2016 NEW DEVELOPMENTS LETTER

INTRODUCTION

It seems that keeping up with the rapid pace of tax changes and developments becomes more difficult each year. This year is no exception. To help you adjust to (and plan for) the most significant tax changes that have occurred over the last year, we are sending this letter providing a summary of key legislative, administrative, and judicial tax developments that we believe will have the greatest impact on our clients. ***As a Preview*** – Some of the ***Major Tax Developments*** we highlight in this letter are:

Recent Tax Legislation that: Extends and enhances the 50% Section 168(k) first-year bonus depreciation and the Section179 write-off for certain business property (including certain improvements to depreciable real property); Expands and extends the research and experimentation credit; Reduces the period an S corporation must wait to avoid the corporate built-in gains tax; Makes permanent the special tax break for qualifying IRA contributions to charities; Modifies the due dates for certain tax returns; Modifies the required documentation for certain education tax benefits; Enhances certain tax benefits of §529 plans.

New Cases, IRS Rulings, and Regulations that: Allow individuals under certain circumstances to obtain an extension of the 60-day rollover period for a distribution from a qualified plan or an IRA without an IRS ruling; Clarify how certain employers may avoid a potential $100 a day penalty for reimbursing an employee's individual health insurance premiums; Explain the new reporting and basis rules for property included on an estate tax return; Illustrate the risks involved in a self-directed IRA; Clarify certain rules involving passive activities; Illustrate how the Courts are applying the hobby-loss rules; Clarify the IRS's position on whether an LLC member/owner is subject to self employment (S/E) tax on the LLC's pass-through business income; Require certain business entities to report foreign investments by filing Form 8938; Clarify how a closely-held corporation should evaluate the "reasonableness" of the compensation paid to its shareholder/employee; Increase the safe harbor amount for writing-off business assets from $500 to $2,500.

CAUTION!

We highlight only *selected* tax developments. If you have heard about other tax developments not discussed in this letter, and you need more information, please call our office for details. Also, ***we suggest that you call our firm before implementing any tax planning technique discussed in this letter.*** You cannot properly evaluate a particular planning strategy without calculating your overall tax liability (including the alternative minimum tax and any state income tax) with and without that strategy. **Please Note!** This letter contains ideas for Federal income tax planning only. ***State income tax issues are not addressed.***

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DEVELOPMENTS IMPACTING PRIMARILY INDIVIDUALS

RECENT TAX LEGISLATION

Background. On December 18, 2015, the President signed the ***Protecting Americans From Tax Hikes Act Of 2015 (PATH Act).*** Although the *PATH Act* is sometimes referred to as an "extenders bill," because it extended many tax provisions that expired at the end of 2014, it also contains other significant tax changes. In addition, Congress passed several other pieces of legislation between June 29, 2015 and February 24, 2016 containing new tax provisions that are ***first effective in 2016.*** These new laws include the Defending Public Safety Act, the Trade Preference Extension Act, the Surface Transportation Act, and the Consolidated Appropriations Act. The following are highlights of key tax provisions contained in this new legislation:

Selected "Individual" Tax Breaks Extended Through 2016. The PATH Act extends several previously-expired tax breaks ***through 2016,*** such as the: Deduction (up to $4,000) for qualified higher education expenses; Deduction for mortgage insurance premiums as qualified residence interest; and 10% credit (with a $500 lifetime maximum) for qualified energy-efficient home improvements (e.g., qualified energy-efficient windows, storm doors, roofing). **Planning Alert!** Individuals wishing to take advantage of these tax breaks should act by the end of 2016 in case Congress does not extend these provisions beyond 2016. The following are several additional tax breaks scheduled to expire after ***2016:***

- **Income Exclusion For Discharge Of Qualified Principal Residence Indebtedness.** A special rule allowing an individual to exclude from income the discharge (e.g., forgiveness) of all or a portion of a mortgage loan (not exceeding $2 million) that was incurred to purchase, construct, or substantially improve the individual's principal residence**.** **Planning Alert!** The exclusion also applies to qualifying debt ***discharged after 2016*** if the discharge is made under a binding written agreement ***entered into before 2017.*** **Tax Tip.** This exclusion could potentially apply to debt forgiveness involving the "short sale" or foreclosure of a principal residence.

- **30% Credit For Qualified Energy-Efficient Fuel Cell Property, Small Wind Energy Property, And Geothermal Heat Pump Property.** An individual is allowed a 30% tax credit known as the residential energy efficient property (REEP) credit, for the cost of installing the following energy-efficient property in the individual's residence: **1)** ***Qualified fuel cell property***; **2)** ***Qualified small wind energy*** **property; and 3)** ***Qualified geothermal heat pump property.*** These credits are scheduled to ***expire for property placed-in-service after 2016.***

  Please note that the 30% REEP credit for ***"Qualified Solar Electric Property"*** and ***"Qualified Solar Water Heating Property"*** doesn't expire after 2016 as discussed in the next paragraph.

The 30% REEP Credit For Qualified Solar Electric And Solar Water Heating Property Begins Phasing Out After 2019. The 30% REEP credit for qualifying solar electric and solar water heating property was scheduled to expire after 2016. However, the Consolidated Appropriations Act extends the 30% REEP credit for qualifying ***solar electric property*** and ***solar water heating property through 2019.*** The credit drops to 26% for qualifying solar property placed-in-service in 2020, to 22% if placed-in-service in 2021, and expires altogether if placed-in-service after 2021.

Selected "Individual" Tax Breaks Made "Permanent." Although the following individual tax breaks previously expired at the end of 2014, the PATH Act retroactively reinstates these provisions and makes them permanent: **1)** Election to deduct state and local sales taxes; **2)** Enhanced American Opportunity Tax Credit up to $2,500 for qualified tuition; **3)** Enhanced "Refundable" Child Tax Credit up to $1,000 for dependents under age 17; **4)** Enhanced Earned Income Tax Credit (EITC) provisions; **5)** Expanded deduction and carryover limits for charitable contributions of conservation easements, **6)** Special tax break allowing IRAs of individuals who are at least age 70½ to make charitable contributions, and **7)** Special "above the line" deduction allowed for certain expenses of teachers.

- **Enhancement Of School Teachers' Deduction.** Historically, teachers have been allowed an "above the line" deduction (with an annual cap of $250) for various school supplies. However, starting ***in 2016,***

in addition to allowing teachers a deduction for school supplies, the PATH Act allows teachers an "above-the-line" deduction (with an annual cap of $250) for amounts paid ***for certain professional development courses.*** Such courses must be related **1)** To the curriculum in which the teacher provides instruction, **or 2)** To the students for whom the teacher provides instruction. Before this change, a teacher's unreimbursed expenses for professional development were classified as *miscellaneous itemized deductions* subject to the 2% threshold which, many times, caused the teacher to get little or no tax benefit from the expenditure. ***Starting in 2016,*** teachers should be aware of this change and retain documentation of unreimbursed costs they incur for professional development courses. Also the $250 cap on this deduction is indexed for inflation starting in 2016. However, for 2016, the cap remains at $250 even after considering inflation.

Expanded Tax Benefits For Section 529 Education Savings Plans (529 Plans). ***Generally effective after 2014,*** the PATH Act makes several pro-taxpayer changes to the tax rules that govern 529 plans, including: Expanding qualified tax-free distributions to the purchase of computer-related expenditures; Providing a new 60-day window to re-contribute previously distributed 529 plan funds where qualifying education expenditures (e.g., tuition) are refunded; and, Removal of the aggregation rules for multiple 529 plans for determining whether and to what extent a non-qualifying distribution represents taxable income.

Disabled Individuals May Now Sign Up For Tax-Favored ABLE Accounts Sponsored By Any State. The ABLE Act establishes a new tax-advantaged savings account ("ABLE Account") for certain qualified disabled individuals. The stated purpose of this new savings account is to "*provide secure funding for disability-related expenses for individuals with disabilities that will supplement, but not supplant, benefits otherwise available to those individuals, whether through private sources, employment, public programs, or otherwise*" (e.g., private insurance, Medicaid, SSI).

The tax rules for ABLE Accounts are generally patterned after the tax rules for the popular Section 529 plans which are currently used to accumulate funds for qualified college expenses. Also, like the Section 529 plans, the new ABLE Accounts can only be established, sponsored, and operated by a state that adopts the necessary ABLE Account provisions. Originally, an ABLE Account could only be established for a qualified disabled individual under an ABLE program sponsored by the state in which the disabled individual lived. This generally meant that a disabled individual could not establish an ABLE Account unless the state in which the individual resided actually sponsored an up-and-running ABLE Account program.

The PATH Act changed this rule *and* now allows an ABLE Account ***sponsored by any state*** to be established for an eligible individual***.*** This should allow those setting up ABLE Accounts for disabled individuals to choose the state program that best fits their needs. Although the vast majority of states either have enacted or have proposed legislation to provide for ABLE Accounts, as of July 8, 2016, only Ohio, Tennessee, Nebraska, and Florida had programs that were up and running and could accept applications. However, many other state programs should be coming on-line soon. For the latest list of state ABLE Account programs, please see the National Down Syndrome Society (NDSS) website.

Starting In 2016 Taxpayers Must Have Form 1098-T In Order To Claim Education Credits Or Tuition Deductions. Generally, educational institutions are required to provide Form 1098-T to attending students and file a copy of Form 1098-T with the IRS. This form contains information regarding the student's qualifying tuition and related fees that are used to determine various education-related tax credits and deductions. ***Effective for tax years beginning after June 29, 2015,*** the Trade Act provides that the following education tax breaks will not be allowed unless the taxpayer possesses a valid Form 1098-T from the educational institution: **1)** The ***American Opportunity Tax Credit*** (up to $2,500 per qualifying student – generally used for the first four years of post-high school education); **2)** The ***Lifetime Learning Credit*** (up to $2,000 per qualifying taxpayer – generally used for graduate school), **and 3)** The college ***Tuition and Fees Deduction*** (up to $4,000). This new documentation requirement effectively means that, if you qualify for any of these education tax benefits, you ***will need Form 1098-T before you can claim*** an education credit or deduction on your 2016 return. **Planning Alert!** As mentioned above, the ***American Opportunity Tax Credit*** (as well as the Lifetime Learning Credit) is now permanent; however, the ***Tuition and Fees Deduction*** of up to $4,000 is ***scheduled to expire after 2016.***

New Due Date And Allowable Extensions For FinCEN Form 114 (FBAR). Generally, if you own (or have signatory authority over) foreign financial accounts exceeding an aggregate value of $10,000 at any time during the year, you are required to file FinCEN Form 114 ("*Report of Foreign Bank and Financial Accounts*" or "FBAR"). Previously, the due date for filing this FinCEN Form 114 was June 30 of the year immediately following the reporting year, and no extensions were available. ***For years beginning after 2015,*** the Transportation Act provides that the ***initial due date*** for ***FinCen Form 114*** will be ***April 15th*** of the following year (i.e., the same initial due date for your Form 1040). The Act also provides for a maximum ***extended due date*** until the following ***October 15th.*** In addition, the IRS is authorized to waive the penalty for failure to timely request an extension for filing the form for any taxpayer who is required to file FinCEN Form 114 for the first time. **Planning Alert!** According to proposed regulations issued by the Treasury Department in March 2016, the ***due date for the 2016 FinCEN Form 114*** is ***April 15, 2017.*** The proposed regulations also provide that "extensions to October 15 of the reporting year are available upon request." However, the regulations do not say how the extension is to be requested or whether the extension request will be automatically approved.

New Extended Due Date For Filing An Estate Or Trust "Income Tax" Return (Form 1041). The Transportation Act did not change the ***"Initial"*** due date for filing a Form 1041 income tax return for an estate or trust (i.e., the 15th day of the fourth month of the following year). However, ***for tax years beginning after 2015,*** the Act provides that the ***"Extended"*** due date of Form 1041 will be the ***"last"*** day of the ninth month following year-end, instead of the ***"15th"*** day of the ninth month following year-end.

New Income Tax Basis And Reporting Rules For Certain Inherited Property. Generally, an individual who inherits property from a decedent receives an "income tax basis" in the property equal to the property's *fair market value* on the date of the decedent's death. In addition, if the *"fair market value"* of all the property included in a decedent's taxable estate exceeds $5,450,000 (for deaths in 2016), the estate must file an *"estate tax return,"* and may be required to pay an estate tax. ***Effective for property with respect to which an estate tax return is filed after July 31, 2015,*** the Transportation Act generally provides that the *"income tax basis"* in the hands of the recipient of the inherited property ***may not exceed*** the value of the property **as reported in the estate tax return** – but only if the inclusion of the property in the estate tax return increases the estate tax liability. Also, executors of these larger estates (i.e., large enough to require the filing of a Federal estate tax return) ***that file the estate return after July 31, 2015*****,** are required to file a new information return (Form 8971) generally within 30 days following the filing of the estate tax return. However, the IRS delayed the deadline for the initial filing of Form 8971 ***until June 30, 2016*** for any Forms 8971 due on or before June 30, 2016.

- **Planning Alert!** The penalty for failing to file Form 8971 is generally the same as the penalty for failure to file a Form 1099 (i.e., for 2016, generally $260 for failing to file with the beneficiary, and an additional $260 for failing to file a copy with the IRS). The IRS has announced that Form 8971 is not required if the decedent's gross estate (including adjusted taxable gifts made before the decedent's death) is not large enough to ***require the filing of an estate tax return*** (for decedents who died in 2016 the estate tax return filing threshold is $5,450,000). The IRS also says that Form 8971 is not required for an estate that falls below the filing threshold even if the estate actually files an estate tax return for other reasons (e.g., to make a generation-skipping transfer tax exemption allocation or election, to make the portability election where the estate of the first spouse to die did not utilize all of the estate's exclusion amount, or to make a protective filing to avoid any penalty if an asset value is later determined to cause a return to be required or otherwise).

The "Minimum Penalty" For Failure To File Income Tax Returns Timely Has Increased. ***Effective for returns required to be filed in calendar years after 2015,*** *The Trade Act* increases the minimum penalty for failing to timely file an income tax return. The Act increases the ***"minimum"*** penalty for failure to file within 60 days of the due date (including extensions) ***from the lesser of $135 or 100 percent*** of the unpaid tax, ***to the lesser of $205 or 100 percent*** of the unpaid tax. Going forward, the $205 penalty amount is adjusted for inflation. The Trade Act retains the rule allowing waiver of the penalty where the failure to file is due to *"reasonable cause"* and not due to willful neglect. **Tax Tip.** There is ***no "minimum" penalty where there is no "net" tax due.*** For example, if the tax is $10,500 and the tax withheld is $10,600, even if the return is filed late, no minimum penalty is due because there is no net tax due. **Planning Alert!** This change only applies to the ***"minimum"*** penalty for failure to file the return. However, current law continues to provide that the

penalty may actually be greater than this "minimum" penalty. For example, subject to the "minimum" penalty just discussed, the penalty under current law for failing to file a Form 1040 is generally ***5% per month*** of the net amount of tax due, with a maximum penalty percentage of 25%.

RECENT CASES, RULINGS, AND REGULATIONS

IRS Issues New Procedure Allowing Individuals To Certify That They Qualify For A Waiver Of The 60-Day IRA Rollover Requirement. Individuals taking a distribution from their IRA (or qualified retirement plan) generally may avoid paying tax on the distribution if they rollover the distribution to another IRA (or qualified retirement plan) within the 60-day period beginning with the date the distribution is received. If the individual fails to rollover the distribution within that 60-day period, the rollover amount is treated as a fully taxable distribution and may also be subject to the 10% early distribution penalty (e.g., if the taxpayer is under 59½). Until recently, taxpayers who violated the 60-day rollover window could seek a waiver (extension) of the 60-day rollover period from the IRS only by applying for a private letter ruling. The IRS recently announced that the IRS fee for applying for such a waiver is $10,000.

Effective August 24, 2016, the IRS announced a new procedure allowing individuals who violated the 60-day rollover period to *"self certify"* that they satisfy one or more of eleven listed reasons for a waiver of the 60-day requirement. Individuals who qualify may report the rollover that occurs after the 60-day period as though it was a valid tax-deferred rollover – without having to seek a private letter ruling from the IRS. The IRS has provided a model certification letter that individuals qualifying for self-certification must complete and keep with their files. If the IRS later audits the individual and determines the individual did not satisfy at least one of the eleven reasons for a waiver, the IRS can then tax the rollover and possibly impose penalties.

To qualify for a waiver, the taxpayer must have missed the 60-day deadline because of the individual's inability to complete the rollover due to at least one of eleven listed reasons, including: error by financial institution, check misplaced and never cashed, family member died or was seriously ill, postal error, and others.

- **Planning Alert!** If you think you may benefit from this new Procedure, please call us promptly. To qualify, you must complete the rollover to the IRA or qualified retirement plan as soon as practicable after the reason or reasons for your delay no longer exists.

- **Tax Tip!** The 60-day rollover requirement may be avoided altogether by simply making a trustee-to-trustee transfer. To effect a trustee-to-trustee transfer, the *distribution should be made directly from the old plan or IRA trustee to the new IRA or plan trustee*. For example, if the distribution is made by check, the ***check should be written by the old trustee to the new trustee.*** The check should not be written to the owner of the IRA or of the qualified plan account.

Recent Case Confirms That Stock "Traders" Making The "Mark-To-Market" Election Must Also Timely File Form 3115 ("Application For Change In Accounting Method"). If you are a "trader" (instead of an "investor") in stocks, the "mark-to-market" election could possibly save you taxes. Generally, you may qualify as a "trader" if you have frequent purchases and sales of stock, you hold the stock for short-term gain (rather than long-term appreciation and dividends), and you have a high volume of stock transactions throughout the year. As a trader, you can elect (for tax purposes) to mark your stock down or up to market at year end. This election will convert what would generally be short-term capital gains and losses, into "ordinary" gains and losses. **Tax Tip.** This election could save taxes if your gains and losses are generally "short-term" gains and losses and at some point you incur significant losses. If you qualify as a "trader," making a timely "mark-to-market" election allows you to deduct those net losses as "ordinary losses," instead of being limited by the $3,000 ceiling on net capital losses. Also, making this election ***will not*** subject your mark-to-market stock gains to Social Security or Medicare taxes. **Planning Alert!** Determining whether you have the necessary volume of stock purchases and sales to qualify you as a *"trader"* requires a case-by-case, facts-and-circumstances analysis. The Courts generally require a high volume of trading to justify "trader" status. For example, the Tax Court recently observed: "*In the cases in which taxpayers **have been held to be traders** in securities, the number and frequency of transactions indicated that they were engaged in market transactions **almost daily** for a substantial and continuous period, generally **exceeding a single taxable year;** and those activities constituted the **taxpayers' sole or primary income-producing activity."*** [Emphasis added].

- **Making The Election.** The "mark-to-market" election by a "trader"must be filed no later than the due date (without regard to extensions) of the original Federal income tax return ***for the taxable year immediately preceding the election year.*** The election must be attached either to that return or to a request for extension to file the return. For example, if an "individual" wanted to elect the mark-to-market method for calendar year 2016, the election was due by the due date of the 2015 return (excluding extensions). The election statement must describe: **1)** The election is being made, **2)** The first taxable year for which the election is effective, and **3)** The trade or business for which the election is made. *Once made, the election applies to all future years during which the taxpayer is a "trader."* **Caution!** A recent Tax Court case concluded that, for this election to be effective, the individual "trader" ***must also*** timely file ***a properly completed Form 3115*** ("Application for Change in Accounting Method") to request a change to the mark-to-market method of recognizing gains and losses on securities. To be timely filed, the original Form 3115 must be attached to the individual's timely filed (including extensions) original Federal income tax return for the year of change (the "year of change" is the first tax year for which the election is effective), and a copy of the Form 3115 must be filed with the National Office no later than when the original Form 3115 is filed with the Federal income tax return for the year of change.

Recent Tax Court Cases Disqualify Certain Self-Directed IRAs. Individuals who like more control over their retirement fund investments sometimes choose to maintain their IRAs as "self-directed" IRAs. A self-directed IRA generally allows owners to *"self direct"* the investment options to best fit their specific investment objectives. However, owners of any IRA (especially a self-directed IRA) must be careful not to engage in a *"prohibited transaction"* with their IRA. Generally, ***if an individual engages in a prohibited transaction*** with his or her IRA, the IRA loses its tax-deferred status as of the beginning of the year of the prohibited transaction and the ***entire value of the IRA is taxed*** to the IRA owner as a distribution. In addition, the distribution may trigger a 10% early distribution penalty (e.g., where the owner is under 59½). A *"prohibited transaction"* includes the ***direct or indirect*** transfer to or use by or for the benefit of the IRA owner of the income or assets of the IRA, the lending of money between the owner and the IRA, the sale, exchange, or leasing of property between the IRA and its owner, and other similar transactions.

- **IRS Challenges Several "Roll Over Business Startups" (ROBS) Transactions In Court.** The IRS has recently targeted arrangements sometimes referred to as "Roll Over Business Startups" (ROBS). Although ROBS can be established in several different ways, the common theme is the use of a taxpayer's existing qualified retirement plan or IRA funds to ultimately acquire, own, and operate a closely-held business without treating the transfer of the funds as a current taxable distribution. Several recent Court cases have reviewed ROBS-Type transactions that generally involved the following steps: **1)** An individual creates a new corporation that will acquire and operate a new business; **2)** The individual establishes a new IRA that owns all or a part of the stock of the new corporation; **3)** The individual takes a distribution from his or her existing employer-sponsored plan or IRA and rolls it over into the newly-established IRA; **4)** The new IRA as stockholder contributes the rollover funds to the newly-formed corporation; and **5)** The newly-formed corporation uses the contributed funds to purchase business assets that are used by the corporation to begin and/or acquire an operating business.

  In just the last 10 months, the IRS has challenged several ROBS-Type transactions in Court, including cases where the Court held: **1)** An individual's personal guarantee of a loan made to a corporation owned by his IRA constituted a "prohibited transaction" causing the IRA to be taxed to the individual as if distributed; **2)** A self-employed civil engineer/real estate advisor engaged in a "*prohibited transaction"* with his self-directed IRA by following a scheme he learned at a promotional seminar advertising the advantages of a "*Self-Directed Checkbook LLC*"; and **3)** An individual's attempt to implement an IRA Roll Over Business Startup (ROBS) failed, in part, because he could not provide the Court with the necessary documentation showing the transaction was legally consummated.

  Planning Alert! These cases illustrate that it is critically important for owners of self-directed IRAs to seek advice from reputable tax advisors before engaging in any transaction with the IRA to avoid violating the "prohibited transaction" rules. This is particularly important if the IRA owner is considering a ROBS-Type transaction and/or has any personal financial connection with the investments owned by the IRA.

Potential "Hobby Loss" Activities Continue To Be Fertile Ground For IRS Attacks. Taxpayers involved in ranching, horse breeding, racing, part-time product-sales businesses, or any other hobby-type operation who offset losses from those activities against other income should be aware of the so-called "hobby loss" restrictions. The *hobby loss* restrictions will apply if it is ultimately determined that the taxpayer did not engage in the business to make a profit. If it is determined that the hobby loss restrictions apply, losses from these hobby-type operations may not be deducted against other taxable income (e.g., wages, interest, dividends).

It seems that each year the IRS takes a significant number of taxpayers to Court contesting their losses with respect to so-called "hobby" activities – and 2016 is no exception! In the past year alone, there were Court cases dealing with "hobby losses" involving the following activities: Real estate sales (Taxpayer lost); Car restoration (Taxpayer won); Horse-breeding (Taxpayer lost); Arabian horse farm (Taxpayer lost); A doctor's airplane activity (Taxpayer lost); A consultant's airplane activity (Taxpayer lost); Part-time Amway dealerships (Taxpayer lost); and A hair-braiding business (Taxpayer won). In several of these cases, the taxpayer unsuccessfully attempted to aggregate "*hobby-type*" activities with *"legitimate"* business activities in order to avoid the hobby loss restrictions.

- **Planning Alert!** The IRS typically wins a significant majority of the *"hobby loss"* cases it litigates. In order to defend against a "hobby loss" attack from the IRS, individuals involved in sideline business activities should at a minimum **1)** Have a business plan and document that the business can make a profit, **2)** Utilize a separate bank account for the activity, **3)** Maintain an accurate set of books and records, ***and*** **4)** If the business is not profitable, consult with others and make changes demonstrating attempts to make a profit.

IRS Ruling Highlights Another Negative Tax Consequence For Real Estate "Dealers". Taxpayers who hold real estate for "investment" are generally allowed capital-gain treatment when the realty is sold. However, taxpayers classified for tax purposes as *"dealers"* in real estate with respect to a parcel of real property, are faced with a long list of negative tax consequences for that property – including that they: **1) *Do not receive capital gain treatment,* 2)** Do not qualify for ***1031 like-kind exchange treatment,* 3)** Are generally ***not allowed*** to defer gain under the **installment method** if they seller finance the real estate sale, and **4)** Must pay ***"self-employment" tax*** on gains from the sale. An owner of real estate is generally deemed to be a *"dealer"* in real estate if it is ultimately determined that the owner held the real estate ***primarily for sale*** to customers in the ordinary course of the owner's trade or business. Real estate developers are frequently classified as "dealers." **Caution!** A recent IRS ruling (discussed below) highlights that there is an additional negative tax consequence for real estate dealers who have *"cancellation of debt"* (COD) income with respect to real estate held for sale to customers in the ordinary course of business.

- **IRS Says Exemption From COD Income Generally Applicable To Real Estate Used In A Business Does Not Apply To "Dealer" Real Estate.** Generally, a taxpayer must include in taxable income any indebtedness of the taxpayer that is reduced, cancelled, or forgiven (commonly referred to as cancellation of debt or COD income). However, in certain situations, taxpayers may qualify for a statutory exemption from COD income. One such exemption applies to *"qualified real property business indebtedness"* (QRPBI). The exclusion for the forgiveness of QRPBI generally applies to the cancellation or reduction of a mortgage that was originally incurred to purchase or improve real estate *"used in the taxpayer's trade or business."* This exemption from the recognition of COD income is commonly used by taxpayers involved in a loan workout for debt secured by business real estate. In a recent ruling, the IRS concluded that the COD exemption that applies to QRPBI ***does not*** apply to the cancellation or reduction of a debt that was incurred with respect to real estate the taxpayer holds for sale in the ordinary course of the taxpayer's trade or business (i.e., *"dealer real estate")*. Consequently, according to the IRS, taxpayers involved in a loan workout involving *"dealer real estate"* will not be able to utilize the COD exemption applicable to QRPBI. **Planning Alert!** The taxpayer may still qualify for other statutory exemptions to COD income. For example, there is a COD exemption that applies to "insolvent" taxpayers.

Recent Tax Court Case Exposes Potential Trap Involving Education Credits. Over the years, Congress has provided a host of education tax incentives that can significantly reduce your taxes. Perhaps the most commonly-used and popular tax break is the ***"American Opportunity Credit"*** (up to $2,500 per student). **Caution!** As discussed previously in this letter, ***starting in 2016,*** the Trade Act provides that this tax credit will not be allowed unless the taxpayer possesses a valid Form 1098-T from the educational institution.

- **Tax Court Concludes That Prepayment Of Tuition For Spring Semester Caused Loss Of AOTC.** Qualifying individuals are entitled to an *"American Opportunity Tax Credit"* (AOTC) of up to $2,500, determined as follows: **1)** 100% of the first $2,000 of qualified tuition and related expenses paid during the taxable year, plus **2)** 25% of the amount by which the qualified tuition and related expenses exceeds $2,000 but does not exceed $4,000. Therefore, an individual will qualify for the maximum $2,500 AOTC with respect to a student so long as the individual pays ***at least $4,000*** of qualified tuition for the year. The AOTC ***may not be taken for more than four tax years*** for the same student. Also, in order for tuition to qualify for the AOTC, the tuition generally must be *"paid"* in the *same tax year* as the *academic period begins*. However, a special rule provides that the pre-payment of tuition for an academic period that begins in the following tax year will qualify for the AOTC in *the year of payment* if the academic period begins within the first three months of the next tax year (i.e., January, February, or March of the tax year that immediately follows the year of payment). For example, this special rule would allow an individual to pre-pay in 2016 the tuition for the 2017 spring semester, and use that tuition pre-payment in determining the 2016 AOTC.

  In a recent tax Court case, an individual pre-paid in December of 2011 the tuition for a qualifying student's graduating semester (i.e., the Spring of 2012). Therefore, the individual did not actually "pay" any tuition in 2012 (the tax year the student graduated). The Court held that a individual can take the AOTC only for the tax year the qualifying tuition is *"actually paid,"* even though the pre-paid tuition relates to an academic period that begins in the following tax year. Since the individual actually paid no tuition in 2012 (the tax year the student graduated), the individual was not allowed an AOTC for 2012. Moreover, the individual had already paid more than $4,000 of tuition in 2011, qualifying him for the maximum AOTC (i.e., $2,500) for that year – even without the 2011 prepayment of the tuition for the 2012 Spring semester. Therefore, the individual received no tax benefit in either 2011 or 2012 for the payment of the tuition for the Spring, 2012 semester.

  Planning Alert! This case is particularly problematic in situations where**: 1)** The payment of tuition for a graduating senior's last (Spring) semester is made in the year preceding that semester, **2)** The total tuition "paid" for that preceding year equals or exceeds $4,000.00 (i.e., the dollar amount needed to generate the maximum $2,500 AOTC), **3)** The credit has not been taken for four tax years for the student, and **4)** No tuition is "actually" paid in that final senior year. In this situation, the Taxpayer should consider delaying the *"payment"* of the tuition for the spring semester until January of that final year. **Tax Tip.** Also, even if the AOTC had previously been taken for four tax years with respect to that graduating student, delaying the tuition payment to the final year could allow the taxpayer to take the Lifetime Learning Credit of 20% on up to $10,000 of the qualifying tuition for the student, if the taxpayer would otherwise qualify.

Tax Court Allows "Business" Deduction For The Cost Of Obtaining An MBA. Whether an employee is entitled to an employee "business" deduction for MBA-related expenses is a hot tax issue. To prevail, the individual generally must establish that his or her pursuit of the MBA: **1)** *"Maintains and improves"* the skills needed in the individual's current line of work, and **2)** Does not prepare the individual for a *"new trade or business."* In a recent case, the Tax Court allowed a business deduction for costs of an MBA incurred by an employee who was an accounting manager and controller of a large hotel. The Court allowed the business deduction because the employee was able to show the following: **1)** He had already established (and continued to work) as a business manager and after his previous employment terminated, he continued to seek employment in the same field while pursuing his MBA; **2)** There were no facts to indicate that he was pursuing the degree to qualify for a new position or a new career path; and **3)** The MBA course of study and the nature of the MBA courses he took were shown to improve and enhance his current employment duties. **Planning Alert!** If an employee incurs an unreimbursed education expense that ***qualifies as a business deduction*,** the deduction will be subject to the 2% threshold that applies to *"unreimbursed employee business expenses."* However, if instead, the employee's education expense is reimbursed under the employer's *"accountable reimbursement arrangement,"* the employer can fully deduct the reimbursement and exclude it from the employee's compensation as a *"working condition fringe."*

DEVELOPMENTS IMPACTING PRIMARILY BUSINESSES

RECENT LEGISLATION

Background. As previously discussed in this letter, over recent months Congress has passed several bills containing a variety of tax provisions that impact businesses of all sizes. This segment provides an overview of these provisions which may have an impact on your business activities.

Selected **"Business" Tax Breaks Extended Through 2016.** The PATH Act extends the following business tax breaks through ***2016:*** **1)** Deductions for Certain Energy-Efficient Commercial Buildings; **2)** Credit for Sale of Certain Energy-Efficient New Homes; **3)** 7-Year Depreciation Period for Certain Motor Sports Racetrack Property; **4)** Several Tax Benefits for Qualified Energy-Efficient Expenditures and for Qualifying Investments in Empowerment Zones; and **5)** 3-year Depreciation Period for Certain Race Horses.

Selected **"Business" Tax Breaks Made "Permanent."** The PATH Act also retroactively reinstates the following provisions which had expired at the end of 2014 and makes the provisions ***permanent*** for future years: **1)** 15-Year (Instead of 39-year) Depreciation Period for "Qualified" Leasehold Improvement Property, Restaurant Property, and Retail Improvement Property; **2)** Enhanced Charitable Contribution Rules for Qualifying Business Entities Contributing Food Inventory; **3)** Favorable S Corporation Provisions for Charitable Contributions of Capital Gain Property; **4)** Parity Between Employer-Provided Parking and Transportation Fringe Benefits; **5)** 5-Year (Instead of 10-year) Waiting Period for S Corporations to Avoid the Built-in Gains Tax; and **6)** Exclusion of 100% of Gain on the Sale of Certain Small Business Stock for Both Regular Tax and AMT purposes.

In addition, the PATH Act not only made the following business tax breaks ***permanent,*** it also ***expanded these tax breaks*** to make them more beneficial:

- **Research & Experimentation Credit Made Permanent And Expanded For Certain Small Businesses.** For ***taxable years beginning after 2015, the PATH Act*** not only made the R&E Credit permanent, but also expanded it by: **1)** Allowing an ***"eligible small business"*** (generally a business that meets a $50 million or less average gross receipts threshold) to use the R&E Credit to offset both *"regular"* tax and the *"alternative minimum tax,"* and **2)** Allowing *a* ***"qualified small business"*** to elect to offset its R&E credit against its portion of the OASDI payroll tax liability. A **"qualified small business"** is generally a business **1)** With ***gross receipts of less than $5 million*** for the taxable year, ***and*** **2)** That ***did not have gross receipts*** for any taxable year ***before the five-taxable-year period*** – *ending with the current taxable year.* **Practice Alert!** In August, the IRS released a draft copy of new Form 8974 to be used by *"qualified small businesses"* to claim the R&E credit against the employer's share of OASDI liability.

- **The 20% "Differential Wage Credit" Made Permanent And Employers Of Any Size May Now Qualify.** Qualifying employers that pay *"differential wages"* are generally entitled to a credit equal to 20% of up to $20,000 of differential wages made to each employee during the tax year. *"Differential wages"* are payments to employees for periods that they are called to active duty (for more than 30 days) with the U.S. uniformed services that represent all or part of the wages that they would have otherwise received from the employer. Previously, an employer qualified for the credit only if it employed on average less than 50 employees during the tax year. The PATH Act not only made the 20% "*differential wage payment credit*" permanent, but for ***taxable years beginning after 2015,*** the Act ***removes the 50-employee threshold*** for qualifying employers. Therefore, ***starting in 2016, employers of any size*** may qualify for the credit.

- **Section 179 Deduction Expanded And Made Permanent.** For tax years beginning in 2010 through 2014, the maximum Section 179 deduction for the cost of qualifying new or used depreciable tangible personal property (e.g., business equipment, computers, etc.) was temporarily increased to $500,000. During that same period, the phase-out threshold of the Section 179 deduction for qualifying Section 179 property acquisitions was temporarily increased to $2,000,000. In addition, for purchases in 2010 through 2014, taxpayers were temporarily allowed to treat up to $250,000 of *"qualified real property"* (discussed below) as Section 179 property.

The **PATH Act** ***makes these "expanded" Section 179 provisions permanent*** (i.e., the $500,000 Section 179 cap; the allowance of a Section 179 deduction for "qualified real property;" and the $2,000,000 phase-out threshold). The PATH Act also permanently allows taxpayers to take the Section 179 deduction for off-the-shelf computer software and to make or modify the Section 179 election on an amended return. In addition, for property placed-in-service in tax years beginning ***after 2015*****,** the Act permanently indexes the Section 179 caps for inflation. The PATH Act also makes the following modifications to the Section 179 deduction for tax years beginning after 2015.

•• **Separate $250,000 Cap For *"Qualified Real Property"* Eliminated.** For tax years beginning in 2010 through 2015, the Section 179 deduction for "*Qualified Real Property*" was capped at $250,000. For *Qualified Real Property* ***placed-in-service in tax years beginning after 2015,*** the PATH Act removes the $250,000 cap. Thus, *Qualified Real Property* is now subject to the overall Section 179 cap of $500,000 (as indexed for inflation). **Caution!** The $500,000 overall cap is reduced by any Section 179 deduction taken for *Qualified Real Property.*

"Qualified Real Property" includes property within any of the following three categories: **1)** *Qualified Leasehold Improvement Property* (generally capital improvements to the interior portion of certain leased buildings that are used for nonresidential purposes); **2)** *Qualified Retail Improvement Property* (generally capital improvements made to certain buildings which are open to the general public for the retail sale of tangible personal property); and **3)** *Qualified Restaurant Property* (generally capital expenditures for the improvement, purchase, or construction of a building, if more than 50% of the building's square footage is devoted to the preparation of, and seating for, the on-premises consumption of prepared meals).

•• **Don't Overlook The Recently-Increased *"De Minimis Safe Harbor"* For Writing Off Tangible Business Property!** The recently-released capitalization regulations allow taxpayers with *"applicable financial statements"* (i.e., financial statement filed with the SEC, certified audited financial statement, or financial statement required to be provided to the Federal or a State government – other than a tax return) to make a ***"de minimis safe harbor"*** election. This election allows a taxpayer to deduct immediately purchases of ***individual items*** of tangible business property (including materials and supplies) not exceeding $5,000 each. For taxpayers ***without*** *"applicable financial statements,"* the *de minimis safe harbor* amount was initially capped at $500 for each item of tangible business property. However, ***generally effective for tax years beginning after 2015*****,** the IRS increased this safe harbor limit for taxpayers ***without*** *"applicable financial statements"* ***from $500 to $2,500.*** The threshold for taxpayers with an *"applicable financial statement"* was not changed, and remains at $5,000. **Planning Alert!** Unlike the Section 179 deduction, there is no overall aggregate dollar limit or trade or business income limit on the total amount of deductions taken under this safe harbor. In addition, assets expensed under the de minimis safe harbor should not affect the amount of the §179 deduction available for a tax year. ***For example,*** assume for 2016 a business (with no *applicable financial statement*) properly elects the safe harbor and expenses all qualifying purchases of $2,500 or less, and the total amount expensed equals $150,000. The $150,000 should not enter into the calculation of the Section 179 limits (i.e., the $500,000 limitation or the $2,010,000 phase-out threshold indexed for inflation).

De Minimis Safe Harbor Election. This election is made annually (by attaching a statement to a timely filed—including extensions—original Federal income tax return). To qualify for the safe harbor, the taxpayer generally must have an ***accounting procedure*** (as of the beginning of the year) to expense the cost of assets costing less than a specified amount for *"nontax"* purposes as well as for tax purposes. If the taxpayer has an *"applicable financial statement,"* the accounting procedure ***must be in writing*****.** For taxpayers that do not have an *"applicable financial statement*," the *"beginning of the year"* accounting procedure referred to above does not have to be in writing. However, having a written procedure may better document your "expensing procedure" in case of an IRS audit.

Selected "Business" Tax Breaks Extended Through 2019. The PATH Act extends the following ***business*** tax breaks ***through 2019:***

- **First-Year 168(k) Depreciation Deduction Extended Through 2019.** The 50% first-year 168(k) bonus depreciation deduction was previously scheduled to expire for qualifying property placed-in-service after 2014. The PATH Act extends the 168(k) deduction for *qualifying* "new" business property placed-in-service ***through December 31, 2019*** (through December 31, 2020 for certain long-production-period property and qualifying noncommercial aircraft), as follows: **1)** A ***50% bonus*** depreciation allowance for qualified property placed-in-service ***in 2015 through 2017***; **2)** A ***40% bonus*** depreciation allowance for qualified property placed-in-service ***in 2018*** (2019 for certain long-production-period property and qualifying noncommercial aircraft)**;** and **3)** A ***30% bonus*** depreciation allowance for qualified property placed-in-service ***in 2019*** (2020 for certain long-production-period property and qualifying noncommercial aircraft*).*

  - **Qualifying 168(k) Bonus Depreciation Property.** Property generally qualifies for the 168(k) bonus depreciation deduction if it is *"new*" and is **1)** Property with a depreciable life for tax purposes of *20 years or less* (e.g., machinery and equipment, furniture and fixtures, business vehicles, sidewalks, roads, landscaping, depreciable computer software, farm buildings, and qualified motor fuels facilities)*;* **2)** "Qualified Improvement Property;" or **3)** Water utility property.

  - **Acceleration Of 168(k) Deduction For Certain Fruit/Nut-Bearing Trees, Vines, And Plants.** The PATH Act allows a taxpayer to *"elect"* to accelerate the date the 168(k) bonus depreciation deduction can be taken with respect to ***certain trees, vines, and plants*** bearing fruit or nuts to the tax year the trees, vines, and plants ***are planted or grafted*** (if planted or grafted after 2015), rather than the tax year they are placed-in-service.

  - **"Qualified Leasehold Improvement Property" Replaced With "Qualified Improvement Property."** For property placed-in-service ***before 2016,*** "*Qualified Leasehold Improvement Property*" (QLIP) qualified for the 168(k) bonus depreciation deduction. QLIP generally includes capital improvements to the interior portion of a commercial (nonresidential) building, if the building is at least three years old and the **improvements are made pursuant to a lease** – ***provided the lease is not between related parties.*** Thus, any improvements to an otherwise qualifying building pursuant to a *"related-party"* lease ***did not*** qualify for the 168(k) bonus depreciation deduction.

    For ***property placed-in-service after 2015,*** the PATH Act provides that the168(k) bonus depreciation deduction applies to *"Qualified Improvement Property."* ***"Qualified Improvement Property"*** (QIP*)* is generally an improvement to the interior portion of an existing commercial building (provided the improvement is not attributable to an enlargement of the building, elevators or escalators, or the internal structural framework of the building). **Planning Alert!** The definition of *QIP* largely follows the definition of *QLIP* – except that building improvements constituting *QIP* do not have to be made pursuant to a *lease* and the improvements only have to be placed-in-service *"after"* the building was initially placed-in-service (i.e., the improvement no longer has to be made more than *"3 years"* after the building was first placed-in-service). Therefore, an otherwise qualifying improvement to a building where the improvements are placed-in-service after 2015, may qualify for the 168(k) bonus depreciation deduction **1)** Where the property is not subject to a lease, or **2)** Where the property is subject to a lease and the lease is between related parties or unrelated parties. Thus, for property ***placed-in-service after 2015,*** otherwise qualifying improvements to a commercial building under a related-party lease may qualify for the 168(k) bonus depreciation – even though the very same improvements would not have qualified if placed-in-service before 2016! **Planning Tip!** Qualified Leasehold Improvement Property should continue to qualify for the 168(k) depreciation deduction since property meeting the definition of *"Qualified Leasehold Improvement Property*" will also be *"Qualified Improvement Property"*.

- **168(k) Bonus Depreciation Deduction For Passenger Automobiles, Trucks, And SUVs Extended Through 2019.** The maximum annual depreciation deduction (including the Section 179 deduction) for most *business automobiles* is capped at certain dollar amounts. For a business auto first placed-in-service

in ***calendar year 2016*****,** the maximum first-year depreciation deduction is generally capped at $3,160 ($3,560 for trucks and vans not weighing over 6,000 lbs). However, Congress previously increased the first-year depreciation cap by $8,000 through 2014 for new vehicles otherwise qualifying for the 168(k) depreciation deduction. The PATH Act extends this $8,000 increase in the first-year depreciation deduction limitation to 2015 through 2017 (i.e., for qualifying vehicles placed-in-service in 2016 the cap is $11,160, and $11,560 for trucks and vans). For new vehicles placed-in-service after 2017, the increase in the depreciation limit will be reduced to $6,400 for 2018, $4,800 for 2019, and no increase for 2020 and subsequent years.

- **Election For C Corporations To Exchange Bonus Depreciation For Refundable AMT Credits Extended Through 2019.** The PATH Act retroactively extended, to qualifying property placed-in-service during 2015, the election under §168(k)(4) for C corporations to treat up to 6% of their pre-2006 unused AMT credits as refundable credits in return for giving up the §168(k) deduction and taking straight-line depreciation on qualifying §168(k) property. In addition, **for taxable years ending after 2015 and before 2020,** the Act extends and modifies the election under §168(k)(4) such that a C corporation making the election may be able to treat as a refundable credit as much as ***the lesser of*** **1)** 50% of the corporation's Minimum Tax Credit for the first taxable year beginning after 2015, or **2)** The Minimum Tax Credit for the taxable year allocable to the adjusted net minimum tax imposed for taxable years ending before January 1, 2016 (determined before the application of any tax liability limitation and determined on a first-in, first-out basis).

- **Work Opportunity Tax Credit Expanded And Extended Through 2019.** For the past two decades, many employers have taken advantage of the popular ***"Work Opportunity Tax Credit"*** (WOTC) by hiring employees from certain disadvantaged groups. The PATH Act extends the WOTC for qualifying individuals who ***begin work before 2020.*** In addition, with respect to individuals who begin work for an employer ***after 2015,*** the Act expands the credit to apply to wages paid to ***"Qualified Long-Term Unemployment Recipients"*** (i.e., a new employee who has been unemployed for 27 consecutive weeks or more). **Planning Pointer!** The instructions to the Form 8850 provide detailed information on the categories of workers who qualify for the WOTC (including the new category of ***"Qualified Long-Term Unemployment Recipients"***). You can locate Form 8850 at www.irs.gov.

  - **IRS Temporarily Delayed Filing Deadline.** To qualify for the WOTC, employers must complete IRS ***Form 8850*** ("Pre-Screening Notice and Certification Request for the Work Opportunity Credit") and the employer generally must submit that form to the State Workforce Agency ***no later than 28 days*** after the employee begins work. However, for qualifying employees ***hired on or after January 1, 2015 through August 31, 2016,*** employers ***had until September 28, 2016*** to submit the Form 8850 to the State Workforce Agency.

The 30% Business Credit For "Solar Energy Property" Begins Phasing Out After 2019. Currently, a 30% Business Credit is available for *solar energy property*. ***"Solar Energy Property"*** is equipment using solar energy to generate electricity, to heat or cool or provide hot water for use in a structure, or to provide solar process heat (other than property used to generate energy for the purpose of heating a swimming pool). This credit was scheduled to expire after 2016. The Consolidated Appropriations Act extends the full 30% Business Credit to ***"Solar Energy Property"*** that is ***under construction before 2020.*** The credit drops ***to 26%*** where ***construction*** of the property ***begins in 2020,*** and ***to 22%*** where ***construction*** of the property ***begins in 2021.*** The credit is ***reduced to 10%*** where ***construction begins after 2021,*** or where ***construction begins before 2022*** and the property is placed-in-service ***after 2023.***

Revised Due Dates For Various Tax Returns. For ***tax years beginning after 2015*****,** the Transportation Act revises the initial due dates and/or the extended due dates for various tax returns including: ***Form 1065*** (partnership return) and ***Form 1120*** ("C" corporation tax return). **Planning Alert!** Since these new due date provisions are effective for ***tax years beginning after 2015*****,** the new deadlines ***will first apply*** to ***2016 returns*** – which are filed ***after 2016.***

The following are just a few examples of the new due dates and extended due dates provided by the Transportation Act for ***returns for tax years beginning after 2015:***

- **Partnership Returns (Form 1065).** The ***"Initial"*** due date for a ***Partnership Return*** (Form 1065) will be the 15th day of the ***"third"*** month following year-end (i.e., March 15 of the following year for a calendar-year partnership). Previously, partnership returns were due the 15th day of the ***"fourth"*** month (i.e., April 15 of the following year for a calendar-year partnership). However, the ***"Extended"*** due date for partnership returns will not change (i.e., it is the 15th day of the ninth month of the following year under both old and new law - September 15 for calendar-year partnerships).

- **Calendar-Year "C" Corporation Returns (Form 1120).** The ***"Initial"*** due date for a calendar-year "C" corporation return will be April 15 of the following year (previously the initial due date was March 15 of the following year). However, the ***"Extended"*** due date for calendar-year "C" corporation returns will be September 15 of the following year which is the same as the extended due date for calendar-year C corporation returns under prior law.

- **Due Dates For "S" Corporation Returns Remain Unchanged (Form 1120S).** The Transportation Act does not change the initial due date or the extended due date for "S" corporation tax returns.

- **W-2s And 1099s.** In order to cut down on identity theft, for ***information returns filed after 2016*** (e.g., 2016 forms filed in 2017), the PATH Act requires Forms W-2, W-2AS, W-2CM, W-2GU, W-2VI, W-3 and W-3SS to be filed with the Social Security Administration (SSA) ***by January 31*** (i.e., the same date these forms are due to be filed with the recipient of the compensation). **Caution!** In addition, there is no longer an extended filing date for forms filed electronically. Furthermore, ***extensions of time to file Forms W-2 with the SSA are no longer automatic*****.** For filings due on or after January 1, 2017, **employers may request one *30-day extension to file Form W-2*** by submitting a complete application to the IRS **on Form 8809,** including a detailed explanation of why additional time is needed. The instructions to Forms W-2 and W-3 say that ***an extension will only be granted in extraordinary circumstances or catastrophe.***

  The Act also provides that ***Forms 1099-MISC which report nonemployee compensation*** must be filed with the IRS ***on or before January 31*** of the following year beginning with 2016 Forms 1099-MISC whether or not the forms are filed electronically. If the Form 1099-MISC does not show nonemployee compensation in Box 7, the form continues to be due with the IRS by February 28th of the following year or by March 31st of the following year, if filed electronically.

- **Other Returns.** In addition to the Forms listed above, the Transportation Act changes the due dates and/or the extended due dates for several other forms for tax years beginning after 2015, including: "C" Corporation Returns With Fiscal Years; Form 990 (Return For Exempt Organizations); and Form 4720 (Return For Certain Excise Taxes).

Failure To Timely File Certain "Information" Returns Has Become More Costly. Effective for returns ***required to be filed after 2015*****,** the Trade Act significantly increases the monetary penalties for failing to file certain information returns (e.g., the Form 1099 series, and the new Affordable Care Act Forms 1095-B and 1095-C). For example, the penalty for failing to file a Form 1099 with the payee is increased from $100 in 2014 to $260 for 2016 (as indexed for inflation) for each Form 1099. In addition, the failure to file a Form 1099 with the IRS is also increased from $100 to $260 for 2016. Therefore, failure to file a 2016 Form 1099 ***required to be filed in 2017*** with both the payee and the IRS would generally trigger a total ***penalty of $520*** ($260 for failing to file with the payee, plus $260 for failing to file with the IRS).

Temporary 23.8% Tax Rate For Timber Gains Of "C" Corporations – For 2016 Only! Effective ***for taxable years beginning in 2016 only,*** the PATH Act provides a 23.8% alternative tax rate for "C" corporations (i.e., corporations that file Form 1120) on the portion of such corporation's taxable income that consists of *qualified timber gain* (or, if less, the net capital gain) for the taxable year. Qualified timber gain means the net gain described in §631(a) and §631(b) for the taxable year, determined by taking into account **only trees held more than 15 years.**

Temporary Suspension Of 2.3% Medical Device Tax – For 2016 And 2017 Only! Effective ***for sales after 2015,*** the PATH Act temporarily suspends the 2.3% medical device excise tax for a period of two years (i.e., suspended for sales ***on or after January 1, 2016 and before January 1, 2018).***

RECENT CASES, RULINGS, REGULATIONS, AND PROPOSED LEGISLATION

If Enacted – Proposed "Small Business Health Care Relief Act" Would Allow Qualifying Employers To Reimburse Employees' Health Insurance Premiums Without $100-Per-Day Penalty. Any employer (regardless of size) that sponsors a stand-alone ***"Health Reimbursement Arrangement"*** (*HRA*) or an ***"Employer Payment Plan"*** **(*EPP*)** could face a $100-a-day penalty for each covered employee. The penalty applies only if the employer covers ***at least 2 employees*** under the HRA or EPP. The IRS defines an ***"HRA"*** as an arrangement (funded solely by an employer) that reimburses an employee for qualified medical care expenses incurred by the employee **up to a maximum dollar amount** for a coverage period. The IRS defines an ***"Employer Payment Plan"*** as an arrangement where the employer reimburses an employee's substantiated premiums for the employee's individual medical insurance coverage (i.e., non-employer sponsored medical insurance coverage) or the employer pays the premiums directly to the insurance company. The IRS has provided several *"safe harbors"* for certain HRAs and for EPPs that could protect employers from this harsh $100-a-day penalty. For example, the IRS says an HRA that only covers employees who are also covered by an ACA compliant employer-sponsored health plan, will generally be exempt from the $100 a day penalty. The IRS also says that reimbursements or payments under an ***Employer Payment Plan*** will be exempt - until IRS announces otherwise - from the $100 a day penalty, where an S corporation reimburses or pays the premiums for individual health insurance coverage for one or more shareholder/employees who own more than 2% of the S corporation. For this exception to apply, the more-than-2% shareholder must properly include the premiums reimbursed or paid by the S corporation in the shareholder's W-2. In addition, if this is handled properly, the shareholder is allowed an above-the-line deduction for the insurance premiums included in his or her W-2.

- **Proposed *"Small Business Health Care Relief Act"* Could Provide Some Relief.** On June 21, 2016, the U.S. House of Representatives passed a bipartisan bill titled ***"Small Business Health Care Relief Act"*** that, if enacted, would generally allow qualifying small businesses to reimburse up to a maximum of $5,130 ($10,260 if arrangement also covers family members) of an employee's individual medical insurance policy premiums and/or qualified medical expenses without incurring the $100-a-day penalty. The relief would only be available to employers with ***fewer than 50 full-time and full-time equivalent employees*** and ***would be effective*** for tax years ***beginning after*** the ***earlier of:*** **1)** The date that is 90 days after the date of enactment, or **2)** December 31, 2016. **Caution!** A similar bill (S 3060) was introduced in the Senate on June 15, 2016. As we complete this letter, the Senate has yet to pass the bill.

Recent IRS Release Explains Self-Employment Tax Treatment For Owners Of Limited Liability Companies (LLCs). "General" partners of businesses operating as partnerships are generally subject to Social Security and Medicare taxes (Self-Employment Tax or S/E tax) on their business income passing through from their partnership and reported on Schedule K-1. By contrast, "limited" partners are generally exempt from S/E tax on the partnership's Schedule K-1 pass-through business income (except for "guaranteed payments" they receive). However, it has never been entirely clear whether and to what extent pass-through business income to the owner of a Limited Liability Company (LLC) is subject to S/E tax.

In a recently-released IRS Chief Counsel Advisory (CCA), the IRS ruled that a majority owner (Member/Owner) of an LLC that owned and operated a group of franchise restaurants should be treated as a "general" (not "limited") partner and, therefore, should be subject to S/E tax on all pass-through business income from the LLC reported on his Schedule K-1. The Member/Owner was actively involved in the LLC's business operations – serving as Operating Manager, President, and Chief Executive Officer. The CCA generally concluded that an owner of an LLC could possibly qualify for the "limited partner" exception to the S/E tax *only if* the LLC owner was a ***"mere investor"*** who did not ***"actively participate"*** in the business operations of the LLC. Since the Member/Owner in this situation was not a "mere investor" and "actively participated" in the LLC's restaurant operations, the CCA concluded that the S/E tax should be imposed on the entire amount of his business income from the LLC. **Planning Alert!** The CCA ***did not provide a specific definition*** of the terms *"mere investor"* or *"actively participate."* Presumably, the IRS intends to apply these critical terms on a case-by-case, facts-and-circumstances basis.

The following are several other important observations and conclusions contained in the CCA:

- The Member/Owner's wife also owned an interest in the LLC, however she had no active involvement in the operations of the LLC. The CCA concluded that the LLC's Schedule K-1 business income that passed through to her was not subject to S/E tax because the IRS determined on these facts that she was a "mere investor" and did not "actively participate" in the LLC's operations.

- The Member/Owner was paid "guaranteed payments" on which he paid S/E tax. He argued that since his "guaranteed payments" reasonably compensated him for the services he provided to the LLC, he should not be required to pay S/E tax on his share of the LLC's pass-through K-1 business income. The IRS rejected this argument entirely, and ruled that the existence of "guaranteed payments" had no bearing as to whether the Husband would be treated as a "limited partner" for S/E tax purposes.

- The Member/Owner also argued that the income he received from the LLC other than the "guaranteed payments" represented a return on his capital investment in the LLC and should not be subject to S/E tax. Again the IRS completely rejected this argument and said that the S/E tax provision ***"provides an exclusion for limited partners, not for a reasonable return on capital,*** *and* ***does not indicate*** *that a partner's status as a limited partner* ***depends on the presence of a guaranteed payment*** *or the* ***capital-intensive nature*** *of the partnership's business."* [Emphasis added].

New Regulations Require "Specified Domestic Entities" To Report "Specified Foreign Financial Assets" On Form 8938. This year, the IRS issued final regulations requiring "*Specified Domestic Entities"* to report their interests in *"specified foreign financial assets"* on Form 8938. Unlike the reporting requirements for U.S. *"individuals"* with interests in *specified foreign financial assets* (which became effective for tax years ending after December 19, 2011), the reporting requirements for ***"specified domestic entities"*** are ***effective for tax years beginning after December 31, 2015. "Specified Domestic Entities"*** include a domestic corporation, partnership, or trust that is formed or availed for purposes of holding *"specified foreign financial assets"* (e.g., certain financial accounts maintained by a foreign financial institution, directly-owned stock in a foreign corporation, and several other types of foreign investment assets). Whether a corporation, partnership, or trust constitutes a *"Specified Domestic Entity"* (requiring it to file Form 8938) is determined by applying certain standards under the final regulations. ***For example,*** certain closely-held domestic partnerships or corporations may constitute a *specified domestic entity* if at least 50% of its gross income is so-called *"passive income*" produced by specified foreign financial assets (generally income comprised of dividends, interest, royalties, annuities, certain rents, etc.). The rules for determining whether a partnership, corporation, or trust meets the definition of a "*specified domestic entity*" are quite detailed and beyond the scope of this letter. Please call our firm for additional details.

Courts Are Emphasizing The "Independent Investor" Test When Determining Whether Closely-Held Corporations Pay "Reasonable Compensation" To Shareholder/Employees. Over the years, determining whether a closely-held regular "C" corporation has paid *"reasonable"* compensation to its shareholder/employees has been hotly contested and frequently litigated. This issue can be particularly costly if successfully applied to a *"personal service corporation"* (PSC) because a PSC's compensation payment to its shareholder/employee that is deemed "unreasonable" generally generates a comparable amount of taxable income to the PSC that is taxed at the full ***35% tax rate*** (i.e., without the benefit of the graduated corporate tax rates). Generally, a "C" corporation is a PSC if it meets the following *"function"* and *"ownership"* tests: **1) Function Test -** substantially all (95% or more) of its activities involve the performance of services in the fields of ***health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting***; and ***2) Ownership Test -*** substantially all (95% or more) of the stock (by value) is held by employees performing such services.

In a recent Tax Court case, the IRS argued that approximately $800,000 of the compensation paid to a family-owned corporation's shareholders/employees in each of the two years at issue was unreasonable. The Court held that the entire compensation paid to the shareholders was reasonable based largely on the *"independent investor"* test. Under this test, the Court said that there is a strong indication that compensation paid to a shareholder/employee is reasonable if the corporation's earnings on equity after payment of compensation remain at a level that would satisfy an independent investor. The Court determined the return on equity by dividing the corporation's "pre-tax income" by its "year-end shareholder equity." Using this formula, the Court

found that the corporation had a return on its equity ***between 9% and 10.2%*** for the two years at issue. In holding for the Taxpayer, the Court said: "*[I]n applying the **independent investor test** the Courts have typically found that a **return on equity of at least 10%** tends to indicate that an **independent investor would be satisfied** and thus payment of compensation that leaves that rate of return for the **investor is reasonable."*** [Emphasis added]. In another recent case, the Tax Court held that a portion of the compensation paid to attorney-shareholders of a PSC (large law firm) was unreasonable, in part because of the independent investor test. In reaching that conclusion, the Court stated: *"Ostensible compensation payments made to shareholder employees by a corporation **with significant capital** that **zero out the corporation's income** and leave **no return on the shareholders' investments** fail the independent investor test*." [Emphasis added].

- **Planning Alert!** These recent cases illustrate how important it is for closely-held corporations (even PSCs) to properly document the economic reasons for the amount of compensation paid to shareholders. Although the determination of "reasonable compensation" is based on a case-by-case analysis, having a policy that uses year-end bonuses to largely eliminate book/tax income for the year is becoming increasingly risky. Leaving enough book/tax income in the corporate business on an annual basis to generate a reasonable rate of return to a hypothetical investor on the existing capital of the corporation should be helpful in minimizing the likelihood of a successful IRS attack.

IRS Increases Attacks On "Qualified Real Estate Professional" Status. Generally, any losses from renting real estate (where the average period rented is more than seven days) are deemed for tax purposes to be "passive activity losses" (PALs). An individual's PALs are generally suspended, and are not allowed unless and until the individual has qualifying "passive" income to offset the losses or until the activity is disposed of. In addition, net rental income is generally deemed to be "passive income" which is potentially subject to the 3.8% Net Investment Income Tax (3.8% NIIT) for high income individuals. However, if you are a ***"qualified real estate professional"*** (*QREP*) and ***meet certain "material participation" tests*****,** you will generally be able to fully deduct your net losses from your rental real estate activities, and any net income generated by your rental real estate activities will generally be exempt from the 3.8% NIIT.

Generally to be a *QREP*: **1)** You must perform more than 750 hours of services during the year in real property businesses in which you materially participate, **AND 2)** More than 50% of your personal services performed in businesses during the year must be performed in real property businesses in which you materially participate. **Tax Tip.** As a *QREP*, you are allowed to make a "tax" election to treat all of your rental real estate activities as a "single" rental real estate activity. If you have multiple rental properties, this election is often necessary to meet the required "material participation" tests.

- **Planning Alert!** Because of the tax benefits afforded to QREPs, taxpayers classifying themselves as QREPs and treating their rental real estate activities as nonpassive activities are receiving more scrutiny from the IRS. Over the last few years, there has been a significant uptick in the number of individuals the IRS has taken to Court contesting their "QREP" classification. For example, the IRS ruled that the activities of a real estate broker or agent generally would qualify for QREP classification, however, the Tax Court recently held that the activities of a real estate "mortgage" broker would not. A recent District Court case held that in determining whether a taxpayer is a "*qualified real estate professional,"* hours worked as an "employee" in a real estate trade or business count as services performed in a real property business (if the employee owns more than 5% of the stock) even if the ownership interest has transfer restrictions and/or carries a "substantial risk of forfeiture." That same District Court case also held that the hours spent by a 10% owner of a real estate management company, working for the company, counted for determining whether the owner met the requirements of a QREP as long as the services were inherently necessary to the functioning of a successful real estate management entity (including hours spent providing legal services and services involving real estate compliance matters).

- **Documenting Hours.** In Court cases dealing with the QREP issue, the IRS has generally prevailed where the individual could not provide adequate documentation that he or she spent more than 750 hours and over 50% of their working hours working in real property businesses in which the individual materially participated. Although the Courts generally have not strictly required taxpayers to maintain daily logs of the time spent working in real property businesses, the Courts generally have not allowed "*after-the-fact ballpark estimates.*" **Tax Tip.** To minimize exposure to IRS attacks, individuals who must qualify as a

QREP in order to deduct their net rental real estate losses or to exempt their net rental real estate income from the 3.8% NIIT, should contemporaneously document their hours spent in real property businesses (e.g., by recording their hours in a daily or weekly calendar).

IRS Releases Updated List Of Automatic Accounting Method Changes. On May 5, 2016, the IRS released its ***updated list of accounting method changes*** which may be made ***"automatically"*** (i.e., without obtaining advance permission from the IRS and without paying an IRS user fee), and also provided updated procedures for making the changes. Generally, a ***Form 3115*** (that must be used for applications for changes in accounting methods) ***filed on or after May 5, 2016*** to implement an automatic accounting method change ***must follow the updated rules.*** **Planning Alert!** On March 2, 2016, the IRS released its ***latest version of Form 3115*** that must be used for applications for changes in accounting methods ***after April 19, 2016.***

FINAL COMMENTS

Please contact us if you are interested in a tax topic that we did not discuss. Tax law is constantly changing due to new legislation, court cases, regulations, and IRS rulings. Our firm closely monitors these changes. In addition, please call us before implementing any of the planning ideas discussed in this letter, or if you need additional information. **Note!** The information contained in this letter represents a general overview of tax developments and should not be relied upon without an independent, professional analysis of how any of the items discussed may apply to a specific situation.