in a previous year when the lifetime exemption was only $1 million, or even less. Similarly, a will or trust that allocates the maximum generation-skipping transfer tax exemption amount to a trust for a child, with the balance directly to the child, might result in substantially all of the child's inheritance being held in trust.

Now that the higher exemption has been made permanent, you should again review your estate plans to determine whether the $5,250,000 exemption may cause consequences you do not intend. Another permanent aspect of the law is "portability," which is the ability to use the exemptions of both spouses at the death of the second spouse, even if no exemption planning is done at the first death. While significant reasons still exist to use to the exemption at the first death, you may want to review this subject with your estate planner to discuss the pros and cons of portability.

Annual exclusion amount for gifts increased for 2013

The amount that a donor can give to a donee each year without paying any gift tax or using any of his lifetime exemption is indexed for inflation. The IRS has announced that the inflation-adjusted exclusion amount for 2013 will be $14,000, an increase of $1,000 over the 2012 exclusion amount of $13,000. Donors can give this amount to each of an unlimited number of donees. Only gifts of a present interest qualify for this exclusion. Please contact us if you have any questions in that regard.

California adopts Proposition 30 increasing sales tax and income tax rates

California voters adopted Proposition 30 in the November 6, 2012, election, with 53.9 percent of the voters who came to the polls voting in favor of the measure. The measure increases the state sales tax rate by 0.25 percent, from 7.25 percent to 7.50 percent for the four-year period beginning January 1, 2013, through December 31, 2016. Local sales taxes will result in a higher total sales tax rate in many areas.

Proposition 30 also increased the personal income tax rate on high-income taxpayers for a seven-year period that is retroactive to January 1, 2012, through December 31, 2018. The rate increases begin at taxable income of $500,000 on a joint return, with an increase from 9.3 percent to 10.3 percent. At taxable income of $600,000, the rate becomes 11.30 percent, and at $1 million, the rate becomes 13.3 percent. Proposition 30 increased the base income tax rate on taxable income over $1 million from 9.3 percent to 12.3 percent. The additional tax for mental health services adds another 1 percent, resulting in a total tax rate of 13.3 percent for the portion of a taxpayer's taxable income in excess of $1,000,000.

IRS issues proposed regulations on 3.8 percent tax on net investment income

The IRS has issued extensive proposed regulations on the 3.8 percent tax on net investment income that becomes applicable in 2013. The tax is imposed on the lesser of a taxpayer's: i) net investment income; or ii) the excess of his adjusted gross income over $250,000 for taxpayers filing joint returns or $200,000 for single taxpayers.

In the case of an estate or trust, the tax applies to the lesser of: i) the undistributed net investment income of the trust or estate; or ii) the excess of the adjusted gross income of the trust or estate over the amount at which the maximum income tax rate first applies. For 2013, this amount is $11,950. The proposed regulations confirm that distributions from trusts and estates to their beneficiaries are considered to contain proportionate amounts of net investment income and other income. In the case of a grantor trust, the grantor simply reports the trust's net investment income on his Form 1040 and pays any tax due.

It will often be advantageous for trusts and estates to distribute their net investment income to their beneficiaries. Each beneficiary will have his own threshold amount before the tax applies, and the threshold for individuals is also much higher than for trusts – $250,000 or $200,000 for individuals versus $11,950 for trusts and estates.

The net investment income tax applies in the tax years beginning after December 31, 2012. For any decedent who died during 2012, electing a fiscal year that ends on the last day of the month that is immediately prior to the month in which the decedent died will delay the application of this tax as long as possible. For example, for any decedent who died during December 2012, electing a fiscal year that ends November 30, 2013, will delay the application of the tax for 11 months until December 2013.

A taxpayer's net investment income is his gross investment income reduced by deductions properly allocable to that income. Investment income includes interest, dividends, rents, royalties, gains from the sale of assets (other than assets used in the conduct of a business that is not a passive activity of the taxpayer) and income from non-qualified annuities, as well as income from a trade or business that is a passive activity of the taxpayer or from a business of trading commodities or financial instruments.

The tax does not apply to income from an active business that is not a passive activity of the taxpayer, except for the business of trading commodities or financial instruments, or gains from the disposition of assets used in such a business. It also does not apply to tax-exempt income, income treated as wages or subject to self-employment tax, or distributions from qualified retirement plans or accounts.

The tax was generally intended to apply to much or most of a taxpayer's income that is not subject either to the Medicare taxes on wages or on self-employment income. Certain types of income are not subject to either tax; however, this includes income that flows through to a taxpayer from a business conducted by an S corporation that is not a passive activity of the taxpayer. The preamble to the proposed regulations also states that income from notional principal contracts (commonly referred to as "swaps") is not treated as investment income unless it is derived from a trade or business of trading financial instruments. Tax-exempt income and distributions from qualified retirement plans and accounts are also not subject to either tax.

The proposed regulations provide some guidance on which deductions are considered allocable to gross investment income. If allocable deductions exceed the amount of the gross investment income in a tax year, the excess does not carry over to be used in subsequent years. All deductions that can be claimed against rent or royalty income on Schedule E of Form 1040 can also be used for purposes of computing net investment income.

Itemized deductions that can be used are limited. Allowed investment interest expense may be deducted in arriving at net investment income. Excess investment interest expense carries over to subsequent tax years the same as it does for purposes of determining the regular income tax. State and local income taxes imposed on investment income may also be deducted in computing net investment income. The apportionment of state and local taxes between investment income and other income may be done using any reasonable method. One reasonable method specifically approved in the proposed regulations is allocating state and local income taxes based on the ratio of investment gross income to all gross income. The proposed regulations also allow investment expenses as defined in IRC Section 163(d)(4)(C) to be deducted, including all deductions allowed that are directly connected with the production of investment income, such as fees paid for investment advisory services.

Any deductions that are disallowed by the limitation on miscellaneous itemized deductions (2 percent of AGI) or the itemized deduction phase-out may not be used in computing net investment income for purposes of the net investment income tax.

The estimated tax payment rules of the Internal Revenue Code also apply to the tax on net investment income, so a taxpayer may be subject to penalties if he does not include the tax due on his net investment income in his quarterly estimated tax payments.

Taxpayer denied investment interest deduction for excess home mortgage debt

In the recent Tax Court case of *Norman v. Commissioner (December 27, 2012)*, the taxpayer made a clever but unsuccessful argument in his attempt to secure an interest deduction for debt related to the purchase of his residence that was in excess of the maximum $1.1 million of debt on which interest can be deducted. The taxpayer purchased a home on 9.875 acres of land for $1.8 million, which he borrowed. He claimed that debt of $1 million applied to the purchase of the residence, which became his primary residence, so interest on that debt was deductible. According to the taxpayer, the remaining $800,000 of debt was attributable to the purchase of excess land, which he intended to develop. The taxpayer claimed that interest on the portion of the debt attributable to the excess land should be deductible as investment interest expense, since he intended to develop the excess land.

The court disallowed the taxpayer's investment interest deduction, pointing out that the purchase agreement for the residence did not contain any allocation of the purchase price between the residence and its appurtenant land, and the excess land that could potentially be developed and sold. Furthermore, the taxpayer did not obtain any appraisal to support his allocation.

While this taxpayer lost his case, the court said nothing in its opinion that would preclude a future taxpayer from establishing, based on allocation in the purchase contract or an appraisal, that a portion of the purchase price was paid for land to be held for investment purposes.

IRS rules that a Mexican land trust is disregarded for United States income tax purposes

Mexican law prohibits non-Mexican citizens from owning land within 100 kilometers of Mexico's inland borders or 50 kilometers from its coastline, encompassing the entire Baja peninsula. Since many U.S. citizens and other non-Mexican citizens find the Mexican coastal zone a desirable location for vacation homes, a legal structure has evolved that enables non-Mexican citizens to acquire beneficial interests in properties within the restricted areas.

A "fideicomiso," or trust, formed with a bank approved by the government of Mexico serving as the trustee, acquires legal title to the property. A non-Mexican citizen can purchase the beneficial interests in the land trust. The terms of the trust agreement give the holder of the beneficial interests virtually all of the rights of an owner of the property, and the bank often does little more than hold bare legal title to the property and collect a fee for doing so.

In *PLR 201245003 (November 19, 2012)*, the IRS ruled that one of these Mexican trusts is not treated as a trust for U.S. income tax purposes, but rather simply serves as an agent for holding legal title to the property. For U.S. income tax purposes, the holder of beneficial interests is treated as the owner of the property.

The ruling is very favorable for the taxpayer who requested the ruling. If U.S. income tax law treated the

Mexican trust as a trust, it would be a foreign trust and would require significant tax reporting and compliance. The ruling applies only to the taxpayer who received it, however. In addition, because these trust agreements may have varying provisions, each agreement should be reviewed to determine whether the bank holds bare legal title as trustee and does not have additional responsibilities, so that the trust need not be reported for U.S. income tax purposes.

California Court of Appeal holds unconstitutional California exclusion of gain from sales of "qualified small business stock"

California's Revenue and Taxation Code Section 18152.5 includes a provision that is similar to IRC Section 1202, which allows a taxpayer to exclude a portion of the gain he recognizes upon the sale of "qualified small business stock." Qualified small business stock is generally stock of a C corporation acquired by the taxpayer at its original issuance and held by the taxpayer for at least five years. The corporation must be engaged in an active trade or business and cannot have more than $50 million of gross assets. While California law generally follows federal law in determining what is qualified small business stock, California imposes additional requirements that at least 80 percent of the corporation's payroll be attributable to employment in California and at least 80 percent of its assets be used in the conduct of an active business in California.

In a recent case, *Cutler v. Commissioner* (2012), the California Court of Appeal for the Second District held that the statute violates the commerce clause of the U. S. Constitution because it favors corporations doing most of their business in California over their competitors in attracting investment capital from California residents.

In *FTB Notice 2012-03*, the Franchise Tax Board provided information on how it will implement the *Cutler* decision. For tax years beginning before January 1, 2008, the FTB will allow claims for the exclusion if they meet the requirements of Section 18152.5, apart from the California payroll and property requirement. For taxpayers for whom the statute of limitations on a pre-2008 tax year is still open, the taxpayer may file an amended return to claim the credit if he meets all of the requirements apart from the California payroll and property requirements. The statute of limitations normally now would be closed for years before 2008 unless such statute has been extended due to a pending audit or appeal.

California adopted this position for pre-2008 years in order to provide the same treatment for taxpayers who are similarly situated. Some taxpayers claimed the exclusion for years prior to 2008 and the statute of limitations for those years has expired so the FTB cannot assess additional tax for those years. To be fair to all taxpayers, the FTB will permit other taxpayers for whom the statute of limitations is still open to now claim the exclusion if they have not previously done so.

For years beginning with 2008, the FTB will not allow the exclusion. For taxpayers who claimed it, the FTB will issue Notices of Proposed Assessment denying the exclusion of gain from qualified small business stock. Taxpayers who wish to minimize the interest that will be due on any additional tax can self-assess the tax by filing an amended return and paying the additional tax due.

California Amazon law takes effect

The California Amazon law, effective September 15, 2012, requires an out-of-state retailer to register and collect use tax if the retailer enters into an agreement under which a person (or persons) in California, for a commission or other consideration, refers potential purchasers of tangible personal property to the retailer, whether by an Internet-based link or an Internet website, or otherwise, if (1) the total cumulative sales price from all of the retailer's sales, within the preceding 12 months, of tangible personal property to California purchasers that are referred pursuant to all of such agreements, exceeds $10,000; and (2) the retailer, within the preceding 12 months, has total cumulative sales of tangible personal property to California purchasers that exceed $1 million.

The California Amazon law does not apply if a retailer can demonstrate that all of the persons with whom the retailer has these agreements did not directly or indirectly solicit potential customers for the retailer in California. A retailer can demonstrate that an agreement is not subject to the California Amazon law if (1) the retailer's agreement prohibits persons operating under the agreement from engaging in any solicitation activities in California that refer potential customers to the retailer, including, but not limited to, distributing flyers, coupons, newsletters and other printed promotional materials or electronic equivalents, and

verbal soliciting, initiating telephone calls and sending emails, (2) the person or persons operating under the agreement in California certify annually, under penalty of perjury, that they have not engaged in any prohibited solicitation activities in California at any time during the previous year; and (3) the retailer accepts the certification or certifications in good faith, and the retailer does not know or have reason to know that the certification or certifications are false or fraudulent. California has released an Annual Certification of No Solicitation form that California marketers may use to certify to retailers that they have not engaged in any prohibited solicitation activities in California.

Estate denied deduction for settlement payment to caregiver

In *Estate of Sylvia E. Bates (2012)*, the Tax Court rejected an estate's attempt to deduct a settlement payment to the decedent's caregiver as an estate administration expense on the estate tax return. In a trust prepared by the decedent, she left $100,000 to the person who had been her caregiver. She subsequently amended her trust to name him as trustee and give him a greater amount. After the decedent died, her children commenced litigation over whether the gift to the caregiver was void under a provision contained in the California Probate Code designed to prevent caregivers from exercising undue influence over their clients. The litigation was settled by the trust agreeing to pay the caregiver $575,000.

On the federal estate tax return, the estate deducted as an administration expense the $475,000 it paid to the caregiver that was in excess of the $100,000 that the decedent had left to him in her original trust. It also deducted $23,113 of life insurance proceeds the caregiver received on the decedent's life. The IRS disallowed the deduction on the grounds that the caregiver was a beneficiary of the trust, and payments made to beneficiaries are not deductible. The court agreed with the IRS and also rejected the estate's claim that the payment was a deductible administration expense. The court said there is no authority that holds that a payment to a named beneficiary can be considered an administration expense of the estate.

A post-death settlement with a decedent's caregiver requires a carefully drafted settlement agreement in which the amount paid is stated to be in settlement of a labor claim brought by the caregiver rather than a settlement of any rights the caregiver may have as a beneficiary.

Court holds that employment severance payments are not subject to FICA taxes

In 2001, Quality Stores, Inc. filed for bankruptcy and eventually closed all of its stores and terminated its employees. The terminated employees received severance payments based on their job level. After initially paying FICA taxes on the payments, the taxpayer subsequently requested a refund of the FICA taxes. After the bankruptcy court and the United States district court approved the refund, the IRS appealed the case to the United States Court of Appeals for the Sixth Circuit.

In *In re Quality Stores, Inc. (September 7, 2012)*, the Sixth Circuit agreed with the taxpayer and lower courts that supplemental unemployment benefits, while taxable to the terminated employee and subject to wage withholding, do not constitute wages for FICA purposes and FICA taxes do not apply to such payments. The Sixth Circuit's opinion conflicts with the Federal Circuit's 2008 opinion, in *CSX vs. United States*, holding that severance payments are wages for purposes of FICA taxes, so the U.S. Supreme Court ultimately may need to resolve this issue.

New York's MTA payroll tax found unconstitutional

New York enacted the Metropolitan Commuter Transportation Mobility Tax, often referred to as the Metropolitan Transportation Authority payroll tax, in 2009 in response to a large MTA budget shortfall. The MTA payroll tax is a quarterly tax on certain employers and self-employed individuals engaging in business within New York's metropolitan commuter transportation district (MCTD), which includes New York (Manhattan), Bronx, Kings (Brooklyn), Queens, Richmond (Staten Island), Rockland, Nassau, Suffolk, Orange, Putnam, Dutchess and Westchester counties. New York distributes the tax proceeds collected from taxpayers to the MTA.

Last fall, a New York State Supreme Court justice declared the MTA payroll tax unconstitutional. The lawsuit was brought by Edward P. Mangano, a Nassau County executive, whose constituents were directly affected by the tax. Four prior lawsuits challenging the constitutionality of the MTA payroll tax had been

dismissed. The court held that the MTA payroll tax is a "special law" because it applies only to counties within the MCTD. A special law will be upheld as constitutional if, among other factors, the law serves a "substantial state interest" or New York followed certain procedural requirements in enacting the legislation. The court found the MTA payroll tax unconstitutional because the legislation did not serve a substantial state interest and New York did not follow the required procedures for enacting a special law. The MTA has appealed the decision.

Taxpayers should consider filing protective refund claims for periods in which the three-year statute of limitations is closing in the event that the decision is not overturned.

Update to controversial New York residency case

New York State and New York City impose a personal income tax on a "resident individual" –generally someone who is domiciled in New York or who is not domiciled in New York but maintains a permanent place of abode in New York and spends more than 183 days of the taxable year in New York.

In *Gaied v. New York State*, the taxpayer, a New Jersey domiciliary, purchased a building in Staten Island, New York, for use by his parents as a residence and an investment. The issue in the case is whether the taxpayer maintained a permanent place of abode in New York. *Gaied* has a long history. In 2009, New York's Division of Tax Appeals determined that the taxpayer was a New York resident because of his access to the apartment. On appeal, the New York Tax Appeals Tribunal reversed the decision, finding the taxpayer not to be a New York resident because of his limited access to the apartment, lack of personal items there, and failure to use the place as a residence. The New York Division of Taxation requested re-argument, controversially arguing that no requirement exists that the taxpayer actually dwell in the abode for it to be permanent, and that the taxpayer's subjective use of the premises is not determinative for purposes of establishing a permanent place of abode where a taxpayer has a legal relationship to the property, continually maintains the premises, and the property meets the physical attributes of an abode. The Tribunal agreed, again finding that the taxpayer was a New York resident.

The taxpayer appealed, and the Tribunal, in December 2012, confirmed that the taxpayer was a resident for New York personal income tax purposes, even though a contrary conclusion would have been reasonable based on the evidence presented. The Tribunal based its decision on the fact that the taxpayer was registered to vote in New York, maintained a telephone and utilities in his own name for the property, paid all expenses for the apartment, retained unfettered access to the apartment, occasionally slept at the apartment, did not establish that he kept the apartment exclusively for his parents, and did not prove that he held the property solely for investment purposes. While this decision does not initially appear to be a good result for the taxpayer, the taxpayer can again appeal this case to the New York Court of Appeals "as of right" because of the two dissenting judges in the case.

New York expands post-production film tax credit

New York state increased the Empire State film post-production tax credit from 10 percent to 30 percent (for post-production facilities in New York City or Dutchess, Nassau, Orange, Putnam, Rockland, Suffolk and Westchester counties) and 35 percent (for post-production facilities in other counties) of the post-production costs paid in the production of a qualified film at such a post-production facility. Qualified film production companies that are ineligible for the Empire State film production credit may qualify for the post-production credit.

To qualify for the post-production credit, (1) the taxpayer must be a qualified film production company, and (2) post-production costs paid or incurred in the post-production of the qualified film at a New York state post-production facility must be at least 75 percent of the total post-production costs paid or incurred in the post-production of the qualified film at any post-production facility.

A qualified film production company is a corporation, partnership, limited partnership or other entity or individual that is principally engaged in the production of a qualified film and controls the qualified film during production.

A qualified film is a feature-length film, television film, television pilot or each episode of a television series, regardless of the medium by means of which the film, pilot or episode is created or conveyed, but does not

include a documentary film, news or current affairs program, interview or talk program, "how-to" (i.e., instructional) film or program, film or program consisting primarily of stock footage, sporting event or sporting program, game show, award ceremony, film or program intended primarily for industrial, corporate or institutional end-users, fundraising film or program, daytime drama (i.e., daytime "soap opera"), commercials, music videos or "reality" program, or a production that contains sexually explicit conduct.

Post-production costs are costs for production of original content for a qualified film employing traditional, emerging and new workflow techniques used in post-production for picture, sound and music editorial, rerecording and mixing, visual effects, graphic design, original scoring, animation, and music composition, excluding the editing of previously produced content for a qualified film.

More explanation of itemized deduction phase-out

After we released our alert on the American Taxpayer Relief Act of 2012, we received a few inquiries about how the phase-out of itemized deductions will work. The phase-out of itemized deductions returns to the tax code in 2013 after a several-year absence and the American Taxpayer Relief Act of 2012 increased the threshold amounts in cases in which it becomes applicable.

Assume that a married couple filing a joint return has an adjusted gross income of $1 million and itemized deductions for state income taxes and charitable contributions of $200,000. The deduction amount disallowed under the phase-out is an amount equal to 3 percent of the excess of the taxpayer's adjusted gross income over $300,000 for taxpayers filing a joint return ($250,000 for single taxpayers or $150,000 for a married taxpayer filing a separate return). These threshold numbers will be adjusted for inflation after 2013. The excess amount in this example is $700,000 ($1 million adjusted gross income minus $300,000) and 3 percent of that amount is $21,000, so the taxpayers would lose $21,000 of their $200,000 of itemized deductions.

The phase-out applies to all itemized deductions except for medical expenses, investment interest, casualty and theft losses, and permitted wagering losses. The disallowance under this provision, however, is limited to 80 percent of a taxpayer's total itemized deductions. All taxpayers, regardless of the level of their adjusted gross income, are permitted to keep at least 20 percent of their itemized deductions. For taxpayers who pay income tax at the maximum rate of 39.6 percent, the phase-out adds about 1.2 percentage points to their effective marginal tax rate.

S corporation distribution treated as wages subject to FICA taxes

Judging by the number of recent cases on this issue, both taxpayers and the IRS have figured out that if the owner of an S corporation withdraws all of the earnings of the business conducted by the corporation in the form of dividends rather than as wages, he avoids paying the FICA taxes on those amounts. Where an owner works for his business but takes no salary, upon audit the IRS very likely will take the position that some part of the distributions to the owner must be treated as wages for services rendered. The argument is essentially the opposite of the cases where the IRS argues that shareholders took too much compensation and unduly reduced the taxable income of a C corporation. In the case of an S corporation, the IRS argues that the shareholder did not take enough compensation for the services he performed for his corporation.

The IRS has been successful in the courts with this argument. Most recently, in *Patrick M. Herbert v. Commissioner (December 26, 2012)*, for the 2007 tax year, the taxpayer took only $2,400 of salary from his S corporation although he received total distributions of $60,000. The IRS argued that his compensation was unreasonably low and that a total of $55,000 should be treated as wages. The court agreed that the taxpayer's wages were unreasonably low but not to the same extent asserted by the IRS. Instead, the court looked at the average salary the taxpayer had received over the prior five years, the earliest two of which were years when the taxpayer did not own the business. On this basis, the court determined that $30,445 of the amount received by the taxpayer should be treated as wages.

This issue may become even more important in the future. Beginning in 2013, the portion of the FICA taxes that is unlimited increases for some taxpayers. Previously, in addition to the FICA tax that is subject to an annual cap, the employer paid an additional

tax of 1.45 percent on all of a taxpayer's wages, and the taxpayer also paid 1.45 percent, for a total of 2.9 percent. Beginning in 2013, the tax imposed on the taxpayer goes up an additional 0.9 percent, to make the total imposed on the taxpayer 2.35 percent of all of his wages. This last 0.9 percent only applies to wages in excess of $250,000 for a married taxpayer filing a joint return or $200,000 if the taxpayer is single.

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