tax report

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Pros and Cons of 401(k) Plan Loans

If you participate in a 401(k) retirement plan, the plan may allow you to borrow money from your plan account. However, before you take a plan loan, you'll want to carefully consider the various pros and cons.

Pros

One benefit of plan loans is their convenience — fees are minimal, there is no credit check, and the application process is relatively easy. Participants can often complete their loan applications online and make their loan payments through automatic payroll deduction.

Your plan may allow you to borrow as much as $50,000 or 50% of your vested account balance, if that amount is less than $50,000. However, loan limits can vary, so you'll want to check the specifics of your plan.

Additionally, the cost of borrowing may be favorable when compared to the cost of other types of borrowing, such as credit cards and auto loans. The law requires plans to charge a "reasonable" rate of interest for participant loans, meaning they must charge what is typically charged for similar loans. In 2014, the most popular rate formula was prime plus 1%.* With the prime rate currently at about 3.5%, the relative advantage of a plan loan over credit card borrowing is clear.

Keep in mind that the "interest" you pay on the loan is not going to an outside lender. Instead, that money is added to your retirement account balance. Depending on market conditions, this could be advantageous. If, for example, the market drops, you would still have added "interest" on the borrowed funds to your plan account.

Cons

On the other hand, the assets you borrow won't be invested in your plan investments. Until you repay the money, you'll miss out on any positive returns those funds would have earned if they'd been left in the plan.

Payments must be made on time. Generally, plans require loans to be repaid within five years. Loans taken to acquire a principal residence may have a longer repayment period. The entire loan balance may be due upon termination of your employment.

Failure to make payments as required can result in the unpaid loan balance being taxable. Moreover, taxpayers under age 59½ will generally incur an additional 10% penalty on the taxable amount unless one of a number of limited penalty exceptions applies. ■

* *58th Annual Survey of Profit Sharing and 401(k) Plans,* Plan Sponsor Council of America

Child Care Choice

Which saves more tax — claiming the dependent care tax credit or contributing to a dependent care flexible spending account (FSA) offered by your employer? It depends.

The *dependent care credit* operates as a direct reduction of your federal income-tax bill. The credit equals a percentage of allowable expenses — up to $3,000 of expenses for one qualifying child and $6,000 for two or more. The applicable percentage starts at 35% but then decreases to 20% when adjusted gross income exceeds $43,000.

A *dependent care FSA* allows you to set aside from earnings — before taxes — as much as $5,000 per year to pay dependent care expenses. You can't claim a credit for expenses paid with FSA funds.*

Generally, if your marginal income-tax rate is 25% or higher, the FSA will save you more income tax than the credit. An additional tax benefit: FSA contributions are not subject to FICA taxes.

* If you fund your FSA with $5,000 and have additional qualifying expenses for the care of two or more children, you may claim a credit for up to $1,000 of those expenses.

short takes

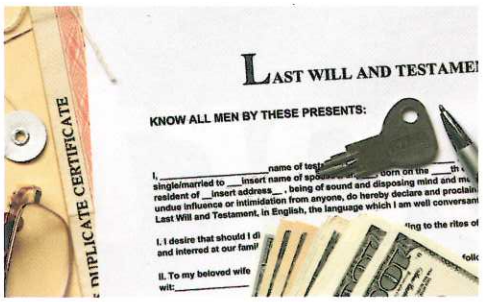
Payroll Tax Problems on the IRS's Radar

With the help of a new detection system, the IRS expects to soon be able to determine within 48 to 72 hours whether a business has incorrectly reported its payroll taxes. The new system — expected to be online by the end of 2016 — will substantially reduce delays in flagging missed payments, which currently can take several months.

Increased Scrutiny of Partnerships

For fiscal year 2015, partnerships faced their highest audit rate in 10 years (.51%). In contrast, the audit rate for large corporations (having $10 million or more in assets) continued its downward trend, reaching its lowest rate in 10 years (11.15%). Concurrent with this apparent shift in resources, the Bipartisan Budget Act of 2015 revised the rules on partnership audits, providing that for tax years beginning after December 31, 2017, a new streamlined set of rules generally will allow the IRS to determine and collect any "imputed underpayment" amount at the partnership level rather than having to pursue audit adjustments through to the partners.

Inheriting IRD



If you are ever called upon to handle someone's estate, you'll want to be aware of the tax law's "income in respect of a decedent" (IRD) rules. These rules also can be important to understand when you are planning your own estate.

What Is IRD?

Essentially, IRD is income a decedent would have declared on his or her income-tax return if death had not interceded. The most common example would be a paycheck the decedent had earned but not yet received at death. Other common items of IRD include unpaid bonuses and commissions, deferred compensation, and accrued but unpaid interest.

Retirement Accounts

In many cases, however, the most significant item of IRD will be tax-favored retirement accounts — whether they be held in an employer's plan, such as a 401(k), or owned individually in a traditional individual retirement account (IRA). Because these accounts typically consist entirely of amounts that have not yet been taxed, the tax rules require that those amounts be subject to income tax upon distribution.

Generally, either the account's designated beneficiary or the person inheriting the account through the estate will incur the income-tax liability for the distributions. As a result, the amount received from a retirement account after income taxes are paid may be less than the amount that could be realized by liquidating a non-IRD asset with the same face value.

For tax purposes, appreciated non-IRD assets included in the estate will generally receive a stepped-up basis equal to their fair market value on the date of death, with the recipient paying *capital gains* taxes only on the difference between the new basis and any subsequent, higher sale price. In contrast, the beneficiary of a retirement account will pay income taxes at his or her *ordinary* rate on any withdrawals of previously untaxed amounts from the account, often on the full distribution received. ■

Employers: Don't Forget the Additional 0.9% Medicare Tax

Since 2013, high earners have been required to pay an extra 0.9% Medicare tax in addition to the standard 1.45% Medicare tax paid by all employees. To ensure that this happens, the IRS requires employers to timely withhold the proper amounts from their employees' pay.

Who Is Liable?

The additional tax applies to wages in excess of $250,000 for joint filers, $125,000 for married individuals filing separately, and $200,000 for all others. Unlike the regular 1.45% Medicare tax, the additional 0.9% tax is payable by the employee only.

Employer Responsibilities

Employers must begin withholding for the tax in the pay period in which an employee's wages exceed $200,000. Note that the definition of "wages" for purposes of the additional 0.9% Medicare tax is the same as for the regular 1.45% Medicare tax, so items such as taxable noncash fringe benefits are included.

It's possible that a highly paid employee's wages could exceed the $200,000 withholding threshold, and yet the employee will not be liable for the tax at the end of the year. This can occur where the combined income of the employee and the employee's spouse does not exceed $250,000. Nevertheless, the employer is still held responsible for timely meeting its withholding responsibilities. Conversely, if an employee anticipates owing additional Medicare tax at the end of the year, the employee may make up for the withholding shortfall by either requesting additional income-tax withholding on Form W-4 or making estimated tax payments. ■

Real Estate Tax Breaks in the PATH Act

The depreciation period for office buildings and other nonresidential commercial real estate is 39 long years. However, taxpayers who acquire, lease, or improve certain real property may be able to write off their costs much more quickly using favorable tax provisions contained in the Protecting Americans from Tax Hikes (PATH) Act of 2015.

Section 179 Expensing

The PATH Act retroactively extended (and made permanent) the higher $500,000 annual expensing limit under Section 179 of the tax code. The Section 179 election may be made for most types of tangible personal property and/or for *qualified real property.*

Under prior law, the maximum amount of qualified real property that could be expensed under Section 179 was $250,000. Now, for tax years beginning after December 31, 2015, taxpayers may choose to allocate their entire $500,000 Section 179 election to qualified real property if desired. Depending on the situation, this could be beneficial because real property has a longer depreciation schedule than equipment or other property eligible for the Section 179 deduction.

The $500,000 expensing limit is reduced dollar for dollar by the amount of Section 179 property placed in service during the year that exceeds a $2,000,000 investment ceiling. Both figures are subject to potential inflation adjustment and for 2016 are $500,000 and $2,010,000, respectively.

There are three types of qualified real property, generally defined as follows:

- Qualified restaurant property — a depreciable building or building improvement if more than 50% of the building's square footage is devoted to preparation of and seating for on-premises consumption of prepared meals.

- Qualified leasehold improvement property — an improvement made to the interior portion of a nonresidential building under or pursuant to a lease where the improved portion is to be occupied exclusively by the lessee or a sublessee and the improvement is placed in service *more than three years* after the date the building was first placed in service.

- Qualified retail improvement property — any improvement to a nonresidential building where that portion is open to the general public and is used in the retail trade or business of selling tangible personal property to the general public and the improvement is placed in service *more than three years* after the date the building was first placed in service.

The latter two categories exclude certain improvements. We can provide further details.

Bonus First-year Depreciation

Under the PATH Act, 50% "bonus" depreciation is available for *qualified improvement property* placed in service after December 31, 2015. Qualified improvement property generally includes any improvement to an interior portion of a nonresidential building placed in service *after* (but not necessarily three years after) the building was placed in service. The property need not be subject to a lease. Excluded are building enlargements, elevators and escalators, and changes to the internal structural framework of the building. However, structural components that benefit a common area may qualify.

The bonus depreciation percentage is subject to phaseout, based on the year the qualified improvement property is placed in service:

- During 2016 or 2017 — 50%
- During 2018 — 40%
- During 2019 — 30%
- After 2019 — 0%

15-year Depreciation Schedule

The PATH Act retroactively restored and made permanent the favorable 15-year depreciation period for qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property. If all the relevant requirements are met, some taxpayers may be able to use all three of these tax breaks for one property. ■

Calendar of Filing Dates

AUGUST

1 Employee Benefit Plan Sponsors: File 2015 Form 5500 Annual Return/ Report of Employee Benefit Plan. If your plan is not a calendar-year plan, file the form by the end of the seventh month after the plan year ends.

1 Employers: File Form 941, Employer's Quarterly Federal Tax Return; quarterly deposit due.

10 Employers: Extended due date for Form 941, if timely deposits were made.

SEPTEMBER

15 Individuals: Third installment of 2016 estimated tax due; file Form 1040-ES.

15 Partnerships: Last day for filing 2015 return (Form 1065) by a calendar-year partnership that obtained a five-month extension.

15 Corporations: Last day for filing 2015 income-tax return (Form 1120, 1120S) by a calendar-year corporation that obtained an automatic six-month filing extension.

15 Corporations: Due date for depositing the third installment of estimated income tax for 2016 for calendar-year corporations.

Deductible Compensation or Dividend in Disguise?

A recent Tax Court decision* serves as a useful reminder that compensation — including year-end bonuses — paid to employee/shareholders of C corporations must be reasonable for the compensation to be tax deductible. Otherwise, the IRS may conclude that the compensation was essentially a nondeductible dividend disguised as compensation.

Independent Investor Test

In determining whether compensation is reasonable, courts generally apply an "independent investor" test. Basically, the court will look to see whether the firm's claimed compensation deduction is so substantial that a hypothetical independent investor in the firm would consider the return on its capital investment to be unreasonably low. If so, the compensation paid to the employee/shareholders may be reclassified as a nondeductible dividend.

Case in Point

The Tax Court decision involved a professional firm that had not paid a dividend for at least 10 years. Each year, the firm determined the year-end bonuses with reference to the firm's book income, calibrating the bonuses to effectively zero out the book income. As a result, the firm's reported taxable income (after certain adjustments) was less than one percent of its total income.

In reaching its decision, the court considered that the firm had invested capital, measured by the book value of its shareholders' equity, of about $8 million and $9 million for the two years in question. In the court's view, given the firm's substantial amount of capital, a hypothetical independent investor would not have received an adequate return on its investment. Therefore, the court held the shareholder compensation to be unreasonable and reclassified the amounts as dividends. ■

* *Brinks Gilson & Lione P.C. v. Comm'r,* TC Memo. 2016-20