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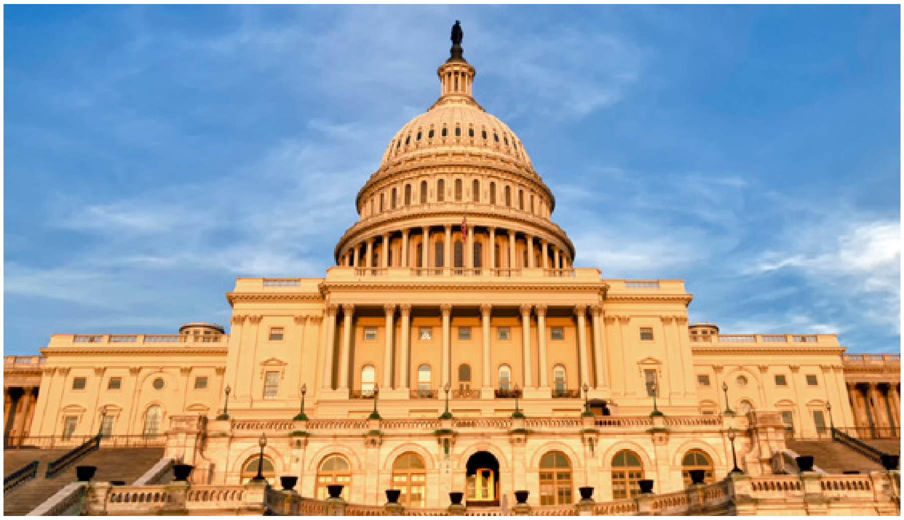

WHY THE MISCELLANEOUS TARIFF BILL DESERVES ATTENTION

Tax extenders aren't the only legislation being held up in Congress. For the last two years, Congress has failed to act on Miscellaneous Tariff Bill (MTB) legislation. The last MTB bill passed expired at the end of 2012; as a result, since January 1, 2013 manufacturers have been paying higher import duties on raw materials and intermediate products that are not produced or available in the United States. According to the National Association of Manufacturers' economic impact assessment of the MTB, failure to pass the MTB resulted in tax hikes of $748 million and will amount to estimated economic losses of almost $2 billion over the next three years.

What is the MTB? It's a means through which import duties on certain products – usually raw materials or intermediate goods such as electronic components, mechanical parts and chemicals, used by downstream US firms to produce their own output – are temporarily suspended for two or three years. To qualify, products must not be produced domestically nor can the proposed duty suspension reduce tariff revenues by more than $500,000. On its own, the $500,000 tariff revenue limit can hardly be considered an eyebrow raiser.

While the legislation lingers, the result has been significant increases in manufacturing costs that are ultimately passed on to consumers. The overall impact of the bill would help US firms reduce costs, compete more effectively at home and abroad, and help US families reduce the cost of living. Cutting the tariff delivers direct benefits to manufacturers buying products in the global markets. If demand in the US is small compared to the size of the overall global market, then global prices will generally not be affected and US companies importing the products will pocket the cost savings from the tariff suspension. If the US is a relatively large customer in the world, the increased demand from the tariff cut can raise global prices for the imported product which allows foreign suppliers to share in the gains.

Lower domestic prices as a result of tariff suspension also have a ripple effect on the economy. A lower price for the imported raw materials and intermediate products allows US manufacturers to cut costs, expand market share, increase production and potentially hire more workers. From this perspective, the tariff suspensions are targeted tax relief that translates directly into productive economic activity.

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With all these positives, why is Congress holding back on the legislation? That's because the MTB process is a tedious one. Each proposed duty suspension is subject to a meticulous and nonpartisan vetting process to ensure that no domestic producers of the affected product exist. In addition to the House and Senate committees, the International Trade Commission, Department of Commerce, Customs and Border Protection and Office of Management and Budget all collaborate to review every bill. Each proposal is then subject to public comment periods then it finally makes its way to the House Ways and Means and Senate Finance Committees for consideration. That is a lot of cooks in the kitchen, maybe just enough to spoil the soup.

By Tracey Powell, Senior Manager (Columbia, MD)

> "Failure to pass the MTB resulted in tax hikes of $748 million and will amount to estimated economic losses of almost $2 billion over the next three years."

DO YOU MATERIALLY PARTICIPATE IN YOUR TRADE OR BUSINESS? CAN YOU PROVE IT?

More than ever before it is important for business owners to document their level of participation in a trade or business activity. An owner's level of participation is important to properly characterize the applicable income or loss as either passive or active (non-passive) on their tax returns. Improper characterization of income or loss on your tax return can have a significant impact on tax liability and many times the impact is not favorable. This issue is even greater for taxpayers who own interests in several business entities. For legal protection purposes, business owners may segregate lines of business into separate legal entities, or place appreciable assets like real estate in a separate entity from the trade or business. These are good reasons to do so; however, for tax purposes this brings some challenges to an individual business owner. The main challenge is – proving that the business owner materially participates in each business activity.

WHY IS THIS IMPORTANT?

Since most business activities are owned by individuals through a flow-through entity structure, such as an S corporation, LLC or partnership, the owners of these interests carry the burden of proof to show that they materially participate in each business activity. Over the past several years there has been a number of tax court cases in which the IRS has challenged taxpayers to prove their characterization of business income or loss on their returns as either active (materially participating) or passive. These characterizations will often lead to different outcomes when calculating taxable income. When you are under audit, the IRS will assume that you are a passive investor, unless you can provide documentation to support and prove your material participation. In several of the tax court cases, taxpayers have lost because they have not been able to produce contemporaneous records to prove they materially participated.

It would be easy if we could just net the income and loss together from all of the businesses which an owner is invested. Unfortunately, it is not that simple. In 1986, Congress recognized that some investors who had income from one business entity were "sheltering" this income by investing in other business entities that produced losses. Many times the owner did not participate in running or managing all of the business activities. To prevent this, the passive activity loss (PAL) rules were put into law. Generally speaking, these rules state that an investor cannot reduce the income from a business in which they materially participate with a PAL from another business activity. Income and loss from passive activities must be segregated from the income and loss of non-passive activities. To the extent passive losses exceed passive income, the losses are suspended and carried over to future years. PALs will be suspended until there is income from any passive activity or the activity is disposed of in a taxable transaction. If none of the business activities had a loss, then generally there were no issues. This situation changed starting in 2013.

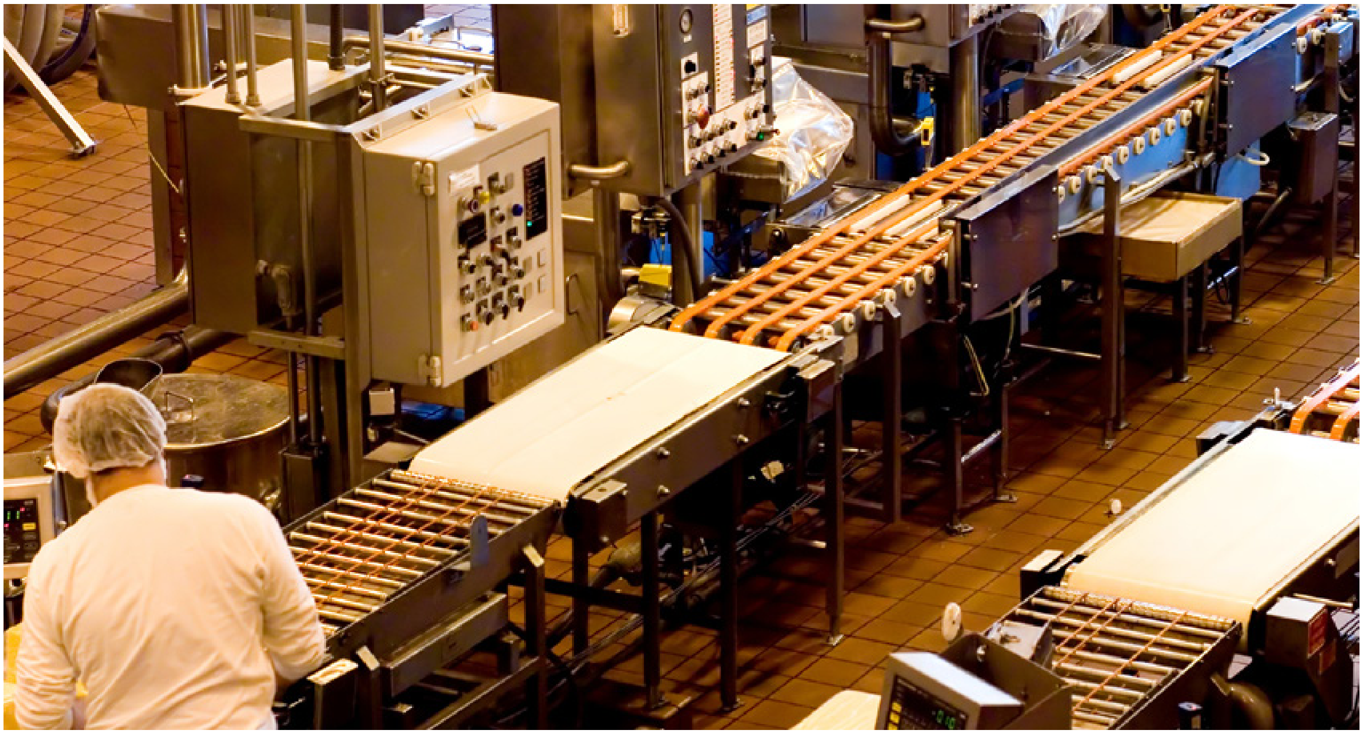
There is now a new reason to make sure that your material participation documentation and support is in good shape. As part of the Health Care and Education Reconciliation Act of 2010, Congress created a new 3.8% Medicare tax called the net investment income tax (NIIT), which became effective for the 2013 tax year. NIIT applies to investment income received by taxpayers. Included in the definition of investment income is passive income from a trade or business. For business owners that materially participate in multiple business entities, it is very important that you maintain some level of documentation to prove your participation and satisfy your burden of proof.

MATERIAL PARTICIPATION – 101

Generally, an individual taxpayer will meet the material participation standards if their duties are customary for a business owner, are not being performed for the purpose of avoiding the impact of the passive activity loss rules, and their level of participation is regular, continuous and substantial. In addition, the regulations provide some tests that will assist taxpayers in determining if their participation rises to the level of material. Passing one of the seven tests outlined in Temp. Reg. 1.469-5T(a) will suffice. They are as follows:

1. *More than 500 hours test* – The taxpayer participates in the activity for more than 500 hours during the tax year in question.
2. *Substantially all participation test* – The taxpayer's participation in the activity for the year constitutes substantially all the participation by all individuals (including those who are not owners of interests in the activity).
3. *More than 100 hours test* – The taxpayer participates in the activity for more than 100 hours during the year in question and no other individual participates more than the taxpayer.
4. *Significant participation activity (SPA) test* – The activity is an SPA in which the taxpayer participates for more than 100 hours during the year and the taxpayer's total participation in all SPAs during the year exceeds 500 hours.
5. *Prior-year material participation test* – The taxpayer materially participated in the activity for any five of the ten immediately preceding years.
6. *Personal service activity test* – The activity is a personal service activity and the taxpayer materially participated in the activity for any three years before the year in question.
7. *Facts and circumstances test* – Consideration of relevant facts and circumstances indicate the taxpayer materially participated in the activity on a regular, continuous and substantial basis.

As you would expect, there are some exceptions to the general rules. Without going into great detail, here are some of the exceptions:



- These tests generally do not apply to non-grantor trusts or estates for determining their participation in a trade or business. At this time, the IRS has not issued any bright line tests for these types of business owners. [The seven tests outlined in Temp. Reg. 1.469-5T(a) were generally intended for individuals and grantor trusts that invest in a trade or business activity.]
- Limited partners can only use tests 1, 5 and 6 above to qualify as a material participant.
- There are additional, more stringent tests, to get rental real estate income or loss characterized as non-passive. In addition to the material participation rules, an investor must also qualify as a real estate professional.

SATISFYING THE BURDEN OF PROOF

Taxpayers can substantiate participation in an activity using any reasonable method. Documentary support may include, but is not limited to, identification of services provided, approximate hours spent, appointment books, calendars and narrative summaries [Temp. Reg. 1.469-5T(f)(4)]. Contemporaneous daily logs or reports are not required; however, they are much more credible. Taxpayers carry the burden of proof for substantiating their participation to the IRS. In order to shift that burden to the IRS, credible documentation is necessary. Without reasonable evidence, the IRS and the courts will likely assert that activities are passive. Here are some examples of recent rulings:

Ben Bartlett v Commissioner, TC Memo 2013-182. Owners' participation in bull breeding ranch was ruled to be passive and losses were disallowed on 2006 and 2007 tax returns. Plaintiff owned a landscaping business and the bull breeding ranch, and he claimed that he materially participated in both activities. Losses from the bull breeding ranch were deducted and reduced the income from the successful landscaping business on the owner's tax return. The tax court ruled that the plaintiff failed to establish material participation in the bull breeding ranch for the following reasons: 1) Plaintiff did not sufficiently corroborate participation with proof that he worked on the ranch for 500 hours, or 2) that he worked there more than any other employee for purposes of the 100 hour test, 3) he offered only noncontemporaneous schedules that were mere "guesstimates" constructed from credit card statements that showed he made purchases on certain dates near ranch property, 4) he could not qualify under the facts and circumstances test when considering all of the information and that he was also operating a very successful landscaping business that was located over 200 miles from the ranch, and 5) management activities couldn't be taken into account due to inconsistencies regarding whether a ranch hand was also paid for management services.

Patrick Lum v. Commissioner, TC Memo 2012-103. Owners' participation in solar power equipment leasing company was ruled to be passive and losses on his 2006 return were disallowed. Even though the plaintiff maintained

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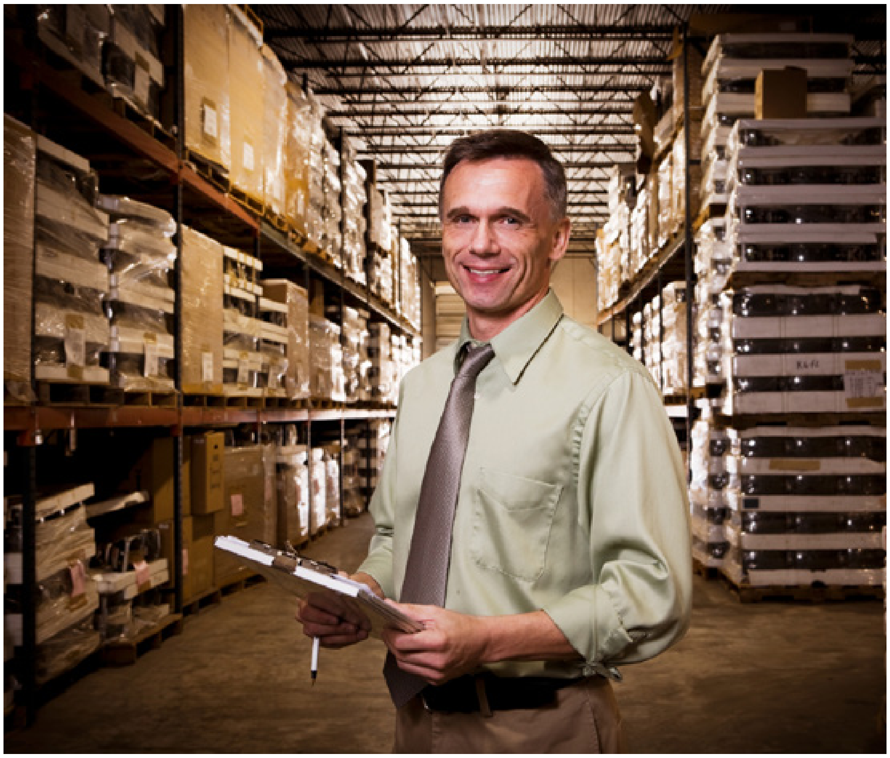

that he materially participated in the business, the United States Tax Court determined that a substantial portion of business activity was outsourced to third party. The third party collected payments, maintained program records, made program-related loans, made tax payments on the owner's behalf and installed equipment in customers' homes. Even though there were no employees, the owner could not show that he met any of the material participation tests, offered almost no evidence of duties that he performed and could not produce any support for times and dates of participation.

GROUPING ACTIVITIES

Owners of two or more business activities can make an election to group their activities into one activity for purposes of the passive activity rules. This technique gives the business owner a better chance of meeting the material participation tests by combining participation hours of multiple activities into a single activity. In other words, an effective grouping election will only require the business owner to meet the material participation test for the combined group versus each individual activity. This also would allow the business owner to currently deduct losses that might have otherwise been suspended and reduce the owner's income subject to the 3.8% NIIT. This sounds great; however, not all activities can be grouped.

Grouped activities must form an "appropriate economic unit". Whether activities constitute an appropriate economic unit and may be treated as a single activity all depends on the relevant facts and circumstances. A taxpayer may use any reasonable method of applying the relevant facts and circumstances; however, the passive activity regulations provide some guidance as to what factors are given the greatest weight in making a determination. These factors are:

- Similarities and differences in types of trades or businesses
- The extent of common control
- The extent of common ownership
- Geographical location
- Interdependence between or among the activities

In addition, the regulations prohibit rental activities from being grouped with other trade or business activities unless they constitute an appropriate economic unit. Real property rentals cannot be combined with personal property rentals and activities conducted as a limited partner cannot be grouped with other activities that are not the same type of business.

FRESH START REGROUPING ELECTION

Once activities are grouped together you generally cannot regroup them in subsequent years. However, regrouping is required in situations where the original grouping was clearly inappropriate or a material change in the facts and circumstances has occurred. The IRS has determined that the NIIT is a material change in facts and circumstances, which would permit a regrouping election. This "fresh start" election must be made in the first year that begins after December 31, 2013, and that the taxpayer first becomes subject to the NIIT.

CONCLUSION

As a result of the limitations on PALs and the extra NIIT burden placed upon passive activity income from a trade or business, it is crucial for business owners to document their level of participation in business activities. The IRS and the courts have shown that they are looking for credible support from taxpayers in order to satisfy their burden of proof. This is especially important if taxpayers have ownership interests in multiple entities and/or have an interest in an entity that generates large losses or large amounts of income. An unfavorable ruling could result in a large tax liability, significant penalties and interest.

Grouping activities is a great strategy to help reduce or eliminate the effects of the PAL and NIIT; however, careful planning must be done to make sure that the groupings are an appropriate economic unit and will hold up to IRS scrutiny. In addition, it is important to carefully review your 2014 tax planning to determine if the "fresh start" regrouping election should be made, and the pros and cons of doing so.

By Paul Truber, Tax Principal
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MANUFACTURING INDUSTRY INSIGHT

UHY LLP recognizes that manufacturing companies require their auditors, tax specialists and business advisors to add value to financial reporting activities. That is why we combine the strength of business and financial expertise with a hands-on, "shop floor" approach to solving complex business decisions in these key segments:

- Aerospace & Defense
- Distribution
- Automotive Suppliers
- Industrial Manufacturing
- Consumer Products

Our professionals are leaders in the industry and take the steps necessary to ensure our client's future success by identifying and addressing new trends, accounting requirements and regulations.

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