FEDERAL AND MARYLAND TAX LAW CHANGES AND CLARIFICATIONS

With the last few days of summer approaching an end, SC&H Group would like to outline some of the federal and Maryland tax law changes and clarifications that have been finalized and introduced over the summer season.

The "Wynne" case – to be decided by the U.S. Supreme Court

To the surprise of many, the United States Supreme Court has agreed to hear the Maryland state's appeal in Maryland Comptroller of the Treasury v. Wynne, 431 Md. 147 (2013) (Supreme Court docket No. 13-485) in its 2014-2015 session.

This is the case in which Maryland's Court of Appeals, the state's highest court, ruled that Maryland's lack of credit against the "local" tax for taxes paid to other states on income generated in and taxed by the other state (a credit/reduction is allowed only against the "state" portion of the tax rate), violates the Commerce Clause of the U.S. Constitution because the resulting tax is not fairly apportioned and discriminates against interstate commerce. Essentially, the court reasoned that the taxation by Maryland of non-Maryland income was an incentive for Maryland residents to conduct business only in Maryland and thus impeded multistate commerce.

The State of Maryland is asserting that it has the right to tax 100% of residents' incomes, even interstate commerce income taxed by other states, based on the individual's status of resident.

The Court's session begins the first week of October 2014.

MARYLAND

Estate tax – increased amount that is not subject to the tax

Maryland's estate tax "unified credit" or exclusion amount is being recoupled to the federal estate tax amount, gradually over five years. The current exclusion amount through 12/31/14 is $1 million.

The phase in is as follows:

1/1/2015	$1.5 million
1/1/2016	$2.0 million
1/1/2017	$3.0 million
1/1/2018	$4.0 million
1/1/2019	The full federal amount, inflation adjusted each year; it is $5,340,000 for 2014.

Also, because full recoupling to the federal statute occurs January 1, 2019, this is also the date that "portability" will be possible under the Maryland estate tax law, that is, the ability of the surviving spouse to use the deceased spouse's unused exclusion amount.

Additional Maryland tax credits were enacted in 2014

Regional Institution Strategic Enterprise Zone Program (RISE zones):

"To access institutional assets that have a strong and demonstrated history of commitment to economic development and revitalization in the communities in which they are located." Businesses that locate in a RISE Zone are entitled to:

* Property tax credit, against the local but not state tax: 50% in first year and at least 10% in the second through fifth years. If in a focus area, the credit is 100% for five years. The credit can be renewed for another five years at 10% each year.

* Income tax credit for businesses (not individuals) the Enterprise Zone credits for wages (e.g. $1,000 per employee general credit, or $3,000 if "economically disadvantaged individual," or $1,500 or $4,500 if in "focus area;" excess credit can be carried over five years.

Endow Maryland – Income Tax Credit:

The new non-refundable credit is for donations to qualified permanent endowment funds at eligible community foundations for irrevocable gifts worth $500 or more of cash or publicly traded securities.

"Eligible community foundation" means: 501(c)(3) - commonly known as a community trust, foundation, or similar name that conveys concept of support of charitable activities in the community; satisfies the public support test of IRC Section 170. The credit is for 25% of the charitable contribution with a $50,000 credit maximum.

FEDERAL

Final Regulations Issued on Shareholder Loans to S Corporations

The IRS has issued final regulations that help clarify when a shareholder loan to an S Corporation will increase the shareholder's basis.* Shareholders may deduct losses passed through to them from the S Corporation to the extent the shareholder has basis in the S Corporation stock, plus the basis of any indebtedness of the S Corporation to the shareholder. The regulations provide that a shareholder in an S Corporation receives basis for the amount of any bona fide indebtedness from the individual to the S Corporation.

Prior to these regulations, the Courts had often held that an S Corporation shareholder received basis in debt under the actual economic outlay standard. Under this judicial standard, the shareholder must be 'poorer in a material sense' to receive basis from shareholder loans. Controversy arose when a shareholder borrowed cash from a related entity and loaned these funds to the S Corporation. Some courts held that the shareholder was not poorer in a material sense under the economic outlay standard and therefore the individual did not receive basis in the loan to the S Corporation.

The final regulations replace the actual economic outlay standard with a bona fide debt requirement. A shareholder receives basis in a bona fide loan to an S Corporation, regardless of the original source of the funds. General federal tax principles, in conjunction with the facts and circumstances, will determine whether the indebtedness is a bona fide debt.

These final regulations allow taxpayers to apply the bona fide debt standard to indebtedness between a shareholder and the S Corporation to any transaction that occurred in a year for which the statute of limitations has not closed as of July 23, 2014.

(Shareholder's basis is generally defined as their stock basis and debt basis which is their capital contributions allocated income less distribution and allocated losses.)

Alternative Simplified Research Credit on Amended Returns

In a pro-taxpayer change, the IRS will now allow the use of the alternative simplified credit (ASC) method of calculating the research credit on an amended tax return. Previously, the ASC could only be elected on an originally filed tax return. These temporary regulations will permit a taxpayer to file an amended return for a prior year that remains open under the three year statute of limitations. The new rules apply for taxpayers who have not claimed the research credit on the originally filed tax return. An amended return cannot be filed under this rule to change from a previously filed research credit method to the ASC method. Also, additional restrictions apply to elections that are made by members of controlled groups. Many taxpayers, especially those that were paying the Alternative Minimum Tax or generating operating losses, have not claimed the available research credit on prior tax returns. The new ASC rules give taxpayers an opportunity to generate tax credits to offset current and future tax liabilities.

Bankruptcy Protection Not Extended to Inherited IRAs

The Bankruptcy Code protects a debtor's retirement funds that are exempt from income tax, such as IRAs. The Supreme Court, in a unanimous decision, held that an inherited IRA no longer maintains its original character as a retirement fund. As such, inherited IRAs are not protected from creditors in bankruptcy proceedings. The term "inherited IRA" does not include an IRA that is inherited by the decedent's spouse. An IRA inherited by the spouse continues to enjoy creditor protection under the Bankruptcy Code.

Since non-spousal inheritances are no longer protected from creditors, a trust should be considered for certain IRA beneficiaries with potential financial difficulties. The individual would be named as a beneficiary of the trust instead of directly owning the inherited IRA. This structure could protect the full balance of the inherited IRA from creditors upon the personal bankruptcy of the beneficiary.

Severance Payments are Subject to Social Security Taxes

The Supreme Court decision of Quality Stores Inc. determined that severance payments to involuntarily terminated employees are subject to social security taxes. The Court held that the payments made to terminated employees were based upon job seniority and time served and were not linked to state unemployment benefits. As such, the payments constituted taxable income under the broad FICA definition of wages.

IRA Rollovers Restricted to Once Per Year Beginning in 2015

In a surprising decision, the Tax Court sided with the IRS and held that a taxpayer can only make one IRA rollover per year. Previous publications and guidance stated that a taxpayer could make one rollover for each separate IRA account per year. For clarity's sake, a rollover occurs when a trustee issues a check to the taxpayer who then deposits the check into another (or the same) IRA account within 60 days of the disbursement date. A transfer (not a rollover) occurs when an IRA account is directly moved from one trustee to another. A taxpayer may continue to use multiple IRA transfers during a single year.

Beginning on January 1, 2015, taxpayers will be limited to one rollover per year. If a taxpayer attempts to makes more than one IRA rollover per year, the second event will represent taxable income to the extent of previously untaxed amounts in the IRA. Additionally, the 10% early withdrawal tax may also apply to the distribution. Finally, if the funds are deposited into another (or the same) IRA, they may constitute excess contributions which are taxed at 6% per year for as long as the funds remain in the IRA.

If multiple IRA account rollovers are needed, taxpayers should make those transactions before the January 1, 2015 effective date of the new rules. Whenever possible, taxpayers should use the direct trustee-to-trustee IRA transfer instead of the IRA rollover option.

Enforcement of Responsible Person Penalty Will Likely Increase

If an employer fails to pay its payroll taxes, the IRS can assess penalty equal to 100% of the unpaid taxes from an individual who is responsible for collecting and paying over the payroll taxes yet willfully fails to do so. Upon review of this governmental process, the Treasury Inspector General for Tax Administration determined that the IRS was not taking adequate and timely action when collecting the responsible person penalty for payroll taxes. The IRS agreed to implement every recommendation for improvement contained in the report. Greater enforcement of the responsible person penalty is likely to occur with these improvements.

Employer Payment Plans are Subject to the Affordable Care Act

Some advisors have recommended implementing a compensation plan through which the company reimburses its employees for health insurance premiums they obtain through a health exchange, otherwise known as an 'employer payment plan'. This structure has been proposed as a method to shift health care expense from the employer's plan to the exchange. The IRS has held that this reimbursement arrangement is a group health plan which fails to conform to the prohibitions on annual limits for essential health benefits and cost sharing of certain preventative care of the Affordable Care Act. Since the group health plan does not meet the market reform requirements, the employer may be assessed a $100/day excise tax for each employee, ($36,500 per year, per employee). Since these employer payment plans have been classified as a group health plan, employers should be aware that an attempt to 'dump' their employees on the health exchange could result in penalty assessments under the Affordable Care Act.

Simplified Reporting for Some Money Market Funds

The IRS has issued proposed regulations that provide for a simplified method for reporting gains and losses on shares of certain money market funds. Under new rules, institutional prime money market funds are required to value their portfolio using market-based factors and sell and redeem shares using a floating net asset value ("NAV"). These funds will no longer be allowed to use pricing and valuation conventions that allowed for a constant share price of $1. To simplify tax compliance for the owners of these investments, the IRS will not require the shareholders to measure net gain or loss on a transaction by transaction basis. Rather, these shareholders may determine net gain or loss using information generally reported to them by the fund. Under this simplified method, net gain or loss is determined as: the increase or decrease in the value of the shareholder's shares during the tax year less the net investment in these holdings during the year.

Taxpayer Bill of Rights

The IRS has adopted a "Taxpayer Bill of Rights" which is easily visible on the IRS website. Under this Bill of Rights taxpayers have (1) the right to be informed; (2) the right to quality service; (3) the right to pay no more than the correct amount of tax; (4) the right to challenge the IRS's position and be heard; (5) the right to appeal an IRS decision in an independent forum; (6) the right to finality; (7) the right to privacy; (8) the right to confidentiality; (9) the right to retain representation; and (10) the right to a fair and just tax system.

Tax Treatment of College Athletic Scholarships for Student Athletes

The IRS released an information letter confirming that student athletic scholarships are qualified scholarships. Qualified scholarships are excluded from gross income to the extent they are used for qualified tuition and related expenses.