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Michael J. Reilly, CPA/ABV, CVA, CFF, CDA

Corporate & Individual Tax Update

Michael J. Reilly, CPA/ABV, CVA, CFF, CDA

Tax Partner

mreilly@dmcpas.com

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Circular 230

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Disclaimer

Proposed Individual Tax Changes in the "Tax Cuts & Jobs Act"

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Proposed Individual Tax Changes

Changes to Tax Rates & Brackets

***New Tax Brackets*.**

1) The number of tax brackets (currently ranging from 10% to 39.6%) would be reduced from seven to four: 12%, 25%, 35%, and 39.6%.
2) The 12% bracket would begin at $0 for all taxpayers.
    a. The 12% rate would be "phased out" for taxpayers with AGI over $1,000,000 for single taxpayers and $1,200,000 for married joint taxpayers effectively creating a 45.6% tax bracket for those individuals.
3) The 25% bracket would begin at:
    a. $90,000 for married filing joint.
    b. $45,000 for married filing separate.
    c. $67,000 for heads of household.
    d. $45,000 for singles.
    e. $2,550 for an estate or trust.

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Proposed Individual Tax Changes (can't)

4) The 35% bracket would begin at:

   a. $260,000 for married filing joint.

   b. $130,000 for married filing separate.

   c. $200,000 for heads of household.

   d. $200,000 for singles.

   e. $9,150 for an estate or trust.

5) The 39.6% bracket would begin at:

   a. $1,000,000 for married filing joint.

   b. $500,000 for married filing separate.

   c. $500,000 for heads of household.

   d. $500,000 for singles.

   e. $12,500 for an estate or trust.

Proposed Individual Tax Changes (cont.)

Inflation adjustment. For tax years beginning after 2018, the dollar amounts above would be indexed for inflation.

Effective date. The above changes would be effective for tax years beginning after December 31, 2017.

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2018 Individual Income Tax Rate Structure

Single Taxpayers				
	Ordinary Income		Dividends and LTCGs	
Income Level	**Current**	**Proposed**	**Current**	**Proposed**
$0 to $9,525	10%	12%	0%	0%
$9,525-$38,700	15%	12%	0%	0%
$38,700-$45,000	25%	12%	15%	15%
$45,000-$93,700	25%	25%	15%	15%
$93,700-$195,450	28%	25%	15%	15%
$195,450-$200,000	33%	25%	15%	15%
$200,000-$424,950	33%	35%	15%	15%
$424,950-$426,700	35%	35%	15%	15%
$426,700-$500,000	39.6%	35%	20%	20%
Greater than $500,000	39.6%	39.6%	20%	20%

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2018 Individual Income Tax Rate Structure

Married Joint Taxpayers				
	Ordinary Income		Dividends and LTCGs	
Income Level	**Current**	**Proposed**	**Current**	**Proposed**
$0 to $19,050	10%	12%	0%	0%
$19,050-$77,400	15%	12%	0%	0%
$77,400-$90,000	25%	12%	15%	15%
$90,000-$156,150	25%	25%	15%	15%
$156,150-$237,950	28%	25%	15%	15%
$237,950-$260,000	33%	25%	15%	15%
$260,000-$424,950	33%	35%	15%	15%
$424,950-$480,050	35%	35%	15%	15%
$480,050-$1,000,000	39.6%	35%	20%	20%
Greater than $1,000,000	39.6%	39.6%	20%	20%

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Proposed Individual Tax Changes (cont.)

Increased Standard Deduction & Elimination of Personal Exemptions

Standard deduction increased.

1) $24,000 for married joint.
2) $12,200 for married filing separate.
3) $18,300 for heads of household.
4) $12,200 for singles.
5) For individuals who are claimed as dependents, the Act would limit the standard deduction to the greater of $500 or the sum of $250 and the individual's earned income.

Personal exemptions repealed.

1) The Act would repeal the deduction for personal exemptions which under current law is scheduled to be $4,150 for 2018, subject to a phase out for higher earners.

Effective date*.* The new standard deductions and repeal of personal exemptions would go into effect for tax years beginning after December 31, 2017.

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Proposed Individual Tax Changes (cont.)

New Maximum Rate on Business Income of Individuals

25% "business income" rate.

1) The Act would provide a new maximum rate of 25% on the "net business income" of individuals.
2) "Qualified business income".
    a. 100% of any net business income from a "passive activity" (defined under IRC Section 469).
        i. A "passive owner" is entitled to a 25% rate on all their pass-through income.
        ii. This would include rental income since rental income is passive income under IRC Section 469.
    b. For a non-passive owner, only the "capital percentage" of their net business income would be subject to the 25% rate and the balance of their net business income would be subject to the normal ordinary income tax rates.
    c. Wages, guaranteed payments and director's fees attributable to the business are treated as part of the net business income.

Proposed Individual Tax Changes (cont.)

3) Business owners could elect to apply the default "capital percentage" (defined as 30%) to the net business income derived from active business activities to determine their business income eligible for the 25% rate (with the remaining 70% subject to ordinary individual income tax rates).

4) As an alternative, business owners may elect to apply a formula based on the facts and circumstances of their business to determine an amount greater than the 30% capital percentage.

    a. The formula would measure the capital percentage based on a rate of return (the short-term Applicable Federal Rate at the end of the year plus 7%) multiplied by the adjusted basis of the assets (excluding bonus depreciation and the IRC Section 179 deduction) of the business at the end of the year.

    b. Once made, the election of the alternative formula would be binding for a 5-year period.

Proposed Individual Tax Changes (cont.)

5) The default capital percentage for certain personal services business (e.g., businesses involved in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, and brokerage services, including investing, trading or dealing in securities) would be 0%

   a. However, such businesses could elect to apply the alternate capital percentage formula based on the business's capital investments if the capital percentage determined is at least 10%.

6) An owner's income capital percentage would be limited if actual wages or guaranteed payments exceeds the taxpayer's otherwise applicable capital percentage.

   a. A special anti-abuse rule would apply to prevent the recharacterization of actual wages paid as business income.

7) Income subject to preferential rates, such as long-term capital gains and qualified dividend income would be excluded from any determination of a business owner's capital percentage.

8) Certain other investment income that is subject to ordinary rates such as short-term capital gains, dividends, etc. not related to the business needs, would also not be eligible to be recharacterized as business income.

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Proposed Individual Tax Changes (cont.)

New 25% rate for certain dividends of REITs and cooperatives.

1) The Act would also provide that certain dividends of real estate investment trusts (REITs) and patronage dividends from cooperatives are subject to a 25% rate.

Effective date. The above provisions would go into effect for tax years beginning after December 31, 2017.

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Tax Rate Structure for Small Business

Example

	Passive Manufacturing	**Non-passive Manufacturing**	**Accounting Firm**
	$ 500,000	$ 500,000	$ 500,000
Income taxed at 25%	$ 500,000	$ 150,000	
Tax at favorable rate	$ 125,000	$ 37,500	
Income taxed at regular rates		$ 350,000	$ 500,000
Tax at regular rates	$ 0	$ 159,600	$ 228,000
Total tax	**$ 125,000**	**$ 197,100**	**$ 228,000**

Tax Rate Structure for Small Business (cont.)

SE Tax Treatment of Flow-Through Income under House Bill:

1) It appears that any flow-through income that is not subject to the 25% rate is subject to SE tax, including income allocated to S corporation shareholders and limited partners in partnerships.

2) It appears rental income will be subject to SE tax.

Proposed Individual Tax Changes (cont.)

Enhanced Child Tax Credit & New Family Tax Credit

Increased child tax credit.

1) The amount of the child tax credit would increase from $1,000 to $1,600.
2) It would also replace the term "qualifying child" with "dependent" and eliminate the phrase "for which the taxpayer is allowed a deduction under Section 151."
3) The Act would also provide a $300 credit for non-child dependents, as well as a $300 "family flexibility credit" for the taxpayer (or both spouses, for a joint return).

Effective date. The non-child dependent credit and the family flexibility credit would be effective for tax years ending *before* January 1, 2023.

Proposed Individual Tax Changes (cont.)

Phase-out.

1) The income levels would increase at which these credits phase-out.

2) Under current law, the credit is phased out beginning at income levels of $75,000 for single filers and $110,000 for joint filers.

3) The Act would raise these amounts to $115,000 and $230,000, respectively.

Refundable portion.

1) Under current law, the child tax credit is partially refundable.

2) The Act would limit the amount that is refundable to $1,000, and index this amount to inflation up to a maximum amount of the $1,600 base credit.

3) A taxpayer would be required to provide a Social Security number (SSN) to claim the refundable portion of the credit.

Effective date. These amendments would apply to tax years beginning after December 31, 2017.

Proposed Individual Tax Changes (cont.)

Repeal of Certain Nonrefundable Credits

***Repealed credits**.* The Act would repeal:

1) The credit for individuals over age 65 or who have retired on disability.

2) The adoption credit.

3) The tax credit associated with mortgage credit certificates.

4) The credit for plug-in electric drive motor vehicles.

Effective date. The provision repealing qualified plug-in electric drive motor vehicles would be effective for vehicles placed in service for tax years beginning after December 31, 2017. The other provisions would be effective for tax years beginning after December 31, 2017.

Proposed Individual Tax Changes (cont.)

Streamlined Education Incentives

Enhanced AOTC.

1) The three higher education credits under current law -- the American Opportunity Tax Credit (AOTC), the Hope Scholarship Credit (HSC), and the Lifetime Learning Credit (LLC) would be reduced to one "enhanced" AOTC.

2) The enhanced AOTC would, like the version under current law, provide a 100% tax credit for the first $2,000 of qualifying higher education expenses and a 25% credit for the next $2,000 of such expenses (for a $2,500 maximum).

3) The HSC and LLC would be repealed.

4) The AOTC would be limited to five years of post-secondary education, with the credit for the fifth year available at half the rate as the first four years, with up to $500 being refundable.

No new Coverdell account contributions.

1) New contributions to Coverdell education savings accounts would be prohibited after 2017.

Proposed Individual Tax Changes (cont.)

Section 529 Account distributions.

1) The Act would treat up to $10,000 per year for elementary and high school expenses as "qualified expenses" under the Section 529 plan rules.

Qualified Tuition Program (QTP) distributions for apprenticeships.

1) The Act would add to the term "qualified education expenses" certain books and supplies required for registered apprenticeship programs.

Treatment of discharged student loan indebtedness.

1) Any income resulting from the discharge of student debt on account of death or total disability of the student would be excluded from taxable income.

2) The Act would also exclude from income repayment of a taxpayer's loans pursuant to the Indian Health Service Loan Repayment Program.

Proposed Individual Tax Changes (cont.)

***Other education provisions repealed*.**

The Act would repeal:

1) The above-the line deduction for interest payments on qualified education loans for qualified higher education expenses.

2) The pre-2017 above-the-line deduction for qualified tuition and related expenses.

3) The exclusion from income of interest on U.S. savings bonds used to pay qualified higher education expenses.

4) The exclusion from gross income of qualified tuition reductions provided by educational institutions.

5) Employer-provided education assistance.

Effective date. The above provisions would generally be effective after December 31, 2017.

Proposed Individual Tax Changes (cont.)

Simplification and Reform of Deductions

"Pease" limitation repealed.

1) The so-called "Pease" limitation on itemized deductions would be repealed.

Mortgage interest deduction retained, but with new limits.

1) The home mortgage interest deduction would be retained in its current form-i.e., subject to a $1 million cap for mortgages that already exist on November 2, 2017, as well as for taxpayers who have entered into a binding written contract before that date to purchase a home.

2) For newly purchased homes, the deduction will be limited to $500,000 ($250,000 for MFS).

3) Taxpayers would be limited to one qualified residence.

4) The Senate version of the Bill may maintain the $1 million dollar cap for mortgages.

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Proposed Individual Tax Changes (cont.)

***State and local property tax deduction retained, but with new limits*.**

1) The deduction for State and local income or sales tax would be eliminated.
2) The deduction for real property taxes would be retained, subject to a $10,000 maximum.

Repealed deductions.

The Act would repeal deductions for:

1) Taxes not paid or accrued in a trade or business.
2) Personal casualty losses.
    a. There's an exception for disaster losses under the recent Disaster Tax Relief and Airport and Airway Extension Act of 2017.
3) State and local income taxes and sales taxes.
4) Tax preparation expenses.

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Proposed Individual Tax Changes (cont.)

5) Alimony payments.

   a. Alimony payments would not be taxable to the payee.

   b. This provision is effective for any divorce decree or separation agreement executed or modified after 2017.

6) Moving expenses.

7) Contributions to Medical Savings Accounts (MSAs).

   a. Existing balances could be rolled over on a tax-free basis into a Health Savings Account (HSA).

   b. The exclusion for employer-provided contributions to MSAs would also be repealed.

8) Medical expenses.

9) Expenses attributable to the trade or business of being an employee.

10) The Act would also modify the limitation on wagering losses to provide that all deductions for expenses incurred in carrying out wagering transactions, and not just gambling losses, would be limited to the extent of gambling winnings.

Proposed Individual Tax Changes (cont.)

Modified rules for charitable contributions*.*

The Act would:

1) Increase the 50% AGI limitation for cash contributions to public charities and certain private foundations to 60%.

2) Repeal the special rule that provides a charitable deduction of 80% of the amount paid to a college or university for the right to purchase tickets for athletic events.

3) Adjust the charitable mileage rate for inflation.

4) Repeal the exception under which a taxpayer that failed to provide a contemporaneous written acknowledgement by the donee organization for contributions of $250 or more is relieved from doing so when the donee organization files a return with the required information.

Effective date*.* Except as otherwise noted, the above provisions would be effective for tax years beginning after December 31, 2017.

Proposed Individual Tax Changes (cont.)

Simplification and Reforms of Exclusions and Taxable Compensation

Employer-provided housing.

1) The Act would limit the exclusion for housing provided for the convenience of the employer and for employees of educational institutions to $50,000 ($25,000 for MFJ).

2) The exclusion would also phase out for higher-income individuals.

Gain from sale of principal residence.

1) The Act would require that, in order to exclude gain from the sale of a principal residence (up to $500,000 for joint filers; $250,000 for others), a taxpayer would have to own and use as a home the residence for five out of the previous eight years.

    a. As opposed to two out of five years under current law.

2) The exclusion could only be used once every five years.

3) The exclusion would be phased out by one dollar for every dollar by which the taxpayer's AGI exceeds $500,000 ($250,000 for single filers).

Effective date: for sales and exchanges after December 31, 2017.

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Proposed Individual Tax Changes (cont.)

Repealed exclusions.

The Act would repeal current law exclusions for:

1) Employee achievement awards.

2) Dependent care assistance programs.

3) Qualified moving expense reimbursements.

4) Adoption assistance programs.

Effective date*.* The above provisions would be generally be effective for tax years beginning after December 31, 2017.

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Proposed Individual Tax Changes (cont.)

Reforms to Savings, Pensions, and Retirement

Roth IRA recharacterization rule repealed.

1) The Act would repeal the current law provisions under which an individual may re-characterize a contribution to a traditional IRA as a contribution to a Roth IRA (and vice versa) and may also recharacterize a conversion of a traditional IRA to a Roth IRA.

Reduction in minimum age for allowable in-service distributions.

1) All defined benefit plans as well as State and local government defined contribution plans would be permitted to make in-service distributions beginning at age 59-1/2.

Modified rules on hardship distributions.

1) The Act would require IRS to, within one year from the date of enactment, change its regulations under Code Section 401(k) to allow employees taking hardship distributions to continue making contributions to the plan.

2) The Act would also let employers choose to allow hardship distributions to include account earnings and employer contributions.

Proposed Individual Tax Changes (cont.)

Extended rollover period for the rollover of plan loan offset amounts in certain cases*.*

1) Code Section 402(c) would be modified to provide that employees whose plan terminates or who separate from employment while they have plan loans outstanding would have until the due date for filing their tax return for that year to contribute the loan balance to an IRA in order to avoid the loan being taxed as a distribution.

Modification of nondiscrimination rules.

1) Code Section 401 would be amended to allow expanded cross-testing between an employer's defined benefit and defined contributions for purposes of the nondiscrimination rules, effective as of the date of enactment.

Effective date*.* Except as otherwise provided, the above provisions would be effective for tax years beginning after December 31, 2017.

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Proposed Individual Tax Changes (cont.)

Estate & Generation-Skipping Transfer Taxes

Basic exclusion doubled.

1) <u>The base exclusion amount would double</u> - i.e., the amount of transferred property that is exempt from estate and gift tax of $5 million (as indexed for inflation; $5.6 million for 2018) to $10 million (which will also be indexed for inflation), effective for tax years beginning after December 31, 2017.

Estate and GST taxes repealed after 2023.

1) The Act would <u>repeal the estate and GST taxes</u> such that they do not apply to the estates of decedents dying <u>after December 31, 2023</u>.

2) The rule under which a beneficiary receives a stepped-up basis in inherited property would not be repealed.

Gift tax provisions.

1) The gift tax <u>would be lowered to a top rate of 35%</u> for gifts made after December 31, 2023, and would provide for a basic exclusion amount of $10 million and an annual exclusion amount of $15,000 (for 2018), as indexed for inflation.

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Proposed Individual Tax Changes (cont.)

Alternative Minimum Tax Repeal

AMT repeal.

The Act would repeal the AMT generally effective for tax years beginning after December 31, 2017.

Treatment of carryforwards.

1) If a taxpayer has AMT credit carryforwards, the Act would allow the taxpayer to claim a refund of 50% of the remaining credits (to the extent the credits exceed regular tax for the year) in tax years beginning in 2019, 2020, and 2021, with the remainder claimed in the tax year beginning in 2022.

2) Presumably, this means the taxpayer could claim a refund of 50% of what's left each year.

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Proposed Business Tax Changes in the "Tax Cuts & Jobs Act"

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Proposed Business Tax Changes

Changes to Corporate Tax Rates

1) The corporate tax rate would generally be a flat 20% rate beginning in 2018, eliminating the current graduated rates of:

    a. 15% for taxable income of $0 - $50,000.

    b. 25% for taxable income of $50,001 - $75,000.

    c. 34% for taxable income of $75,001 - $10,000,000.

    d. 35% for taxable income over $10,000,000.

2) Personal service corporations would be subject to a flat 25% corporate tax rate, rather than the current 35% rate.

3) A personal service corporation is: a corporation the principal activity of which is the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and such services are substantially performed by the employee-owners.

Effective date. Effective for tax years beginning after 2017.

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Proposed Business Tax Changes (cont.)

100% Cost Recovery Deduction

1) Under the Act, instead of bonus depreciation for qualified property, taxpayers would be able to fully and immediately expense 100% of the cost of qualified property acquired and placed in service after September 27, 2017 and before January 1, 2023 (with an additional year for certain qualified property with a longer production period).

2) Property would be eligible for this immediate expensing if it is the taxpayer's first use, repealing the current requirement that the original use of the property begin with the taxpayer.

3) Qualified property would not include any property used by a regulated public utility company <u>or any property used in a real property trade or business</u>.

4) The taxpayer's election to use the minimum tax credit in lieu of the additional depreciation would be repealed, effective for tax years beginning after 2017.

Proposed Business Tax Changes (cont.)

Increased Code 179 Expensing.

1) The Section 179 deduction limit would be increased to $5 million (from the current $500,000), and the phase-out amount would be increased to $20 million (from the current $2 million), effective for tax years beginning after 2017 through tax years beginning before 2023.
2) Both amounts would be indexed for inflation.
3) The definition of Section 179 property would also include qualified energy efficient heating and air-conditioning property permanently, effective for property acquired and placed in service after November 2, 2017.

Proposed Business Tax Changes (cont.)

Small Business Accounting Method Reforms

Cash Method of Accounting.

1) Under current law, a corporation or partnership with a corporate partner may only use the cash method of accounting if its average gross receipts do not exceed $5 million for all prior years (including the prior tax years of any predecessor of the entity).
2) Under the Act, the $5 million threshold for corporations and partnerships with a corporate partner would be increased to $25 million and the requirement that such businesses satisfy the requirement for all prior years would be repealed.
3) Under current law, farm corporations and farm partnerships with a corporate partner may only use the cash method of accounting if their gross receipts do not exceed $1 million in any year.
   a. An exception allows certain family farm corporations to qualify if its gross receipts do not exceed $25 million.
4) Under the Act, the increased $25 million threshold (above) would be extended to farm corporations and farm partnerships with a corporate partner, as well as family farm corporations (the average gross receipts test would be indexed for inflation).

Proposed Business Tax Changes (cont.)

Accounting for Inventories.

1) Businesses with average gross receipts of $25 million or less would be permitted to use the cash method of accounting even if the business has inventories.
2) In contrast, under current law, the cash method can be used for certain small businesses with average gross receipts of not more than $1 million ($10 million businesses in certain industries).
3) Under the cash method, the business could account for inventory as non-incidental materials and supplies.
4) A business with inventories that qualifies for and uses the cash method would be able to account for its inventories using its method of accounting reflected on its financial statements or its books and records.

Proposed Business Tax Changes (cont.)

Capitalization and Inclusion of Certain Expenses in Inventory Costs.

1) Businesses with average gross receipts of $25 million or less would be fully exempt from the uniform capitalization (UNICAP) rules.
2) The UNICAP rules generally require certain direct and indirect costs associated with real or tangible personal property manufactured by a business to be included in either inventory or capitalized into the basis of such property.
3) The Act's exemption would apply to real and personal property acquired or manufactured by such businesses.

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Proposed Business Tax Changes (cont.)

Accounting for Long-Term Contracts.

1) Under current law, an exception from the requirement to use the percentage-of-completion method is provided for certain businesses with average annual gross receipts of $10 million or less in the preceding three years.

2) Under the Act, the $10 million average gross receipts exception to the percentage-of-completion method would be increased to $25 million, effective for tax years beginning after 2017.

3) Businesses that meet the increased average gross receipts test would be allowed to use the completed-contract method (or any other permissible exempt contract method.

Effective date. The above provisions would be effective for tax years beginning after 2017.

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Proposed Business Tax Changes (cont.)

Limits on Deduction of Business Interest

1) Every business, regardless of its form, would be subject to a disallowance of a deduction for net interest expense in excess of 30% of the business's adjusted taxable income.
2) The net interest expense disallowance would be determined at the tax filer level.
   a. For example, it would be determined at the partnership level rather than the partner level.
3) Adjusted taxable income is a business's taxable income computed without regard to business interest expense, business interest income, net operating losses (NOLs), and depreciation, amortization, and depletion.
4) Any interest amounts so disallowed would be carried forward to the succeeding five tax years and would be an attribute of the business (as opposed to its owners).

Proposed Business Tax Changes (cont.)

5) Special rules would apply to allow a pass-through entity's unused interest limitation for the tax year to be used by the pass-through entity's owners and to ensure that net income from pass-through entities would not be double counted at the partner level.

6) These business-interest-limit provisions would not apply to certain regulated public utilities and real property trades or businesses, which would be ineligible for 100% cost recovery deduction discussed above.

7) Businesses with average gross receipts of $25 million or less would be exempt from the above interest limitation rules.

Effective date. The above provisions would be effective for tax years beginning after 2017.

Proposed Business Tax Changes (cont.)

NOL Deduction Limited

1) Taxpayers would be able to deduct a net operating loss (NOL) carryover or carryback only to the extent of 90% of the taxpayer's taxable income (determined without regard to the NOL deduction).
2) This would conform to the current AMT rule.
3) The Act would also generally repeal all carrybacks but provide a special one-year carryback for small businesses and farms in the case of certain casualty and disaster losses.
4) This provision generally would be effective for losses arising in tax years beginning after 2017.
5) In the case of any net operating loss, specified liability loss, excess interest loss or eligible loss, carrybacks would be permitted in a tax year beginning in 2017, as long as the NOL is not attributable to the increased section 179 deduction.
6) The Act would allow NOLs arising in tax years beginning after 2017 and that are carried forward to be increased by an interest factor to preserve its value.

Proposed Business Tax Changes (cont.)

Alternative Minimum Tax Repealed.

1) The Act repeals the alternative minimum tax, including the alternative minimum tax on corporations.

Proposed Business Tax Changes (cont.)

Business Related Exclusions, Deductions, etc.

Like-Kind Exchanges.

1) The rule allowing the deferral of gain on like-kind exchanges would be modified to allow for like-kind exchanges only with respect to real property.

2) Under current law, the rule provides that no gain or loss is recognized to the extent that property-which includes a wide range of property from real estate to tangible personal property-held for productive use in the taxpayer's trade or business, or property held for investment purposes, is exchanged for property of a like-kind that also is held for productive use in a trade or business or for investment.

Effective date. The provisions would generally be effective for transfers after 2017. A transition rule would allow like-kind exchanges of personal property to be completed if the taxpayer has either disposed of the relinquished property or acquired the replacement property on or before December 31, 2017.

Proposed Business Tax Changes (cont.)

Contributions to Capital.

1) Under current law, the gross income of a corporation generally does not include contributions to its capital (i.e., transfers of money or property to the corporation by a non-shareholder such as a government entity).

2) Under the Act, the gross income of a corporation would include contributions to its capital, to the extent the amount of money and fair market value of property contributed to the corporation exceeds the fair market value of any stock that is issued in exchange for such money or property.

3) Similar rules would apply to contributions to the capital of any non-corporate entity, such as a partnership.

Effective date. The provision would be effective for contributions made, and transactions entered into, after the date of enactment.

Proposed Business Tax Changes (cont.)

Entertainment and Other Expenses.

1) No deduction would be allowed for entertainment, amusement or recreation activities, facilities, or membership dues relating to such activities or other social purposes.
2) No deduction would be allowed for transportation fringe benefits, benefits in the form of on-premises gyms and other athletic facilities, or for amenities provided to an employee that are primarily personal in nature and that involve property or services not directly related to the employer's trade or business, except to the extent that such benefits are treated as taxable compensation to an employee (or includible in gross income of a non-employee who received the benefit).
3) The 50% limitation under current law also would apply only to expenses for food or beverages and to qualifying business meals under the Act provision, with no deduction allowed for other entertainment expenses.
4) No deduction would be allowed for reimbursed entertainment expenses paid as part of a reimbursement arrangement that involves a tax-indifferent party such as a foreign person or an entity exempt from tax.

Effective date. The provision would be effective for amounts paid or incurred after 2017.

Proposed Business Tax Changes (cont.)

Unrelated Business Taxable Income.

1) Tax-exempt entities would be taxed on the values of providing their employees with transportation fringe benefits, and on-premises gyms and other athletic facilities, by treating the funds used to pay for such benefits as unrelated business taxable income (UBTI), and so subjecting the values of those employee benefits to a tax equal to the corporate tax rate.

Effective date. The provision would be effective for amounts paid or incurred after 2017.

Limitation on Deduction for FDIC Premiums.

1) Under current law, amounts paid by insured depository institutions pursuant to an assessment by the Federal Deposit Insurance Corporation (FDIC) to support the Deposit Insurance Fund (DIF) are currently deductible as a trade or business expense.
2) Under the Act, a percentage of such assessments would be non-deductible for institutions with total consolidated assets in excess of $10 billion.
3) The percentage of nondeductible assessments would be equal to the ratio that total consolidated assets in excess of $10 billion bears to $40 billion, so that assessments would be completely non-deductible for institutions with total consolidated assets in excess of $50 billion.

Proposed Business Tax Changes (cont.)

Self-Created Property not Treated as a Capital Asset.

1) Gain or loss from the disposition of a self-created patent, invention, model or design (whether or not patented), or secret formula or process would be ordinary in character.
2) The election to treat musical compositions and copyrights in musical works as a capital asset would be repealed.

Effective date. The provision would be effective for dispositions of such property after 2017.

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Proposed Business Tax Changes (cont.)

Repeal of Numerous Provisions.

The Act would also repeal the following business provisions:

1) The **deduction for local lobbying expenses**, effective for amounts paid or incurred after 2017.
2) The **domestic production activities deduction** under Code Section 199, for tax years beginning after 2017.
3) The rollover of publicly traded securities gain into specialized small business investment companies, effective for sales after 2017.
4) The special rule treating the transfer of a patent prior to its commercial exploitation as long-term capital gain, effective for dispositions after 2017.
5) The rule on the **technical termination of partnerships**.
6) The deduction for certain unused business credits, effective for tax years beginning after 2017.

Proposed Business Tax Changes (cont.)

Business Credits

Credit for Portion of Employer Social Security Taxes.

1) The credit for a portion of the employer social security taxes paid with respect to employee tip would be modified to reflect the current minimum wage so that it is available with regard to tips reported only above the current minimum wage rather than tips above $5.15 per hour.
2) All restaurants claiming the credit would be required to report to IRS tip allocations among tipped employees (allocations at no less than 10% of gross receipts per tipped employee rather than 8%), which is a reporting requirement now required only of restaurants with at least ten employees.

Effective date. The provision would be effective for tips received for services performed after 2017.

Proposed Business Tax Changes (cont.)

Repeal of Numerous Credits.

The Act would also repeal the following business credits:

1) The **credit for clinical testing expenses** for certain drugs for rare diseases or conditions, effective for tax years beginning after 2017.
2) The **employer-provided child care credit**, effective for tax years beginning after 2017.
3) The **rehabilitation credit**, generally for amounts paid or incurred after 2017.
   a. Under a transition rule, the credit would continue to apply to expenditures incurred through the end of a 24-month period of qualified expenditures, which would have to begin within 180 days after January 1, 2018.
4) The **work opportunity tax credit**, effective for wages paid or incurred to individuals who begin work after 2017.
5) The **new markets tax credit** - No additional new markets tax credits would be allocated after 2017, but credits that would have already been allocated may be used over the course of up to seven years as contemplated by the credit's multi-year timeline.
6) The **credit for expenditures to provide access to disabled individuals**, effective for tax years beginning after 2017.

Proposed Business Tax Changes (cont.)

Tax Changes for Energy Credits

Extension and Phase-Out of Residential Energy Efficient Property Credit.

1) Under current law, a taxpayer may claim a 30% credit for: the purchase of qualified solar electric property and qualified solar water heating property that is used exclusively for purposes other than heating swimming pools and hot tubs; and the purchase of qualified geothermal heat pump property, qualified small wind energy property, and qualified fuel cell power plants.
2) The credit applies to property placed in service prior to 2017, but for qualified solar electric property and qualified solar water heating property, it applies for property placed in service before 2022 (subject to a reduced rate of 26% for property placed in service during 2020 and 22% for property placed in service during 2021.
3) Effective for property placed in service after 2016, the Act would retroactively extend the credit for residential energy efficient property for all qualified property placed in service before 2022, subject to a reduced rate of 26% for property placed in service during 2020 and 22% for property placed in service during 2021.

Proposed Business Tax Changes (cont.)

Other Energy Credits.

1) Production tax credit (PTC) modified.
2) Energy investment tax credit (ITC) modified.
3) Enhanced oil recovery (EOR) credit repealed.
4) Credit for marginal well production repealed.

Proposed Business Tax Changes (cont.)

Compensation

Nonqualified Deferred Compensation.

1) Under the Act, an employee would be taxed on compensation as soon as there is no substantial risk of forfeiture with regard to that compensation (i.e., receipt of the compensation is not subject to future performance of substantial services).

2) A condition would not be treated as constituting a substantial risk of forfeiture solely because it consists of a covenant not to compete or because the condition relates (nominally or otherwise) to a purpose of the compensation other than the future performance of services, regardless of whether such condition is intended to advance a purpose of the compensation or is solely intended to defer taxation of the compensation.

Effective date. The provision would be effective for amounts attributable to services performed after 2017. The current-law rules would continue to apply to existing non-qualified deferred compensation arrangements until the last tax year beginning before 2026, when such arrangements would become subject to the Act's provision.

Proposed Business Tax Changes (cont.)

Limitation on Excessive Employee Remuneration.

1) Under current law, the deduction for compensation paid or accrued with respect to a covered employee of a publicly traded corporation is limited to no more than $1 million per year.
2) Exceptions apply for: (a) commissions; (b) performance-based remuneration, including stock options; (c) payments to a tax-qualified retirement plan; and (d) amounts that are excludable from the executive's gross income.
3) Under the Act, the exceptions to the $1 million deduction limitation for commissions and performance-based compensation would be repealed.
4) The definition of "covered employee" would be revised to include the CEO, the chief financial officer, and the three other highest paid employees.
   a. Under the modified definition, once an employee qualifies as a covered person, the deduction limitation would apply for Federal tax purposes to that person so long as the corporation pays remuneration to such person (or to any beneficiaries).

Effective date. The provision would be effective for tax years beginning after 2017.

Proposed Business Tax Changes (cont.)

Excise Tax on Excess Tax-Exempt Organization Executive Compensation.

1) A tax-exempt organization would be subject to a 20% excise tax on compensation in excess of $1 million paid to any of its five highest paid employees for the tax year.
2) The excise tax would apply to all remuneration paid to a covered person for services, including cash and the cash value of all remuneration (including benefits) paid in a medium other than cash, except for payments to a tax-qualified retirement plan, and amounts that are excludable from the executive's gross income.
3) Once an employee qualifies as a covered person, the excise tax would apply to compensation in excess of $1 million paid to that person so long as the organization pays him remuneration.
4) The excise tax also would apply to excess parachute payments -i.e., a payment contingent on the employee's separation from employment with an aggregate present value of three times the employee's base compensation or more.

Effective date. The provision would be effective for tax years beginning after 2017.

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Proposed Business Tax Changes (cont.)

Changes for Exempt Organizations

UBIT of Entities Exempt under Code Section 501(a).

1) The Act would clarify that all entities exempt from tax under Code Section 501(a), notwithstanding the entity's exemption under any other Code provision, are subject to the UBIT rules.

2) The change would end the uncertainty over whether certain State and local entities (such as public pension plans) that are exempt under Code Section 115(1) as government-sponsored entities as well as Code Section 501(a) are subject to the UBIT rules.

Exclusion of Research Income from UBIT.

1) Currently, where an organization operated primarily to carry on fundamental (as opposed to applied) research the results of which are freely available to the general public, it may exclude from UBIT all income derived from research performed for any person and all deductions connected with such income.

2) The Act would clarify that under Code Section 512(b)(9), an eligible organization may exclude from UBIT only income from such fundamental research the results of which are freely made available to the public.

Proposed Business Tax Changes (cont.)

Streamlined Excise Tax on Private Foundation Income.

1) Private foundations currently are subject to a 2% excise tax on their net investment incomes, but they may reduce this excise tax rate to 1% by making distributions equal to the averages of their distributions from the previous five years plus 1% of the net investment income for the tax year.

2) Under the Act, the excise tax rate on net investment income would be streamlined to a single rate of 1.4% and the rules providing for a reduction in the excise tax rate from 2% to 1% would be repealed.

Excise Tax on Private Colleges and Universities.

1) The excise tax on net investment income currently does not apply to public charities, including colleges and universities, even though some have substantial investment income similar to private foundations.

2) Under the Act, a 1.4% excise tax on net investment income would apply to private colleges and universities that have at least 500 students and assets (other than those used directly in carrying out the institution's educational purposes) valued at the close of the preceding tax year of at least $100,000 per full-time student. State colleges and universities would not be subject to the change.

Proposed Business Tax Changes (cont.)

Changes for Art Museums.

1) Under the Act, an art museum claiming the status of a private operating foundation would not be recognized as such unless it is open to the public for at least 1,000 hours per year.

Certain Philanthropic Business Holdings Exempt from Excess Business Holding Tax.

1) Under current law, a private foundation that has any excess business holdings generally is subject to an initial tax equal to 10% of those excess holdings.
2) Under the Act, private foundations would be exempt from this Code Section 4943(a) excess-business-holdings tax if they own a for-profit business and: (a) the foundation owns all of the for-profit business' voting stock, (b) the foundation acquired all of its interests in the for-profit business other than by purchasing it, (c) the for-profit business distributes all of its net operating income for any given tax year to the private foundation within 120 days of the close of that tax year, and (d) the for-profit business' directors and executives are not substantial contributors to the private foundation nor make up a majority of the private foundation's board of directors.

Proposed Business Tax Changes (cont.)

Johnson Amendment Restricted.

1) Under current law, the so-called "Johnson Amendment," a provision in Code Section 501(c)(3), bars tax-exempt organizations, including religious and educational institutions, from engaging in certain types of political activity if they want to retain exempt status.

2) Effective for tax years ending after the date of enactment, the Act would provide that a church won't fail to be treated as organized and operated exclusively for a religious purpose, nor will it be deemed to have participated in, or intervened in any political campaign on behalf of (or in opposition to) any candidate for public office, solely because of the content of any homily, sermon, etc., made during religious services or gatherings.

3) The change would apply only if the preparation and presentation of such content is in the ordinary course of the organization's regular and customary activities in carrying out its exempt purpose, and results in the organization incurring not more than de minimis incremental expenses.

Observation.: On May 4, President Trump signed an Executive Order (EO) "promoting free speech and religious liberty." Among other provisions, the EO directs IRS not to enforce the so-called "Johnson Amendment."

Proposed Business Tax Changes (cont.)

New Reporting for Donor Advised Funds.

1) **Donor advised funds** would be required to disclose the average amount of grants made during the tax year (expressed as a percentage of the value of assets held in the funds at the beginning of the tax year), and to indicate whether the organization has a policy with respect to donor advised funds for frequency and minimum level of distributions (and if so, to include with its return a copy of the policy).

Effective date: For returns filed for tax years beginning after December 31, 2017.

Proposed Business Tax Changes (cont.)

Bond Reforms

The Act would make the following bond-related reforms:

1) Provide that interest on newly issued private activity bonds would be included in income and thus subject to tax, effective for bonds issued after 2017.

2) Provide that interest on advance refunding bonds (i.e., refunding bonds issued more than 90 days before the redemption of the refunded bonds) would be taxable, effective for advance refundable bonds issued after 2017.

    a. Interest on current refunding bonds would continue to be tax-exempt.

3) Generally, repeal the rules relating to tax credit bonds, effective for bonds issued after 2017.

4) Provide that interest on bonds used to finance the construction of, or capital expenditures for, a professional sports stadium would be subject to Federal tax, effective for bonds issued after the date of introduction.

Proposed Foreign Income and Foreign Person Changes

Proposed Foreign Income and Person Changes

Establishment of Participation Exemption System for Taxation of Foreign Income

Deduction for foreign-source portion of dividends.

1) The Act would replace the current-law system of taxing U.S. corporations on the foreign earnings of their foreign subsidiaries when these earnings are distributed, with a dividend-exemption system.
2) Under the exemption system, 100% of the foreign-source portion of dividends paid by a foreign corporation to a U.S. corporate shareholder that owns 10% or more of the foreign corporation would be exempt from U.S. taxation.
3) No foreign tax credit or deduction would be allowed for any foreign taxes (including withholding taxes) paid or accrued with respect to any exempt dividend.
4) The provision would eliminate the "lock-out" effect under current law, which encourages U.S. companies to avoid bringing their foreign earnings back into the U.S.

Effective date: The provision would be effective for distributions made after 2017.

Proposed Foreign Income and Person Changes (cont.)

Repeal of tax on foreign subsidiary investments in U.S. property.

1) Under current law, undistributed earnings of a foreign subsidiary of a U.S. shareholder that are reinvested in U.S. property are subject to current U.S. tax.
2) This rule prevents a U.S. corporate shareholder from avoiding U.S. tax on the distribution of earnings from a foreign subsidiary by instead reinvesting those earnings in U.S. property.
3) The Act would repeal this provision effective for tax years of foreign corporations beginning after 2017.
4) The provision would no longer be needed because, as a result of the above dividend exemption provision, no U.S. tax would be avoided by a U.S. parent corporation reinvesting earnings of its foreign subsidiary in U.S. property rather than distributing those earnings.

Effective date: The Act would repeal this provision effective for tax years of foreign corporations beginning after 2017.

Proposed Foreign Income and Person Changes (cont.)

Limitation on losses with respect to foreign subsidiaries.

1) A U.S. parent would reduce the basis of its stock in a foreign subsidiary by the amount of any exempt dividends received by the U.S. parent from its foreign subsidiary - but only for purposes of determining the amount of a loss (and not the amount of any gain) on any sale or exchange of the foreign subsidiary.

Treatment of deferred foreign income upon transition to the new participation exemption system-deemed repatriation.

1) Under the Act, U.S. shareholders owning at least 10% of a foreign subsidiary generally would include in income for the subsidiary's last tax year beginning before 2018 the shareholder's pro rata share of the net post-'86 historical earnings and profits (E&P) of the foreign subsidiary to the extent such E&P has not been previously subject to U.S. tax.
2) The portion of the E&P comprising cash or cash equivalents would be taxed at a reduced rate of 12%, while any remaining E&P would be taxed at a reduced rate of 5%.
3) At the election of the U.S. shareholder, the tax liability would be <u>payable over a period of up to eight years</u>, in equal annual installments of 12.5% of the total tax liability due.

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Proposed Foreign Income and Person Changes (cont.)

Modifications Related to Foreign Tax Credit System

Repeal of indirect foreign tax credits.

1) No foreign tax credit or deduction would be allowed for any taxes (including withholding taxes) paid or accrued with respect to any dividend to which the dividend exemption provision would apply.

2) A foreign tax credit would be allowed for any subpart F income that is included in the income of the U.S. shareholder on a current year basis.

Effective date: The provision would be effective for tax years of foreign corporations beginning after 2017 and for tax years of U.S. shareholders in which or with which such tax years of foreign subsidiaries end.

Proposed Foreign Income and Person Changes (cont.)

Change in rule for sourcing income from sales of inventory.

1) Under current law, in determining the source of income for foreign tax credit purposes, up to 50% of the income from the sale of inventory property that is produced within the U.S. and sold outside the U.S. (or vice versa) may be treated as foreign-source income.

2) Under the Act, income from the sale of inventory property produced within and sold outside the U.S. (or vice versa) would be allocated and apportioned between sources within and outside the U.S. solely on the basis of the production activities with respect to the inventory.

Effective date: The Act would repeal this provision effective for tax years of foreign corporations beginning after 2017.

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Proposed Foreign Income and Person Changes (cont.)

Modification of Subpart F Provisions

Repeal of qualified shipping investment rule.

1) The imposition of current U.S. tax on previously excluded foreign shipping income of a foreign subsidiary, if there is a net decrease in qualified shipping investments, would be repealed.
2) The provision would be effective for tax years of foreign corporations beginning after 2017, and for tax years of U.S. shareholders in which or with which such tax years of foreign subsidiaries end.

Repeal of foreign base company oil-related income rule.

1) The imposition of current U.S. tax on foreign base company oil-related income would be repealed.
2) The provision would be effective for tax years of foreign corporations beginning after 2017, and for tax years of U.S. shareholders in which or with which such tax years of foreign subsidiaries end.

Proposed Foreign Income and Person Changes (cont.)

Inflation adjustment for Subpart F de minimis exception.

1) Under current law, a U.S. parent of a foreign subsidiary is subject to current U.S. tax on its pro rata share of the subsidiary's subpart F income.
2) However, a de minimis rule states that if the gross amount of such income is less than the lesser of 5% of the foreign subsidiary's gross income or $1 million, then the U.S. parent is not subject to current U.S. tax on any of the income.
3) Under the Act, the $1 million threshold would be adjusted for inflation.
4) The provision would be effective for tax years of foreign corporations beginning after 2017, and for tax years of U.S. shareholders in which or with which such tax years of foreign subsidiaries end.

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Proposed Foreign Income and Person Changes (cont.)

Foreign subsidiary passive income exception made permanent.

1) Under current law, a U.S. parent of a foreign subsidiary generally is subject to current U.S. tax on passive income earned by the foreign subsidiary.

2) However, for tax years of foreign subsidiaries beginning before 2020, and tax years of U.S. shareholders in which or with which such tax years of the foreign subsidiary end, a special "look-through" rule provides that passive income received by one foreign subsidiary from a related foreign subsidiary generally is not includible in the taxable income of the U.S. parent, provided such income was not subject to current U.S. tax or effectively connected with a U.S. trade or business.

3) The Act would make this provision permanent.

Modification of CFC status attribution rules.

1) Under current law, a U.S. parent of a controlled foreign corporation (CFC) is subject to current U.S. tax on its pro rata share of the CFC's subpart F income.

2) A foreign subsidiary is a CFC if it is more than 50% owned by one or more U.S. persons, each of which owns at least 10% of the foreign subsidiary. Constructive ownership rules apply in determining ownership for this purpose.

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Proposed Foreign Income and Person Changes (cont.)

3) The Act would add an additional constructive ownership rule-a U.S. corporation would be treated as constructively owning stock held by its foreign shareholder.

Effective date: The provision would be effective for tax years of foreign corporations beginning after 2017, and for tax years of U.S. shareholders in which or with which such tax years of foreign subsidiaries end.

Elimination of 30-day minimum holding period for CFC.

1) Under current law, a U.S. parent of a CFC is subject to current U.S. tax on its pro rata share of the CFC's subpart F income, but only if the U.S. parent owns stock in the foreign subsidiary for an uninterrupted period of 30 days or more during the year.
2) Under the Act, a U.S. parent would be subject to current U.S. tax on the CFC's subpart F income even if the U.S. parent does not own stock in the CFC for an uninterrupted period of 30 days or more during the year.

Effective date: The provision would be effective for tax years of foreign corporations beginning after 2017, and for tax years of U.S. shareholders in which or with which such tax years of foreign subsidiaries end.

Proposed Foreign Income and Person Changes (cont.)

Prevention of Base Erosion

Current year inclusion by U.S. shareholders with foreign high returns.

1) Under the Act, a U.S. parent of one or more foreign subsidiaries would be subject to current U.S. tax on 50% of the U.S. parent's foreign high returns.

2) A Foreign high returns would be the excess of the U.S. parent's foreign subsidiaries' aggregate net income over a routine return (7% plus the Federal short-term rate) on the foreign subsidiaries' aggregate adjusted bases in depreciable tangible property, adjusted downward for interest expense.

3) Foreign high returns would not include, among other things, income effectively connected with a U.S. trade or business and subpart F income.

Effective date: This provision would be effective for tax years of foreign corporations beginning after 2017 and for tax years of U.S. shareholders in which or with which such tax years of foreign subsidiaries end.

Proposed Foreign Income and Person Changes (cont.)

Limitation on interest deduction by domestic corporations with international intercompany debt.

1) The deductible net interest expense of a U.S. corporation that is a member of an "international financial reporting group" would be limited under the Act to the extent the U.S. corporation's share of the group's global net interest expense exceeds 110% of the U.S. corporation's share of the group's global earnings before interest, taxes, depreciation, and amortization (EBITDA).

2) An international financial reporting group is a group of entities that includes at least one foreign corporation engaged in a trade or business in the U.S. or at least one domestic corporation and one foreign corporation, prepares consolidated financial statements, and has annual global gross receipts of more than $100 million.

Effective date: The provision would be effective for tax years beginning after 2017.

Proposed Foreign Income and Person Changes (cont.)

New tax on certain payments from domestic corporations to related foreign corporations.

1) In order to prevent shifting of profits to foreign affiliates, the Act would provide that payments (other than interest) made by a U.S. corporation to a related foreign corporation that are deductible, includible in costs of goods sold, or includible in the basis of a depreciable or amortizable asset would be subject to a 20% excise tax, unless the related foreign corporation elected to treat the payments as income effectively connected with the conduct of a U.S. trade or business.

2) The provision would apply only to international financial reporting groups with payments from U.S. corporations to their foreign affiliates totaling at least $100 million annually.

Effective date: The provision would be effective for tax years beginning after 2018.

Proposed Foreign Income and Person Changes (cont.)

Provisions Related to Possessions of the U.S.

Extension of Puerto Rico provision under domestic production activities deduction.

1) The domestic production activities deduction allows for a deduction based on qualifying receipts, which are defined as certain types of revenue derived from activities in the U.S. The term "U.S." includes Puerto Rico for this purpose for tax years beginning before January 1, 2017.

2) The Act would provide that the term "U.S." would include Puerto Rico for tax years beginning before January 1, 2018.

Extension of temporary increase in rum excise tax paid to Puerto Rico and the Virgin Islands.

1) Under current law, the U.S. collects an excise tax on distilled spirits produced in or imported into the U.S. A portion of the tax attributable to rum produced in Puerto Rico or the U.S. Virgin Islands is paid to Puerto Rico or the U.S. Virgin Islands. The portion is $13.25 per proof gallon for imports before 2017 and $10.50 per proof gallon for other imports.

2) The Act would extend the $13.25 amount to rum imported into the U.S. before January 1, 2023. (Act Section 4402).

Extension of American Samoa economic development credit.

1) The Act would extend the American Samoa economic development credit to tax years beginning before January 1, 2023.

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Proposed Foreign Income and Person Changes (cont.)

Other International Reforms

Restriction on insurance business exception to passive foreign investment company rules.

1) Under current law, U.S. shareholders of a passive foreign investment company (PFIC) are taxed currently on the PFIC's earnings.
2) An exception to this rule applies to certain income derived in the active conduct of an insurance business.
3) The Act would provide additional requirements before this exception would apply.

Effective date: The provision would be effective for tax years beginning after 2017.

Other Developments, Cases and Rulings

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Case Rulings

- **Taxpayer Advocate Warns of Reliance on IRS FAQs:** National Taxpayer Advocate (NTA) Nina Olson has published a blog post about the dangers of relying on certain Frequently Asked Questions (FAQs) and answers posted to the IRS's website. In general, taxpayers may rely upon FAQs published in the Internal Revenue Bulletin (IRB). **However, FAQs that have not been published in the IRB are not legal authority and should not be used to sustain a tax position unless otherwise indicated**. The NTA recommends that the IRS use FAQs only when there is a need to provide guidance on an emergency or highly expedited basis. In addition, the IRS should prominently display a disclaimer with FAQs that such information is not binding unless published in the IRB.

Case Rulings

- **Taxpayer Cannot Blame TurboTax for Improper Deductions:** The taxpayer paid a settlement in a business-related lawsuit by taking out a $500,000 loan secured by his residence. In addition, as part of a separation agreement, the taxpayer agreed to pay his ex-wife $2,000 per month in spousal support. However, the taxpayer made an oral agreement with his ex-wife to increase the payments to $5,000 per month. On his income tax returns, the taxpayer claimed deductions for alimony paid and interest expense related to the loan. The IRS challenged these deductions and assessed accuracy-related penalties. The Tax Court agreed with the IRS, finding that the taxpayer failed to substantiate the interest expense deductions and that oral modification of the separation agreement wasn't enough to justify higher alimony deductions. **The Court also rejected the taxpayer's argument that TurboTax lured him into claiming improper deductions and upheld the penalties**. *Barry L. Bulakites, TC Memp 2017-79* (*Tax Ct*.).

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Case Rulings

- **Treasury Announces Plans to End myRA Program**: The U.S. Department of the Treasury has announced plans to phase out the myRA (my Retirement Accounts) program initially started in 2014. The decision by the Treasury came after a review found the program wasn't cost effective. **Since its start, the demand for the program has been extremely low and the cost to manage the program has been nearly $70 million**. Effective immediately, myRA retirement savings program is no longer accepting new enrollments. However, existing accounts remain open and accessible at this time. The Treasury plans to notify the participants about the changes and will provide information on how to move their account savings to another Roth IRA. Participants are encouraged to visit www.myRA.gov for further developments.

Case Rulings

- **Leave-based Donation Programs for Hurricane Irma Victims:** In the wake of Hurricane Irma, many employers are considering leave-based donation programs. **Under these programs, employees may elect to forgo vacation, sick, or personal leave in exchange for employer contributions to charitable organizations**. In a recent notice, the IRS announced that cash payments made by an employer under a leave-based donation program will not constitute employee wages if they are paid before 1/1/19 to *Section 170(c)* organizations for the relief of Hurricane Irma victims. In addition, the IRS will not assert that the opportunity to participate in a leave-based donation program results in constructive receipt of gross income or employee wages. Leave-sharing donations don't need to be included in Box 1, 3, or 5 of Form W-2, and employers may deduct the *payments as ordinary and necessary business expenses under* IRC Section 162 rather than *IRC Section 170* . This is similar to relief provided to victims of Hurricane Harvey. *Notice 2017-52, 2017-40 IRB*.

Case Rulings

- **IRS Withdraws Proposed Regulations on Gift and Estate Tax Valuations:** In August 2016, the IRS issued proposed regulations under *IRC Sec. 2704* on the valuation of closely-held business interests for estate, gift, and Generation-skipping Transfer (GST) tax purposes. Among other things, the proposed rules disregarded certain noncommercial restrictions on the ability to dispose of or liquidate family-controlled entities. In addition, the proposed regulations created an additional category of restrictions that would be disregarded in assessing the fair market value of an interest. In response to *Executive Order 13789*, which directed the Department of the Treasury to identify burdensome tax regulations, the IRS has withdrawn the proposed *Section 2704* regulations. **According to the IRS, the proposed regulations provided an unworkable approach to artificial valuation discounts**. *REG-163113-02*.

Case Rulings

- **Court's Change to Beneficiary Didn't Create Inherited IRA:** During his lifetime, the decedent designated a trust as his IRA's beneficiary. However, the IRA's custodian didn't have a copy of the trust instrument and found no evidence that a trust had been created. According to his will, the decedent's entire estate was left to his spouse, who wanted to roll over the account to her own IRA. To accomplish this, the spouse sought court approval to change the beneficiary designation from the trust to herself. In a Private Letter Ruling, **the IRS concluded that the IRA was not an inherited IRA** for purposes of *IRC Section 408(d)(3)* and that a rollover was permitted **despite the court's change to the beneficiary designation.** In addition, the IRS held that the IRA was subject to the five-year required minimum distributions rule. *Ltr. Rul. 201706004*.

Case Rulings

- **Homeowner's Friend Entitled to Mortgage Interest Deduction: The** taxpayer, a U.S. Air Force veteran, lived with a longtime friend. The home was originally purchased by the friend; however, she and the taxpayer refinanced the property as co-borrowers to make renovations. During the years at issue, the taxpayer resided in and maintained the property, made monthly mortgage payments, and received Form 1098. As such, the taxpayer claimed mortgage interest deductions on his tax returns. **<u>The IRS disallowed these deductions, claiming that the taxpayer was not the legal or equitable owner of the property. The Tax Court disagreed, finding that the taxpayer had an equitable ownership interest in the home because he assumed the benefits and burdens of ownership under state law.</u>** Therefore, he was entitled to the mortgage interest deductions. *John E. Wainwright, TC Memo 2017-70* (*Tax Ct*.).

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Case Rulings

- **Software Engineer Couldn't Deduct MBA Costs:** The taxpayer was a software engineer who provided consulting services. In 2011, she enrolled in an Executive Master of Business Administration (EMBA) program. On her income tax return, **<u>the taxpayer claimed a business deduction of $59,282 for tuition, fees, and expenses related to the EMBA program</u>**. **<u>The IRS disallowed the deduction, claiming that the EMBA qualified the taxpayer for a new trade or business</u>**. **<u>The Tax Court agreed,</u>** finding that the taxpayer's tasks and duties as a software engineer were largely unrelated to her EMBA coursework**. <u>Although she would continue to be qualified to manage people after the EMBA program, the taxpayer would become qualified to perform business, management, finance, and marketing tasks</u>**. Therefore, costs associated with the EMBA program were nondeductible. *Megan and John Creigh, TC Summ. Op. 2017-26* (*Tax Ct.*).

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Case Rulings

- **Hockey Team Meals for Away Games Were Fully Deductible:** The owner of the **<u>Boston Bruins</u>**, a National Hockey League team, contracted with hotels to provide pregame meals to the players and team personnel while they were at hotels for games away from home. During the meals, which were provided in designated meal rooms of the hotel, the team discussed game strategy and reviewed game film, and the PR staff discussed anticipated media inquiries. After deducting the full cost of the meals, the owner received a notice of deficiency from the IRS, determining that the cost of the meals was subject to the 50% limitation under *IRC Section 274(n)(1)*. **<u>The Tax Court disagreed with the IRS, concluding that the costs qualified as de minimis fringe benefits under *IRC Section 274(n)(2)(B)* because they met the exception of *IRC Section 132(e)* and were, therefore, fully deductible, rather than being subject to the 50% limitation</u>**. *Jeremy M. Jacobs,148 TC No. 24* (*Tax Ct.*).

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Case Rulings

- **Arrangement with Micro-captive Insurance Company Wasn't Insurance**: The taxpayers owned various shopping centers and jewelry stores. After consulting with tax and business advisors, they decided to form a micro-captive insurance company in St. Kitts. This company sold property and casualty insurance policies to various entities owned by the taxpayers. For the years at issue, the taxpayers deducted a total of $2.4 million in insurance expenses. The IRS challenged these deductions, arguing that the arrangement didn't qualify as insurance. The Tax Court agreed, finding that **the arrangement didn't adequately distribute risk**. In addition, the Court concluded that **the arrangement charged unreasonable premiums, dealt with claims on an ad hoc basis, and made investment decisions that only an unthinking insurance company would make**. Therefore, the premiums paid were not for insurance and were not deductible as ordinary and necessary business expenses. *Benyamin and Orna Avrahami*,*149 TC No. 7* (*Tax Ct*.).

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Case Rulings

- **IRS Announces Non-acquiescence with Passive Activity Loss Case:** In Stanley (*116 AFTR 2d 2015-6766*), **the District Court** for the Western District of Arkansas **held that**, for purposes of the real estate professional's exception to the Passive Activity Loss (PAL) rules, **a real estate management executive who also owned interests in the properties managed by his firm may count his work for the entity as work in managing his own real estate interests**. Accordingly, the taxpayer materially participated in his aggregated rental activity and appropriately grouped on Schedule E (Supplemental Income and Loss) most of his trade or business activities with his rental activities as a single activity for PAL purposes. Recently, **the IRS announced its non-acquiescence with this decision**. The IRS should release an Action on Decision to explain why it disagrees with the Court's decision. Decisions of the Tax Court with Court Decisions, *2017-42 IRB 311*.

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Case Rulings

- **Stock Broker Was a Real Estate Professional under Passive Activity Loss Rules**: The taxpayer, a stock broker, owned 12 rental properties and a 50% interest in a vacant lot in Florida. She managed all aspects of the properties, including vetting potential clients, collecting rent, and overseeing contractors. **According to her records, the taxpayer spent 901.25 hours on real estate activities during the tax year in question. This gave rise to a loss of $307,933, which she used to offset her broker income**. The IRS disallowed the loss, claiming it was passive in nature. **The Tax Court found that each real estate interest had to be viewed as a separate activity because the taxpayer failed to make an election to group them. Despite this, the Court concluded that the taxpayer was a real estate professional** and could therefore treat her rental real estate activities as non-passive. *Patricia S. Windham*, *TC Memo 2017-68 (Tax Ct.).*

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Case Rulings

- **Taxpayer Wasn't a Real Estate Professional under Passive Activity Loss Rules:** The taxpayer was a licensed real estate broker who worked full-time in an unrelated field. He also owned an S corporation that engaged in rental real estate activities. During the year at issue, the taxpayer spent significant time acquiring and repairing rental properties. According to his monthly calendar, the taxpayer spent 2,520 hours on real estate activities. Accordingly, he claimed a non-passive loss of $96,354 on his tax return, which the IRS disallowed. The taxpayer argued that he was a real estate professional under *IRC Section 469(c)(7)* and that he materially participated in the business. <u>**The Tax Court disagreed, holding that the taxpayer's calendar greatly exaggerated the time spent on real estate activities and didn't properly substantiate his claim**</u>. *Zane and Monika Penley*, *TC Memo 2017-65 (Tax Ct.)*.

Case Rulings

- **IRS Directs LB&I to Accept Financial Statements as Proof of Qualified Research Expenses**: The IRS has issued a directive to Large Business and International (LB&I) examiners **to accept as sufficient evidence the amount of research and development expenses from the taxpayer's audited financial statements**, with certain specified adjustments, as the amount of Qualified Research Expenses (QREs) used to calculate the credit for increasing research activities under *IRC Section 41*. **The directive applies to LB&I taxpayers who follow U.S. GAAP to prepare certified audited financial statements pursuant to *FASB ASC 730***. The directive is intended to reduce the burden of determining and documenting the correct amount of research credit claimed for both taxpayers and LB&I examiners. **The directive only applies to LB&I taxpayers**, who choose to follow its terms, on original returns filed on or after 9/11/2017. *News Release IR 2017-158*.

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Case Rulings

- **IRS Rejects Method to Determine Qualified Wages for Research Credit:** The taxpayer claimed the research credit based on liabilities accrued for employee wages. To estimate the portion of this liability that qualified for the credit, **the taxpayer used a two-step process**. **First, the company's controller estimated the time each employee spent on qualified services**. Second, the taxpayer multiplied this estimate by a fraction derived from statistical analysis. This showed that only 52% of the projects involved an employee engaged in qualified research. In a Legal Advice Issued by Field Attorneys (LAFA), the IRS concluded that the taxpayer's methodology was inappropriate. Statistical analysis was improper in this case because it failed to consider that the scope of research activities and associated expenses may differ significantly from project to project. **However, it noted that the method used in the first step may be sufficient to substantiate the credit**. *LAFA 20171601F*.

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Case Rulings

- **S Corporation and ESOP Participants Were Related under IRC Sec. 267(b):** During the years at issue, an S corporation was partially owned by an Employee Stock Ownership Plan (ESOP). **The corporation accrued payroll expenses for employees who participated in the ESOP**; however, a portion of these expenses remained unpaid at the end of the year. Despite this, the corporation claimed deductions for these expenses, which flowed through to the shareholders. Upon audit, the IRS disallowed the deductions, arguing that the S corporation and the ESOP participants were related persons under *IRC Section 267(b)*. **The Tax Court agreed, holding that the ESOP participants were constructive owners of the S corporation stock under *IRC Section 267(c)*. As such, the S corporation was required to defer its compensation deductions to the year in which such pay was received by the ESOP participants**. *Steven and Pauline Petersen, 148 TC No. 22* (*Tax Ct.*).

Case Rulings

- **No Basis Increase for S Corp. Shareholders' Co-borrowed Loans:** An Arkansas couple owned shares of S corporation stock in companies that managed several nursing homes. The companies borrowed or co-borrowed funds for the purchase of its facilities. **Although the husband and wife were co-borrowers and/or guarantors of the loans, the companies were directly liable for the loans and made all loan payments**. After claiming net operating losses from the business, the couple received a notice of deficiency from the IRS, indicating that there was insufficient basis to claim the losses. The couple argued that state law caused them to be directly liable for the loans taken out as co-borrowers, which increased their tax basis. **The Tax Court disagreed, concluding that the basis could not be increased on loans for which the shareholders were not directly indebted or that were not collateralized by their own property**. *Bobby R. and Brenda J. Hargis, TC Memo 2016-232* (*Tax Ct*.).

Case Rulings

- **Dog's Location Helps Determine Domicile:** Mr. Blatt resided in New York until he became the CEO of Match.com, based in Dallas. In 2009, Mr. Blatt signed a one-year lease for an apartment in Dallas. His employment contract listed his principal place of employment as Dallas, but he maintained his New York apartment. Mr. Blatt filed a New York nonresident/part-year resident tax return for 2009 and 2010. On audit, the **New York taxing agency claimed that Mr. Blatt continued to be domiciled in New York and owed income tax of $430,065**. **A state court disagreed** after evaluating the factors supporting Mr. Blatt's change in domicile to Texas, **among the most important being his decision to move his dog to Texas**. According to the court**, the move of items that are "near and dear tend to demonstrate a person's intention" indicate a change to domicile**. Gregory Blatt (*N.Y. Division of Tax Appeals, No. 826504*).

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Michael J. Reilly
CPA/ABV, CVA, CFF, CDA, Partner

Email: mreilly@dmcpas.com

Web: www.dmcpas.com and
www.dmconsulting.com

Address:

Financial Plaza
221 S. Warren St.
Syracuse, New York 13202-2687

Phone: 315-472-9127

Scan to add Mike Reilly to your contacts.

DANNIBLE & MCKEE, LLP
Certified Public Accountants and Consultants