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# Your Presenters:

**Lynn Freer, EA**
**Tim Hilger, CPA**
**Wayne Otchis, CPA**
**Renée Rodda, J.D.**
**Mark Seid, CPA, EA**
**Steve Yukelson, CPA**

**Publisher:**
Lynn Freer, EA

**Editor-in-Chief:**
Tim Hilger, CPA

**California Editor:**
Renée Rodda, J.D.

**Contributing Editors:**
Michael Giangrande, J.D., LL.M.
Sandy Weiner, J.D.

**Spidell Publishing, Inc.**

P.O. Box 61044
Anaheim, CA 92803-6144

1134 N. Gilbert Street
Anaheim, CA 92801-1401

**Phone:** (714) 776-7850
**Fax:** (714) 776-9906

**Website:** www.caltax.com
**E-mail:** subscriptions@spidell.com


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Chapter 1

# Individuals

# INDIVIDUALS

## PERSONAL EXEMPTIONS AND DEPENDENTS — IRC §§151–153

### PERSONAL EXEMPTION PHASEOUT

The 2016 personal exemption amount is $4,050. (Rev. Proc. 2015-53) The 2017 amount remains at $4,050. (Rev. Proc. 2016-55)

#### Exemption phaseouts continue

Phaseouts of exemptions returned for higher income taxpayers in 2013 under the American Taxpayer Relief Act of 2012 (ATRA '12). (ATRA '12 §101(b)(2)) Those phaseouts continue for 2016.

| Exemption Phaseouts (Rev. Proc. 2015-53, Rev. Proc. 2016-55) | | |
|---|---|---|
| **Filing status** | **2016 AGI** | **2017 AGI** |
| Single | $259,400 | $261,500 |
| Head of household | $285,350 | $287,650 |
| Married filing joint; surviving spouse | $311,300 | $313,800 |
| Married filing separate | $155,650 | $156,900 |

The threshold amounts are adjusted for inflation. Exemption amounts phase out by 2% for each $2,500 (or fraction thereof) by which the taxpayer's AGI exceeds the threshold amount.

#### California conformity

California phases out personal exemptions when a taxpayer's federal AGI exceeds a threshold amount. (R&TC §17054.1)

### DEPENDENTS

When it comes to dependents, the amount at stake can be substantial and may affect one or more of the following:

- Exemption deduction;
- Child Tax Credit;
- Earned Income Tax Credit;
- Child Care Credit; and
- Head of household status.

***Greatest number of nights***

Generally, the custodial parent gets the dependent exemption for a child.

The final regulations define the custodial parent as the parent with whom the child resides for the greater number of nights during the year. (Treas. Regs. §1.152-4(d))

The final regulations clarify that:

- The child resides for a night with a parent if:
  - The child sleeps at the parent's residence whether or not that parent is present;
  - The child is in the company of the parent when not at the parent's residence (for example, when parent and child are on vacation together); or
  - If at neither parent's residence, then the child is deemed to reside for that night with the parent with whom the child would have resided, if that can be determined; and
- A night that extends over two calendar years is counted in the year in which the night begins (the night that begins on December 31, 2016, is counted for tax year 2016).

***Example of counting nights***

Joey generally spends four nights per week with his mother and three with his father. Joey goes to summer camp for a week. During that week he is treated as having spent four nights with his mother and three with his father.

## Form 8332

Under IRC §152(e), a child is treated as a qualifying child of the noncustodial parent when the custodial parent signs a written declaration that such custodial parent will not claim such child for that taxable year. The declaration must be made either on a completed Form 8332 or on a statement conforming to the substance of Form 8332.

Under final regulations, the IRS no longer accepts a divorce decree in lieu of Form 8332 even if the decree contains all of the information otherwise found on Form 8332 and is not conditional in any respect (for example, conditioned on child support payments being current). (Treas. Regs. §1.152-4)

***Comment***

The Form 8332 transfers to the noncustodial parent the right to claim the dependent exemption and the Child Tax Credit. However, the Earned Income Tax Credit, the Child Care Credit, and Head of Household filing status are available only to the custodial parent (and are still available to the custodial parent even if that parent signs the Form 8332).

## Form 8332 may have been forgery — still valid

A noncustodial father was allowed to claim his children as dependents because he attached a signed Form 8332 to his return in spite of the fact that the mother claimed she never signed the form. (CCA 201602009)

### Facts

Mother had been the custodial parent of her two children since her divorce from Father. In the tax year at issue, both parents claimed the dependency exemption for the children.

Father attached Form 8332, Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent, to his return. Part II of the form was completed, and on the line of Part II dealing with the years for which the release was effective, "all future years" was written.

Mother did not recall signing the form and said she was confident that she would not have released the exemption.

### CCA ruling

Chief Counsel noted that a Form 8332 may be executed for all future years. A Form 8332 that specifies all future years is treated as specifying the first taxable year after the taxable year of execution and all future years.

The CCA went on to note that if the Form 8332 is completed, signed, and attached to the noncustodial parent's tax return, the IRS should allow the dependency exemption for the children named on the form to the noncustodial parent and deny the custodial parent's claim to the dependency exemption.

Furthermore, the CCA explained that if the custodial parent did not execute the Form 8332, *her remedy is against the noncustodial parent*. In addition, if the custodial parent did release the dependency exemption for all future years, she may file another Form 8332 to revoke the release and such revocation would be effective for the first calendar year after the year in which she revokes the release.

### California partial conformity

California conforms to the federal law definition of a dependent. California allows a dependent exemption credit rather than a dependency deduction. A taxpayer who elects to forgo the federal dependent exemption so that the child can claim education benefits may still claim the dependent exemption credit for California purposes, as California does not conform to IRC §25A — Hope and Lifetime Learning Credits. (Treas. Regs. §1.25A-1(f)(1))

**Note:** California allows exemption credits to reduce regular tax below tentative minimum tax, so it is more common to lose the benefit of dependents on the federal return than the California return.

California also conforms to the federal definition of head of household. (IRC §2(b); R&TC §17042)

# FILING ISSUES

## FILING DEADLINE IS APRIL 18, 2017

The original filing deadline for 2016 personal income tax returns is Tuesday, April 18, 2017.

April 15, 2017, falls on a Saturday, which would normally mean Monday, April 17, would be the due date. But Emancipation Day in Washington, D.C., is observed the weekday closest to April 16, which would be Monday, so the due date moved to April 18.

### California conformity

California conforms to the April 18, 2017, filing deadline for individuals.

**Caution**

The filing deadlines for partnership and C corporation returns change for the 2016 tax year. For further discussion, see page 4-1.

## DELAYED REFUNDS FOR EARNED INCOME TAX CREDIT AND REFUNDABLE CHILD TAX CREDIT

The IRS has announced initial plans for processing tax returns involving the Earned Income Tax Credit (EITC) and Additional Child Tax Credit (ACTC) during the opening weeks of the 2017 filing season.

Section 201 of the PATH Act, enacted on December 18, 2015, mandates that no credit or refund for an overpayment for a taxable year shall be made to a taxpayer before February 15 if the taxpayer claimed the EITC or ACTC on the return. (IRC §6402(m))

To comply with the law, the IRS will hold the refunds on returns claiming the EITC and the ACTC until after February 15.

This allows additional time to help prevent revenue lost due to identity theft and refund fraud related to fabricated wages and withholdings.

The IRS will hold the entire refund. Under the new law, the IRS cannot release the part of the refund that is not associated with the EITC and ACTC.

According to the IRS, even though they cannot issue refunds for some early filers until at least February 15, they will still be issued within the normal timeframe: 21 days or less, after being accepted for processing by the IRS.

### California nonconformity

California is doing heightened reviews of returns claiming the California EITC, but there is no set period (e.g., February 15) for which they will hold up refunds.

## IRS ISSUED FINAL REGULATIONS DEFINING MARITAL STATUS

The IRS has issued final regulations that reflect the holdings of ***Obergefell v. Hodges*** (576 U.S. 135 S.Ct. 2584 (2015)), ***Windsor v. U.S.*** (570 U.S. 133 S.Ct. 2675 (2013)), and Rev. Rul. 2013-17 (T.D. 9785). The new regulations largely follow proposed regulations issued in October 2015 and describe the marital status of taxpayers for federal tax purposes.

### Terms defined

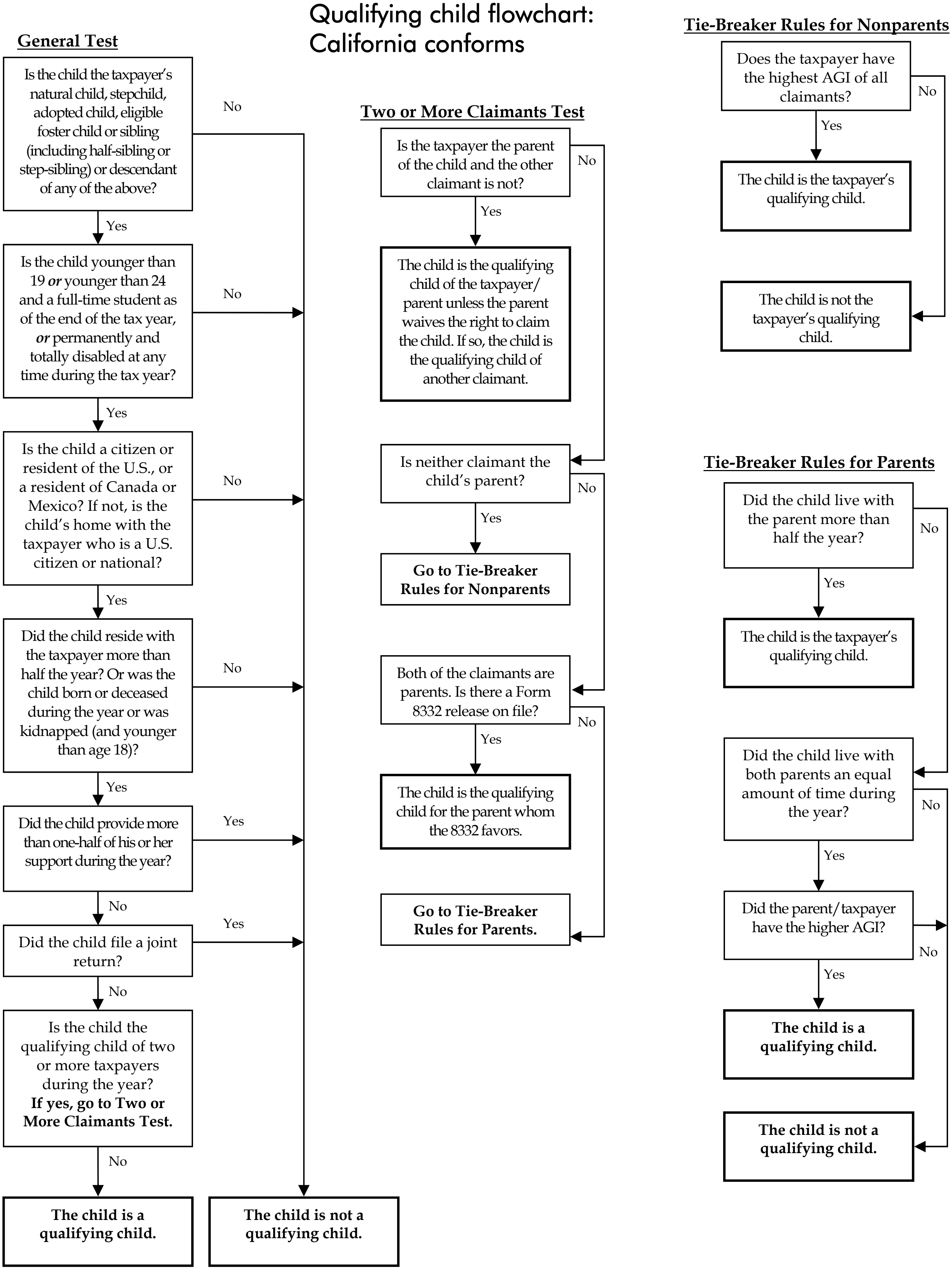
As in the proposed regulations, the final regulations provide that the terms "spouse," "husband," and "wife" mean an individual lawfully married to another individual.

In addition, the regulations provide that a marriage of two individuals is recognized for federal income tax purposes if that marriage was recognized by the state, possession, or territory of the United States in which the marriage was entered into. This reflects a change from the proposed regulations which referred to any state, possession, or territory rather than the one in which the marriage was entered into. The change is meant to avoid a situation in which a couple would have to analyze the marriage laws of all states to determine if they had a marriage for income tax purposes. Moreover, the rules under the proposed regulations could create other problems such as causing what is mere cohabitation in the state of residence to be deemed a marriage because in some other state such cohabitation could be deemed a common law marriage.

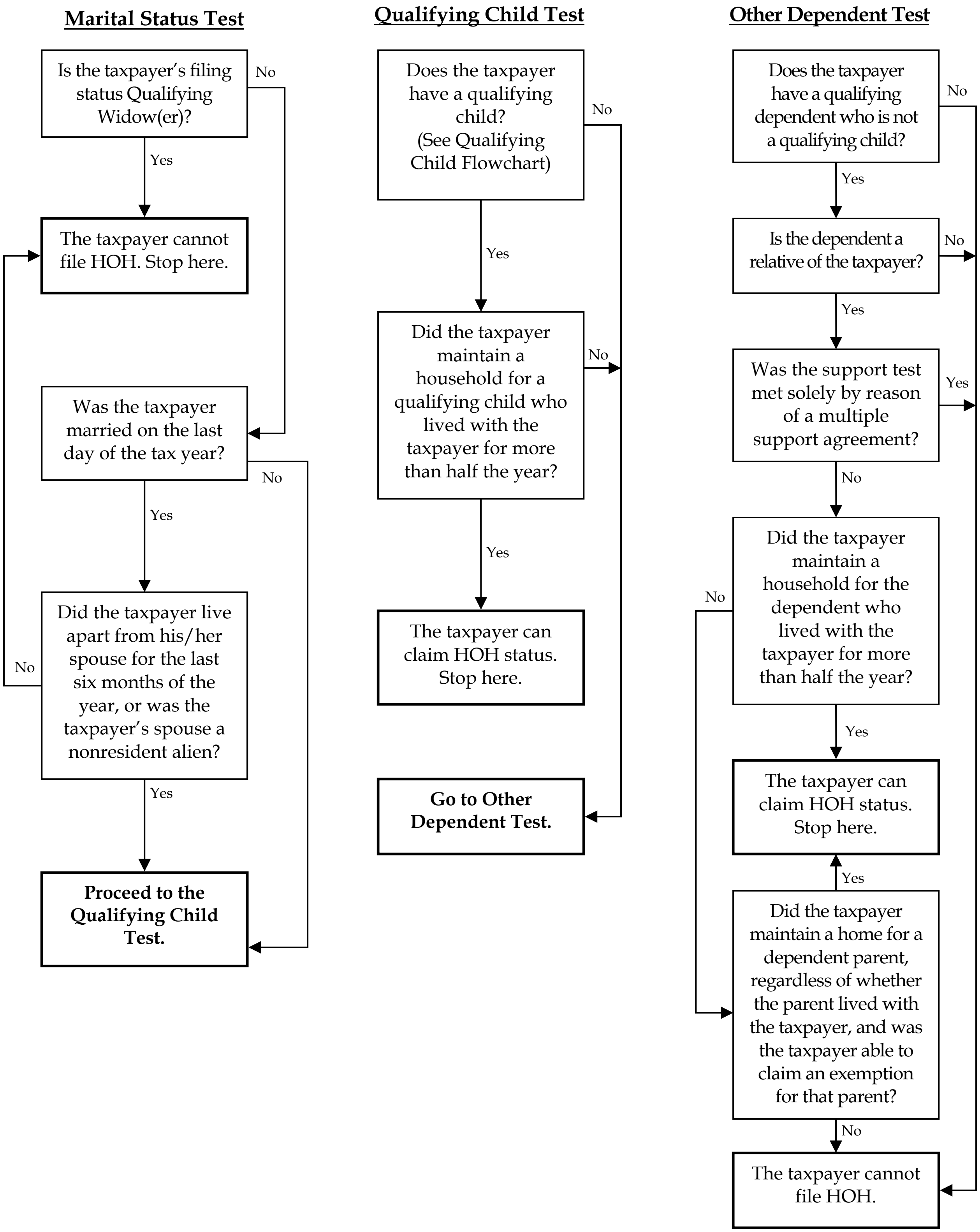
The regulations clarify that the term "marriage" does not include registered domestic partnerships, civil unions, or other similar relationships under state law.

The regulations further provide that two individuals who enter into a marriage under the laws of a foreign jurisdiction are married for federal tax purposes if the relationship would be recognized as marriage under at least one state, possession, or territory, regardless of whether the couple has ever resided in such state, possession or territory.

## Qualifying child flowchart: California conforms



## Head of household flowchart: California conforms



# GROSS INCOME

## CAPITAL GAINS

| Individual Long-Term Capital Gains Rates (IRC §1(h)) | | | | |
|---|---|---|---|---|
| **Tax bracket** | **January 1, 2001–May 5, 2003** | **May 6, 2003–2007** | **2008–2012** | **2013–2017** |
| 10% and 15% | 8% and 10%, respectively | 5% | 0% | 0% |
| 25%–35% | 20% | 15% | 15% | 15% |
| 39.6% | N/A | N/A | N/A | 20% |

### California nonconformity

California does not have a reduced rate for capital gains or qualified dividends. (R&TC §§17041, 17062.5).

## OTHER INCOME

### Ex gets 1099 for breaking fidelity contract

If hindsight is 20/20, then the foresight in this case was 20/200. On paper, it seems obvious that the financial arrangement that landed a taxpayer in Tax Court was doomed to fail, but the heart (read: pocketbook) wants what the heart (read: pocketbook) wants. (***Blagaich v. Comm.***, TCM 2016-2)

#### The juicy details

Between 2009 and 2011, Diane Blagaich was romantically involved with Lewis Burns, the CEO of a manufacturing company. In 2010, she was age 54 and he was age 72. Over the course of 2010, Mr. Burns generously gave Ms. Blagaich cash and gifts totaling $743,819 (yes, all in one year), none of which she included in income. The gifts included a $70,000 Corvette, a wire transfer of $200,000 to her bank account, various other checks that amounted to $73,819, and an "engagement" ring — although the couple agreed that neither wanted to marry.

However, this cases hinges on a $400,000 additional payment that Burns made to Blagaich under the terms of a written agreement that formalized the couple's "respect, appreciation and affection for each other" and mandated that the couple "shall respect each other and shall continue to spend time with each other consistent with their past practice … shall be faithful to each other and shall refrain from engaging in intimate or other romantic relations with any other individual." You give me your undying devotion, I give you $400,000.

And they lived happily ever after … for about four months.

#### The fallout

The $400,000 payment was made at the end of 2010, and by the following March, Blagaich had moved out and Burns terminated the agreement, accusing her of having a relationship with someone else the entire time they were together. That April, Burns filed a 1099-MISC reporting $743,819 to Blagaich.

A civil trial ensued, and in 2013 the court found that Blagaich had fraudulently induced Burns to enter into the written agreement. The court ordered her to repay the $400,000 to Burns' estate (he had since died), which she did in 2014. But regarding the Corvette, the wire transfer, the various checks, and the ring, the court found those to be gifts. The Burns estate reissued the 2010 1099-MISC to report $400,000 rather than $743,819. But the IRS adjusted Blagaich's 2010 income to reflect the amount on the original 1099-MISC: $743,819.

Blagaich claimed that she should have no income tax deficiency for 2010, and she presented two arguments to wipe out all of the extra income:

1. $343,819 constitutes nontaxable gifts under IRC §102(a) and, under the doctrine of collateral estoppel, the IRS may not deny the $343,819 reduction in income for the gifts; and
2. The doctrine of rescission applies to the $400,000 that she repaid to Burns' estate in 2014.

### Claim of right and rescission

Under the claim of right doctrine, a taxpayer receives income whenever one "acquires earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition." (IRC §1341; ***James v. U.S.*** (1961) 366 U.S. 213, 219) The Supreme Court took this further, stating that if a taxpayer receives income without any restrictions as to what the taxpayer may do with the funds, it's still income even if it may later be decided that the funds need to be paid back. (IRC §1341; ***James v. U.S.*** (1961) 366 U.S. 213, 219)

An exception to the claim of right doctrine is the doctrine of rescission, which says that if a taxpayer receives income under a claim of right, and within that same tax year the income is rescinded, the taxpayer is not required to report the income. (Rev. Rul. 80-68) The key is that the parties are back in the same position they were in before the transaction took place, and again, both parts of the transaction must take place within the same tax year.

Blagaich failed because she received the $400,000 payment in 2010, but she didn't repay it until 2014, and there was no obligation to repay until the outcome of the civil suit. Therefore, she was liable for tax on the $400,000 payment for 2010.

## Taxpayer proves "identifiable event": no COD income

A taxpayer proved that debt was actually discharged at an earlier date than the IRS argued, which meant that she therefore had no COD income for the year at issue. (***Clark v. Comm.***, TCM 2015-175)

### Facts

In 2005, the taxpayer defaulted on her car loan, and the car was repossessed and sold at auction. The auction proceeds were applied to the loan balance on June 20, 2005, but the taxpayer still owed $4,768.79. Over the next five years, the creditor assigned five different debt collection agencies to the account, but none were successfully able to collect any payments. Finally, in August of 2011, the creditor discharged the debt and issued a 1099-C.

The taxpayer had since moved, the 1099-C was returned as undeliverable, and the taxpayer filed her 2011 tax return without reporting the discharged debt.

In protesting the resulting assessment by the IRS for 2011, the taxpayer asserted the cancellation actually occurred, and therefore the debt was discharged when the creditor failed to receive payment on the debt over a 36-month period that ended December 2008.

### Identifiable event

A debt is considered cancelled or discharged (resulting in COD income) at the moment that it becomes clear that the debt will never be paid. An "identifiable event" fixes the loss with certainty and indicates the time when a debt has been discharged. Whether an event has occurred is based on facts and circumstances. (***Cozzi v. Comm.*** (1987) 88 TC 435)

Under Treas. Regs. §1.6050P-1(b)(2)(iv), an identifiable event has occurred during a calendar year if a creditor has not received a payment on a debt at any time during a "testing period" ending at the close of the year; the testing period is generally a 36-month period.

### Findings

Looking to these regulations, the taxpayer argued that her last payment date was June 20, 2005, meaning that the testing period had ended (and therefore the debt should have been reported as discharged) on December 31, 2008, not in 2011 as the IRS argued.

The IRS argued against the testing period being met, because during that time the creditor had employed five collection agencies to pursue the debt, although all were unsuccessful. However, Treas. Regs. §1.6050P-1 came to the taxpayer's rescue again. It states that, yes, the identifiable event test is not met if the creditor engaged in significant collection activity … but clarifies that "significant collection activity" does not include merely sending automated notices. The IRS was unable to prove exactly what methods the collection agencies had used in their attempts to collect.

The court found an identifiable event occurred that fixed the discharge of debt in 2008, as the taxpayer argued. Thus, there was no discharge of debt in 2011, and the taxpayer had no COD income in 2011.

***IRS eliminates 36-month testing rule for issuing 1099-C***

In final regulations, the IRS has eliminated the existing regulation under which a creditor must furnish Form 1099-C, Cancellation of Debt, if there is a 36-month period during which the creditor has not received any payment on the debt from the debtor. (T.D. 9793, Treas. Regs. §1.6050P-1)

The IRS is concerned that the 36-month rule causes confusion among taxpayers. In cases in which a Form 1099-C is issued before the debt is actually discharged, the IRS does not receive third-party reporting when the debt is actually discharged.

The IRS has concluded that the 36-month rule does not increase tax compliance.

## Adult entertainer dances her way to jail

During a failure-to-file investigation, an IRS agent determined there were more than $1 million in bank deposits that were not reported on an exotic dancer's tax return. (***U.S. v. Fairchild*** (March 17, 2016) U.S. Court of Appeals, Eighth Circuit, Case No. 14-3517) From 2005 to 2008, the agent found evidence of more than $1.1 million in checks from an individual named David Karlen, and $50,000 from Paul Pietz, plus over $210,000 in cash deposits. When the taxpayer and her husband filed their returns, none of those deposits were reported.

Exotic dancer Veronica Fairchild and her husband Tim (who passed away in 2013) filed 2005–2008 tax returns in July 2010, reporting only the wages and tips from the exotic dance clubs where she worked but none of the other income she received for private lap dances at the clubs or elsewhere.

Their CPA originally prepared the 2005 return using the income from the taxpayers' bank statements, and the balance due was $56,217. The CPA also prepared a "working draft" of the 2006 return, including the bank deposits in the account. When the Fairchilds saw the $56,217 tax liability, they immediately used the tax return to borrow money from the credit union — but not to pay their taxes; they purchased two Cadillacs and a boat.

### Oops — it's a gift

Subsequently, Veronica Fairchild advised the CPA that the other income was a gift. She had him redo the 2005 return and prepare the 2006–2008 returns omitting the "gift" income. (**Note:** $30,000 from Pietz was included on one return, but Fairchild told the IRS agent that the CPA made a mistake and that he shouldn't have reported the income because it too was a gift.)

However, Fairchild continued to use the original, unfiled 2005 return and the draft 2006 return to obtain loans for real estate and a Corvette.

Later, at trial, she stated that she was going to report some of the income so that the tax burden for Karlen would not be so great. She also stated that the lap dances never included sex.

Unfortunately, Karlen and Pietz testified that the payments were not gifts but were made in return for services.

The jury found that she was liable for $239,118.94 in tax, based on unreported income of $853,996, and sentenced her to 33 months in jail.

## Final §83(b) regulations simplify election requirements

The IRS issued final regulations that simplify the IRC §83(b) election filing requirements by no longer requiring a copy of the election to be filed with the taxpayer's income tax return. The IRC §83(b) election must be filed with the IRS within 30 days of the property transfer, and until these regulations were finalized, a copy of the previously filed election was required to be attached to the taxpayer's income tax return. The change is good news for e-filers because some software programs make it difficult to attach a copy of the election to an e-filed return, thus requiring the return to be paper filed. The new regulations apply to property transfers on or after January 1, 2016.

IRC §83(b) allows a taxpayer to elect to include the value of property received for services which is subject to a substantial risk of forfeiture in the year the property is transferred to the taxpayer, rather than the year the risk of forfeiture expires as normally required by IRC §83(a).

# EXCLUSIONS FROM INCOME

# ALISO CANYON GAS LEAK REIMBURSEMENTS

The IRS has announced that taxpayers affected by the Southern California Gas Company (SoCal Gas) natural gas leak may exclude reimbursements for certain relocation and cleaning expenses from gross income. (IRS Ann. 2016-25)

On October 23, 2015, SoCal Gas discovered a natural gas leak at the Aliso Canyon storage field, which was sealed on February 18, 2016. Because the gas leak caused significant symptoms for area residents, the Los Angeles County Department of Public Health directed SoCal Gas to offer free temporary relocation to affected residents. SoCal Gas was required to either pay on behalf of, or reimburse, affected residents for certain relocation and cleaning expenses incurred generally for the period beginning November 19, 2015, through May 31, 2016.

### California conformity

Because California conforms to both IRC §139 (disaster relief payments) (R&TC §17131) and IRC §61 (R&TC §17071), we believe California will conform to this announcement.

These expenses include:

- Hotel expenses, including meal reimbursement ($45 per day for an individual age 18 and older; $35 per day or $25 per day for a child based on age), mileage reimbursement, parking expenses, pet boarding fees, internet fees, electric vehicle charging fees, and laundry fees;
- Expenses of staying with friends or family at the rate of $150 per day, and mileage reimbursement;
- Expenses of renting another home for a lease term (including a lease term extending beyond May 31, 2016) as approved by SoCal Gas, including expenses of housewares, appliances, pet fees, furniture rental, utility fees, and moving expenses;
- Mileage allowances or alternative transportation for a resident whose child or children attended the relocated area schools until the date the resident exited the relocation program. If, however, a resident enrolled a child in a school outside of the affected area, SoCal Gas must pay the mileage allowance until the child no longer attends the reenrolled school or the school year ends, whichever occurs first;
- Expenses of cleaning the interior of an affected individual's home prior to returning home according to protocols established by the Los Angeles County Department of Public Health;
- Air filtration and purification expenses;
- Expenses of cleaning residue from the exterior of an affected individual's home, outdoor fixtures, and exterior furniture and appliances;
- Expenses of a vehicle detailing treatment; and
- Other expenses not specifically described in the relocation plan based on SoCal Gas's evaluation of the expenses.

### No exclusion for family and friends

The IRS guidance states that family and friends who received payments under the relocation plan for housing affected area residents must include these payments in gross income, unless these amounts are properly excludable from gross income under IRC §280A (relating to the exclusion for rental income from a taxpayer's residence for less than 15 days during the taxable year).

As a result, those friends and family members who received the $150 per day reimbursements must include this income in their gross income if their family or friends stayed with them for more than 14 days (or if they had total "rentals" for the year that exceeded 14 days).

## NEW EXCLUSION FOR OLYMPIC MEDALS AND PRIZES — IRC §74(d)

On October 7, 2016, the President signed into law the United States Appreciation for Olympians and Paralympians Act of 2016 (HR 5946). The Act adds new IRC §74(d), which provides that gross income shall not include the value of any medal awarded in, or any prize money received from, the United States Olympic Committee on account of competition in the Olympic Games or the Paralympic Games.

The exclusion does not apply if the taxpayer's adjusted gross income (determined without regard to the exclusion) for the taxable year exceeds $1 million ($500,000 in the case of a married individual filing a separate return).

# COD EXCLUSION — IRC §108

## Principal residence COD exclusion extended (but not for California)

The PATH Act retroactively extended the exclusion for cancellation of debt on a qualified principal residence so that it applies to debts discharged before January 1, 2017. However, the exclusion applies to discharges that occur in 2017 if the discharge is pursuant to a written agreement entered into in 2016. (IRC §108(a)(1)(E); Act §151)

### No California conformity

In 2016, Governor Brown once again vetoed a COD conformity bill. This year's bill, SB 907, would have retroactively reinstated California's qualified principal residence indebtedness exclusion for COD income for the 2014-2016 tax years. As a result, California taxpayers must look to the insolvency exclusion for these tax years, or report the income and pay the tax. See page 10-10.

## Taxpayer allowed insolvency exception

The Tax Court ruled that a taxpayer was entitled to the insolvency exception under IRC §108(a)(1)(B) in the year he received a Form 1099-C for cancellation of debt income that resulted because he failed to reimburse his bank after overdrawing his checking account. (***Newman v. Comm.***, TCM 2016-125)

In 2008, the taxpayer opened a checking account at Bank of America and deposited a check for $8,500 drawn on his checking account at Wells Fargo. Shortly after making the deposit, he withdrew $8,000 in cash from the Bank of America account. However, the check he deposited did not clear, and he did not deposit funds into the Bank of America account to correct the negative balance.

In December 2011, Bank of America issued the taxpayer a Form 1099-C reporting COD income for the overdrawn amount. The taxpayer did not report the amount on his 2011 federal tax return.

### Court's findings

The court agreed that Bank of America had properly issued the 1099-C. Bank of America hadn't received any payments from the taxpayer after August 2008, so the debt was presumed discharged in 2011 under the 36-month testing period under Treas. Regs. §1.6050P-1(b)(2)(iv), and the taxpayer did not rebut that presumption. Accordingly he had COD income.

However, the court found that the COD income was excludable under the insolvency provisions of IRC §108. The taxpayer owned assets with a total value of $35,500 and was liable for debts totaling $50,000 — liabilities in excess of assets of $14,500.

***The insolvency exclusion***

A taxpayer may exclude from income a discharge of indebtedness that occurs while the taxpayer is insolvent (but not involved in bankruptcy proceedings) up to the amount by which he or she is insolvent. (IRC §108(a)(1)(B), (a)(2)(A), and (a)(3))

The amount of any discharge of indebtedness in excess of the amount by which the taxpayer is insolvent is treated in the same manner as the discharge of the indebtedness of a wholly solvent taxpayer, and thus will generally be included in income. (IRC §§61(a)(12), 108(a)(3))

The term "insolvent" means that there is an excess of liabilities over the FMV of assets, determined on the basis of the taxpayer's assets and liabilities immediately before the discharge. (IRC §108(d)(3)) Assets for this purpose include assets that are exempt from creditors' claims under state law. (***Carlson v. Comm.*** (2001) 116 TC 87) Liabilities include contingent liabilities or liabilities that the taxpayer has guaranteed if it is more likely than not that the taxpayer will be called upon to pay them. (***Merkel v. Comm***. (1999) 192 F.2d 844) A taxpayer must be able to prove insolvency. (***Rinehart v. Comm***., TCM 2002-71)

## COD for ITT Technical Institute?

ITT Technical Institute closed its doors in September 2016, leaving thousands of students with student loans and many without having completed their degrees. The Department of Education states that certain individuals may be eligible for a 100% discharge of their direct loans, Federal Family Education Loan Program loans, or Federal Perkins Loans under certain circumstances. (https://studentaid.ed.gov/sa/about/announcements/itt)

Most students will qualify to have 100% of their federal government student loans discharged by the U.S. Department of Education under the department's Closed School discharge program. According to the department, students are eligible for this program if:

- Their school closed while they were enrolled, and they did not complete their program because of the closure; or
- The school closes within 120 days after they withdraw.

Students are not eligible for a loan discharge if their school closed and any of the following is true:

- They withdrew from all classes before May 6, 2016, which is more than 120 days before ITT ceased instruction;
- They are completing a comparable educational program at another school:
  - Through a teach-out agreement with the school;
  - By transferring academic credits or hours earned at the closed school to another school; or
  - By any other comparable means; or
- They completed all the course work for the program, even if they did not receive a diploma or certificate.

Private loans taken out by ITT students might also be eligible for discharge under the department's Defense to Repayment discharge program.

In 2015, the IRS issued Rev. Proc. 2015-57 in which it stated that the IRS would not require Corinthian College students whose loans were discharged under the Defense to Repayment programs to report the discharge as income. As the circumstances under which ITT closed are similar to the circumstances under which Corinthian Colleges closed, it seems likely that the IRS will issue similar guidance with respect to students who took out loans to attend ITT.

### California conformity

For California purposes, ITT students will be able to exclude their COD income regardless of which federal program their loans were discharged under. (R&TC §17144.7)

# FOSTER CARE — IRC §131

## Excludable difficulty-of-care payments

In a private letter ruling, the IRS held that payments under four state programs to in-home care providers qualify as difficulty-of-care payments that are excludable under IRC §131 from the caregiver's income. (PLR 201624012)

### Facts of PLR

State agencies are responsible for directing and overseeing the state's four in-home supportive care programs. The programs assist qualifying aged, blind, or disabled persons who are unable to perform one or more activities of daily living independently. Three of the four programs are under other provisions of the Social Security Act, notably §§1905(a)(24), 1915(j), and 1915(k). The fourth program is the state's own state-funded residual program.

In California, the California Department of Social Services is charged with overseeing the IHSS program.

The PLR addresses whether the payments made to caregivers under the programs should be treated the same as payments described in Notice 2014-7.

The IRS looked at the purpose and design of the programs and the nature of the payments and concluded that the payments qualified as nontaxable difficulty-of-care payments excludable from gross income under IRC §131.

### Takeaway

This PLR does not mention the state or states in which these programs were established and operated, nor does it mention the specific criteria used to judge qualification. Any program that does not meet the specific requirements of Notice 2014-7 may be well–advised to obtain a private ruling from the IRS to ensure qualification.

## Background on foster care payments

IRC §131 provides an exclusion for "qualified foster care payments," which are amounts paid under the foster care program of a state which:

- Are made by a state or a qualified foster care placement agency; and
- Are either:
  - Paid to the foster care provider for caring for a qualified foster individual in the foster care provider's home; or
  - Paid as a difficulty-of-care payment.

(IRC §131(b)(1))

### Difficulty-of-care payment

A difficulty-of-care payment is additional compensation to a foster care provider for the additional care required because the foster individual has physical, mental, or emotional handicaps. (IRC §131(c))

Under the Social Security Act, a state may obtain a Medicaid waiver that allows the state to include in the state's Medicaid program the cost of home- or community-based services provided to individuals who otherwise would require care in a hospital, nursing facility, or intermediate care facility.

IRC §131 does not directly address whether payments received under Medicaid waiver programs are qualified foster care payments. Medicaid waiver programs and state foster care programs share similar purposes. Both programs require state approval, and both share the objective of enabling individuals who would otherwise be institutionalized to live in a family home.

The IRS has historically challenged the excludability under IRC §131 of payments made to care providers caring for related individuals in the provider's home. (***Alexander v. Comm.***, TCS 2011-48; ***Bannon v. Comm.*** (1992) 99 TC 59; ***Harper v. Comm.***, TCS 2011-56; Program Manager Technical Advice 2010-007)

### IRS guidance on Medicaid waiver payments — Notice 2014-7

In Notice 2014-7, the IRS says that "Medicaid waiver payments" are treated as qualified foster care payments excludable under IRC §131 regardless of whether the care provider is related to the eligible individual. Medicaid waiver payments made to a provider for care outside of the home where the provider resides are not qualified Medicaid waiver payments and are not excludable under IRC §131.

To achieve consistent tax treatment, the IRS is reversing course on the treatment of Medicaid waiver payments to relatives. In Notice 2014-7, the IRS says that it will treat qualified Medicaid waiver payments as difficulty-of-care payments excludable under IRC §131, even when the care provider is related to the eligible individual.

**Note:** In California, Medicaid waiver payments are payments from the In-Home Supportive Services Program (IHSS). (www.cdss.ca.gov/agedblinddisabled/pg1296.htm)

IRS Notice 2014-7 is effective for payments received on or after January 3, 2014, and may be applied in tax years for which the period of limitations on claims for a credit or refund under IRC §6511 has not expired.

### IRS provides guidance on how to report

In FAQs, the IRS notes that payments may be reported in one of three ways and discusses how to treat them for each of the ways reported:

**Form 1099-MISC, Box 3, Other Income:** Generally, amounts reported in Box 3 are included on line 21, Other Income of Form 1040. However, do *not* include the amount on line 21. If paper filed, enter "Notice 2014-7" on the dotted line next to line 21. No entry is necessary if filed electronically.

**Form 1099-MISC, Box 7, Nonemployee compensation:** Report as income on Schedule C, and report the same amount as a Schedule C expense. If paper filed, enter "Notice 2014-7" on the dotted line next to line 12 of Form 1040. No additional entry is required if electronically filed.

**Form W-2:** Include the full amount of the payment on line 7 of Form 1040. Enter the excludable portion as a negative amount on line 21. If paper filed, enter "Notice 2014-7" on the dotted line next to line 21. No entry is necessary if filed electronically.

### California conformity

California conforms to IRC §131 and the notice. (FTB Publication 1001, Supplemental Guidelines to California Adjustments) However, California's statute of limitations is four years (R&TC §19057), so if amending prior year returns, you may go back one more year.

## WRONGFULLY INCARCERATED INDIVIDUALS — IRC §139F

Under the PATH Act, gross income doesn't include any civil damages, restitution, or other monetary award relating to an individual's wrongful incarceration.

The term "wrongfully incarcerated individual" means an individual who was convicted of a "covered offense" and served all or part of a sentence of imprisonment for that offense if either:

- The individual was pardoned or granted clemency or amnesty for the covered offense because the individual was innocent of the offense; or
- The individual's conviction for the covered offense was reversed or vacated after which the covered offense was dismissed or the individual was found not guilty at a new trial.

A "covered offense" is any criminal offense under federal or state law.

### Effective date

The provision is effective for all tax years.

A special provision provides that, even if a claim for refund is otherwise closed by the statute of limitations of refund, the taxpayer may file a claim for refund within one year from December 18, 2015. If that deadline is missed, the usual limitations period applies.

### California partial conformity

For California purposes, a wrongfully incarcerated individual may exclude payments by the state equal to $140 per day of incarceration served that is considered to be part of the term of wrongful incarceration. (R&TC §17157)

## FOREIGN-EARNED INCOME EXCLUSION — IRC §911

### Current limits

In 2016, a U.S. individual living abroad can exclude up to $101,300 (Rev. Proc. 2015-53) of foreign-earned income if the taxpayer satisfies either the *bona fide* residence test or the physical presence test. The exclusion applies separately to spouses; as such, if both spouses are qualified individuals, the spouses may exclude up to $202,600.

The 2017 exclusion amount $102,100. (Rev. Proc. 2016-55)

### Worker classification determines foreign-earned income exclusion

A taxpayer was found to be an employee of the Unites States Office of Overseas Buildings Operations, which precluded him from claiming the IRC §911 foreign-earned income exclusion. (***Alfred S. Co. v. Comm.***, TCM 2016-19) The exclusion is not allowed for amounts "paid by the United States or an agency thereof to an employee of the United States or an agency thereof." (IRC §911(b)(1)(B)(ii)) The taxpayer attempted to argue he was an independent contractor, but the court found that he worked under direct supervision of the office, accrued sick leave and vacation time, was not allowed to delegate duties, and was required to work the number of hours per week directed by the office. Therefore, he was liable for tax for the three years at issue, plus accuracy-related penalties.

### Cuba removed from list of countries for which Foreign Tax Credit denied

The IRS has removed Cuba from the list of countries subject to special restrictions on taking a Foreign Tax Credit for taxes paid to those countries. (Rev. Rul. 2016-8) That list of countries is contained in Rev. Rul. 2005-3. Cuba's removal from the list is effective December 21, 2015.

#### California nonconformity

California does not — and never has — allowed an exclusion for foreign-earned income. (R&TC §17024.5)

# ADJUSTMENTS TO GROSS INCOME

## EDUCATOR EXPENSES — IRC §62(a)(2)(D)

The above-the-line deduction for educator expenses is made permanent under the PATH Act. Moreover, it is enhanced in two ways:

- The $250 maximum amount will be indexed for inflation in tax years ending after 2015. The inflation adjusted amount for 2016 is unchanged and remains at $250 (Rev. Proc. 2016-14) and will remain at $250 for 2017 (Rev. Proc. 2016-55); and
- Qualifying expenses will include costs incurred in taking professional development courses effective for tax years beginning after 2015. (Act §104)

#### California nonconformity

California does not allow an above-the-line deduction for educator expenses. (R&TC §17072(b)) As such, there is an increase in AGI and an increase in miscellaneous itemized deductions for the amount of the exclusion.

## ALIMONY — IRC §§71, 215

### Transfer of property is not alimony

A taxpayer was denied a loss deduction for property that she signed over to her ex-husband in lieu of paying part of her alimony obligation to him. The property transfer was determined to be a transfer incident to divorce under IRC §1041(a). The taxpayer unsuccessfully claimed that it was a loss on investment property. (***Mehriary v. Comm.***, TCM 2015-126) The taxpayer alternatively, and unsuccessfully, argued that the property transfer was instead a substitute for alimony and should constitute a deductible alimony payment. The transfer failed to meet the requirements of IRC §71. Alimony payments, to be deductible, must be made in cash or a cash equivalent. A transfer of property does not qualify as an alimony payment. (Treas. Regs. §1.71-1T(b))

## Payments were alimony, not a property settlement

Married taxpayers were liable for tax on income received by the wife from her ex-husband but which the taxpayers did not report. (***Nuzum v. Comm.***, TCS 2016-9) The taxpayers claimed that the payments were property settlements, but the payments were made in compliance with the divorce decree, which did not designate them as not includable in the wife's income and not allowable as a deduction by her ex-husband. Also, the payments met the IRC §71 definition of alimony. The taxpayers were also liable for an accuracy-related penalty because the taxpayer-husband had an LL.M. in taxation and had worked for the IRS.

## Lack of constructive receipt delays recognition of alimony income

The Tax Court has held that payments received by an ex-spouse were alimony, but the court also concluded that the payments weren't includible in income in the year deposited into an account because the taxpayer was denied access to the account. (***Leslie v. Comm.***, TCM 2016-171)

Under the taxpayer's marital separation agreement (MSA), she was entitled to receive 10% of whatever fee her ex-husband would receive for services performed as an attorney with respect to Enron litigation. This provision of the MSA did not say whether this payment obligation would terminate in the event of either party's death.

In 2009, after receiving $55 million for those services, the ex-husband deposited the taxpayer's share into an account that had both his name and the taxpayer's name on it. However, the taxpayer credibly testified that she had no control over the account, and it was her impression that the money wasn't yet legally hers. In January 2010 she filed a petition in state court to gain control of the account, and the state first refused to grant her petition. The Tax Court noted that it was not clear from the record when or if the taxpayer ever gained control over the account containing the 2009 payment.

### Arguments

The IRS argued that the 2009 payment qualified as alimony, and even if the taxpayer didn't have knowledge of, or control over, the trust, her ex-husband should be considered her agent, thus giving her constructive receipt of the funds.

The taxpayer countered that because the obligation to pay didn't terminate on her death, the payment didn't qualify as alimony and was, therefore, a nontaxable property payment. In the alternative, she argued that even if the payment was taxable, she did not have control over the bank account and, therefore, did not have constructive receipt in the year under question.

### Court's ruling

Because the MSA in this case didn't specify what would happen to the fee percentage payment in the event of Maria's death or her ex-husband's, the court looked to California law, which states:

"Except as otherwise agreed by the parties in writing, the obligation of a party under an order for the support of the other party terminates upon the death of either party or the remarriage of the other party." (Family Code §4337)

The court found the payments to be taxable alimony under California law, but they noted that Maria did not have constructive receipt of the payments in 2009, the year at issue. She had no control over the account that the funds were deposited into, and her ex-husband could not be considered her "agent" for the purposes of constructive receipt because he had an adverse interest in the same funds.

### What is alimony?

Under IRC §71(b)(1), a payment is alimony if all the following conditions are met:

- The payment must be made in cash;
- The payment is received by a spouse under a divorce or separation agreement;
- The divorce or separation agreement does not specifically designate that the payment is not includable in gross income and not deductible under IRC §215;
- The payee spouse and the payor spouse are not members of the same household when the payment is made; and
- There is no liability to make the payment after the death of the payee spouse.

If **all** these conditions are met, then the payments are included in the gross income of the recipient and deductible by the payor.

#### Payments disguised as child support

Payments are not alimony if the divorce agreement fixes part of any payment for a child's support in dollar amounts, or percentage. Payments that are child support or in lieu of child support are not includable in income and not deductible.

**✐ Practice Pointer**

If a client comes to you with alimony payments, be cautious about whether they actually qualify as such. Inspect the decree document, and also attempt to verify, if practical, that the recipient reported the income, as the IRS is matching SSNs and amounts. A mismatch between the amount claimed as a deduction and the amount reported as income by the recipient will spell trouble.

## STUDENT LOAN INTEREST — IRC §221

A taxpayer may deduct up to $2,500 of interest on debt incurred solely to pay qualified higher education expenses.

For 2016, the deduction begins to phase out for taxpayers with modified adjusted gross income (MAGI) between $65,000 and $80,000 and MAGI between $130,000 and $160,000 for joint returns. (Rev. Proc. 2015-53)

For 2017, the deduction begins to phase out for taxpayers with modified adjusted gross income (MAGI) between $65,000 and $80,000 (same as 2016) and MAGI between $135,000 and $165,000 for joint returns (up $5,000 from 2016). (Rev. Proc. 2016-55)

### California conformity

California fully conforms to the student loan interest deduction. (R&TC §§17024.5; 17201)

## TUITION DEDUCTION — IRC §222

The tuition deduction is extended retroactively to 2015 and through 2016 under the PATH Act. At press time, it had not been extended beyond 2016.

The deduction must be coordinated with the education credits, discussed on page 1-41. Taxpayers may not claim the deduction in any year in which they claim the American Opportunity Tax Credit or Lifetime Learning Credit with respect to the same student.

### California nonconformity

California does not allow a tuition deduction or the education credits. (R&TC §17204.7)

## HEALTH SAVINGS ACCOUNTS — IRC §223

The inflation-adjusted limitations for Health Savings Accounts (HSAs) under IRC §223(g) are below. (Rev. Proc. 2015-30; Rev. Proc. 2016-28)

| Inflation-Adjusted Limitations for HSAs | | | | | | |
|---|---|---|---|---|---|---|
| | **2015** | | **2016** | | **2017** | |
| | **Family** | **Self only** | **Family** | **Self only** | **Family** | **Self only** |
| Contribution limit | $6,650 | $3,350 | $6,750 | $3,350 | $6,750 | $3,400 |
| Additional catch-up contribution for taxpayer age 55 or older | $1,000 per qualifying spouse | $1,000 | $1,000 per qualifying spouse | $1,000 | $1,000 per qualifying spouse | $1,000 |
| Minimum health insurance deductible | $2,600 | $1,300 | $2,600 | $1,300 | $2,600 | $1,300 |
| Maximum out of pocket | $12,900 | $6,450 | $13,100 | $6,550 | $13,100 | $6,550 |

### Contribution rules, generally

Contributions made to a HSA by an individual are deductible above-the-line. (IRC §62(a)(19)) Contributions made by an employer either directly or through a cafeteria plan are deductible by the employer, not taxable to the employee, and not subject to FICA and FUTA taxes. (IRS Notice 2004-2)

To be eligible to set up a health savings account (HSA), an individual must:

- Be covered under a high deductible health plan (HDHP) with an annual deductible of not less than $1,300 for an individual and $2,600 for a family and annual out-of-pocket limits not exceeding $6,550 for individuals and $13,100 for families (for 2016 and 2017);
- Not be also covered under a non-HDHP;
- Not be eligible for Medicare; and
- Not be claimed as a dependent on another person's tax return.
(IRC §223(c)(1); Rev. Proc. 2015-30; Rev. Proc. 2016-28)

Eligibility comes into play in two situations:

- **Eligible to open an account:** This comes into play only once, in the year that an account is opened. Once the account is opened, the owner of the account may maintain the account and make qualifying distributions from the account even in years in which they don't meet the eligibility requirements.
- **Eligible to make contributions:** This must be determined on an annual basis.

An excess regular contribution is not deductible and is subject to a 6% penalty tax unless corrected by the deadline. The deadline is the HSA owner's return filing due date, plus extensions (generally October 15 for timely filers) of the year after the year for which the contribution was made.

### California nonconformity

California does not conform to HSAs. (R&TC §§17131.4, 17131.5) Thus, a taxpayer with an HSA must:

- Include annual income or loss from investments in HSA accounts in California AGI;
- Increase the medical expense deduction for any qualified expenses paid out of the HSA account; and
- Reduce California income by any taxable distributions from an HSA.

**Caution**

California W-2 wages must be increased by the amount of the federal HSA deduction. This is one more reason it's important to always check the California wages box on the W-2 when preparing personal returns, in addition to reporting amounts that contain a code W in box 12 on the Form W-2.

## STANDARD DEDUCTION AND ITEMIZED DEDUCTIONS

## STANDARD DEDUCTION — IRC §63

| Standard Deductions (Rev. Proc. 2015-53, Rev. Proc. 2016-55) | | |
|---|---|---|
| **Filing status** | **2016** | **2017** |
| Married Filing Joint and Qualifying Widow(er) | $12,600 | $12,700 |
| Head of household | $9,300 | $9,350 |
| Single | $6,300 | $6,350 |
| Married Filing Separate | $6,300 | $6,350 |

| Additional Standard Deductions for Elderly and Blind | | |
|---|---|---|
| **Filing status** | **2016** | **2017** |
| **Unmarried** | | |
| Elderly or blind | $1,550 | $1,550 |
| Elderly and blind | $3,100 | $3,100 |
| **Married** | | |
| Elderly or blind (per taxpayer) | $1,250 | $1,250 |
| Elderly and blind (per taxpayer) | $2,500 | $2,500 |

### California nonconformity

California does not increase standard deductions for any of these amounts, including for age and blindness. (R&TC §17073.5(b)) California allows an additional exemption credit for age and blindness. (R&TC §17054)

## ITEMIZED DEDUCTION PHASEOUT

### Itemized deduction phaseouts continue

Higher-income taxpayers must phase out itemized deductions.

| Itemized Deduction Phaseouts | | |
|---|---|---|
| **Filing status** | **2016 AGI** | **2017 AGI** |
| Single | $259,400 | $261,500 |
| Head of household | $285,350 | $287,650 |
| Married filing joint; surviving spouse | $311,300 | $313,800 |
| Married filing separate | $155,650 | $156,900 |

The threshold amounts are adjusted for inflation.

The mechanics of the computation do not change from prior law; only the threshold amount changes. Thus, a taxpayer's itemized deductions are reduced by the lesser of:

- 3% of the excess AGI over the threshold amount; or
- 80% of the itemized deductions otherwise allowable.

As with prior law, certain items, such as medical expenses, investment interest expenses, and casualty, theft, or wagering losses, are excluded. (IRC §68(c))

### California nonconformity

California continues to phase out itemized deductions using 6% of federal AGI. (R&TC §17077) Generally, a taxpayer's itemized deductions are reduced by the lesser of:

- 6% of the excess AGI over the threshold amount; or
- 80% of the itemized deductions otherwise allowable.

## MEDICAL EXPENSES — IRC §213

### Medical mileage rates

The medical mileage rate for 2016 is 19 cents. (Notice 2016-01) The medical mileage rate for 2017 is 17 cents. (Notice 2016-79)

### California conformity

California automatically conforms to the federal medical mileage rates. (R&TC §§17024.5, 17201)

## AGI medical expense threshold increase

In 2013, the federal AGI medical expense threshold increased from 7.5% to 10% for most taxpayers. (IRC §213(a))

### A grandfather rule

There is a temporary reprieve for seniors. That reprieve expires on December 31, 2016, unless it is extended by Congress. For tax years 2013 through 2016, the 7.5% floor continues to apply for individuals who reach age 65 before the close of the taxable year. (IRC §213(f))

In the case of married individuals, the 7.5% floor applies if either spouse is age 65, regardless of the age of the other spouse. This is true even if they file separate returns.

For alternative minimum tax (AMT) purposes, the 10% floor continues to apply, and there is no special rule for seniors. (IRC §56(b)(1)(B))

## California nonconformity

California does not conform to this provision. So taxpayers may have a California medical expense deduction but not a federal deduction. California uses federal AGI to compute this threshold, and all taxpayers will use 7.5% of federal AGI. The increase in the threshold was not included in California's conformity bill. (R&TC §§17024.5, 17062, 17201, 17241)

## Long-term care insurance

For 2016, up to $4,870 in premiums paid for long-term care insurance, per person, can qualify as a deductible medical expense. (IRC §213) For 2017, the maximum is $5,110.

Self-employed individuals may include their qualified long-term care insurance premiums in the self-employed health insurance deduction, subject to the age limitations discussed below. (IRC §162(l)(1))

Keep two things in mind:

- The deduction is limited based on the taxpayer's age; and
- Only premiums paid for "qualified long-term care" plans are deductible.

| Long-Term Care Premium Deduction Limits (2016: Rev. Proc. 2015-53, 2017: Rev. Proc. 2016-55) | | |
|---|---|---|
| **Age of individual before close of tax year** | **Maximum deductible premium for 2016** | **Maximum deductible premium for 2017** |
| 40 or less | $390 | $410 |
| More than 40 but not more than 50 | $730 | $770 |
| More than 50 but not more than 60 | $1,460 | $1,530 |
| More than 60 but not more than 70 | $3,900 | $4,090 |
| More than 70 | $4,870 | $5,110 |

## California conformity

California automatically conforms to the federal long-term care limitations. (R&TC §§17024.5, 17201).

## Reminder: no deduction for medical marijuana

Taxpayers cannot include in medical expenses amounts paid for controlled substances (such as marijuana), even if such substances are legalized by state law. (Rev. Rul. 97-9 and IRS Publication 502, Medical and Dental Expenses) Such substances are not legal under federal law and therefore cannot be included in medical expenses. See page 10-4 for further discussion of issues related to marijuana including California conformity.

# TAXES — IRC §164

## State and local general sales tax deduction

The deduction for state and local sales tax was made permanent under the PATH Act.

## California nonconformity

California does not allow a deduction for sales tax or state income taxes. (R&TC §17220)

# CASUALTY AND THEFT LOSSES — IRC §165

## Casualty loss disallowed when deterioration was well documented

The Tax Court disallowed casualty losses from the collapse of a retaining wall because the wall's collapse was not due to a sudden, unexpected, or unusual cause. (***Alphonso v. Comm.***, TCM 2016-130)

### Must a casualty be a singular event?

Individual taxpayers may deduct a casualty loss if the loss arises from fire, storm, shipwreck, other casualty, or theft. (IRC §165(a), (c)) The phrase "other casualty" has been recognized as an identifiable event that is sudden, unexpected, violent, and not due to deliberate or willful actions of the taxpayer. (See, e.g., ***White v. Comm.*** (1967) 48 TC 430; ***Cooper v. Comm.***, TCS 2003-168; ***Maher v. Comm.*** (1982) 680 F.2d 91; ***Coleman v. Comm.*** (1981) 76 TC 580)

The retaining wall at issue in ***Alphonso*** was built in the 1920s and at the time of its collapse in 2005 had a 20-year history of documented problems. Multiple engineering and architectural firms were hired to assess and repair the damage. One such repair was a new drainage system that was installed in 2004. The taxpayer argued that the wall's collapse was due to the failure of the new drainage system caused by excessive rain over a four-month period, causing rapid movement in the wall in the four weeks leading to its downfall.

The taxpayer relied heavily on the Tax Court's ruling in ***Helstoski***, where the taxpayer prevailed on a casualty loss claim where a dam with documented problems, built on the taxpayer's property by its previous owner, failed during a period of violent thunderstorms. (***Helstoski v. Comm.*** TCM 1990-382)

In rejecting Alphonso's argument and ruling in favor of the IRS's disallowance of the casualty loss, the Tax Court went out of its way to distinguish ***Helstoski*** from this case, citing several cases holding that a collapse, even one that occurs suddenly by contributing factors such as rain or wind, is not a casualty when it is caused by progressive deterioration. (***Alphonso v. Comm.***, TCM 2016-130, citing ***Fay v. Helvering***, 120 F.2d 253; ***Coleman v. Comm.***, TCM 1981-702; ***Chipman v. Comm.***, TCM 1981-194; ***Hoppe v. Comm.*** (1964) 42 TC 820)

## Even a "foolish victim" can get a theft loss deduction

The Tax Court has held that a taxpayer was allowed a deductible theft loss from her "investment" in an African diamond scheme. (***Leslie v. Comm.***, TCM 2016-171)

Through a friend she met at a swap meet, the taxpayer was offered an opportunity to invest in a shipment of diamonds that, once sold, would yield her a return of $1 million. Her friend explained that if she invested immediately, she'd have the $1 million in 10–30 days — as soon as his old Navy buddy, Lawyer Stanley, was able to get the shipment out of Africa and sell the diamonds. Without asking many questions and without signing a contract, the taxpayer wired $320,000 to Lawyer, who was organizing the scheme.

Of course, the initial investment "didn't quite cover the expenses," so the taxpayer wired another $85,000. This ultimately bought her months of delays and excuses, followed finally by some paperwork from the "Foreign Credit Commission" that detailed the transaction. When she called the number on those papers, it turned out to be a fake.

After spending almost a year trying to track down Lawyer and her money, the taxpayer gave up and deducted a $405,000 theft loss for tax year 2009. The IRS argued that the loss was not a theft loss, but the court looked to California law to make this determination. In California, in order to meet the definition of theft, the taxpayer must establish that the failed transaction wasn't "merely a result of a commercial default," such as when a taxpayer enters into a contract with a legitimate business.

In this case, Lawyer Stanley's "business" was not only illegitimate, but when he created the phony Foreign Credit Commission paperwork, he proved his intent to deceive. Maria trusted her investment would bring the promised return, and the court noted that "even reliance by a foolish victim of an absurd fraud is nonetheless reliance." The court allowed Maria the theft loss deduction for 2009, the year in which she gave up trying to find Lawyer and her money and abandoned any prospect of recovery.

# INTEREST — IRC §163

## Form 1098 to include additional information beginning in 2017

Under the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, mortgage interest statements must include additional information for mortgage interest statements issued after December 31, 2016.

The statements will be required to include the amount of outstanding principal, the loan origination date, and the property's address.

CORRECTED (if checked)

| | | |
|---|---|---|
| RECIPIENT'S/LENDER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no. | *Caution: The amount shown may not be fully deductible by you. Limits based on the loan amount and the cost and value of the secured property may apply. Also, you may only deduct interest to the extent it was incurred by you, actually paid by you, and not reimbursed by another person. | OMB No. 1545-0901<br>2016<br>(Rev. July 2016)<br>Form 1098<br>**Mortgage Interest Statement** |
| | 1 Mortgage interest received from payer(s)/borrower(s)*<br>$ | **Copy B**<br>**For Payer/ Borrower** |
| RECIPIENT'S/LENDER'S federal identification number \| PAYER'S/BORROWER'S taxpayer identification no. | 2 Outstanding mortgage principal as of 1/1/2016<br>$ \| 3 Mortgage origination date | The information in boxes 1 through 9 is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if the IRS determines that an underpayment of tax results because you overstated a deduction for this mortgage interest or for these points, reported in boxes 1 and 6; or because you didn't report the refund of interest (box 4); or because you claimed a non-deductible item. |
| | 4 Refund of overpaid interest<br>$ \| 5 Mortgage insurance premiums<br>$ | |
| PAYER'S/BORROWER'S name | 6 Points paid on purchase of principal residence<br>$ | |
| Street address (including apt. no.) | 7 Is address of property securing mortgage same as PAYER'S/BORROWER'S address?<br>If Yes, box is checked . . . . . . . . . . ☐<br>If No, see box 8 or 9, below | |
| City or town, state or province, country, and ZIP or foreign postal code | 8 Address of property securing mortgage | |
| 10 Other | 9 If property securing mortgage has no address, below is the description of the property | |
| Account number (see instructions) | | |

Form 1098 (Keep for your records) www.irs.gov/form1098 Department of the Treasury - Internal Revenue Service

## Deduction of mortgage insurance premiums

The deduction of mortgage insurance premiums was extended retroactively through 2016 under the PATH Act. Thus, unless extended by Congress the deduction will not be available after 2016.

Certain premiums paid for qualified mortgage insurance in connection with acquisition indebtedness incurred after December 31, 2007, and before January 1, 2017, are deductible as qualified residence interest. (IRC §163(h)(3)(E) and (4)(E)) Any deduction for mortgage insurance premiums that can be treated as qualified residence interest is phased out for higher-income taxpayers.

### California nonconformity

California does not conform to this provision. (R&TC §17225)

## IRS acquiesces to per-individual limitation on home mortgage interest

The IRS has announced that it will follow the Ninth Circuit's decision that the limitations on indebtedness for qualified residence interest are determined on a per-individual basis and not on a per-residence basis. (IRB 2016-31)

The Court of Appeals for the Ninth Circuit, in reversing a Tax Court decision (***Sophy v. Comm***. (2012) 138 TC 8), concluded that the home mortgage interest limitations under IRC §163(h)(3) are applied on a per-taxpayer basis, and not a per-residence basis, as previously ruled by the Tax Court. (***Voss v. Comm***. 796 F.3d 1051 (Ninth Cir. 2015) Thus, two (or more) unmarried co-owners are individually limited to a deduction for interest paid on $1 million of acquisition indebtedness and $100,000 of home equity indebtedness.

***Yes, there is a marriage penalty***

There is clearly a marriage penalty with respect to the home mortgage interest deduction. However, that penalty is created by Congress and the Code, not by this case.

Assume, for example, that Sparky and Ellen are not married and own a home as cotenants. The mortgage on the home is $2.2 million, they are both on the mortgage, and they make equal mortgage payments. They will each get to deduct the full amount of interest that they pay.

Assume they get married. The limit will be reduced to $1.1 million, and as long as the balance of the mortgage remains at $2.2 million, they will only get to deduct 50% of their interest expense.

## Deduction denied for postponed mortgage interest

Taxpayers were denied a mortgage interest deduction for years in which their interest payment was capitalized into the unpaid mortgage principal. (***Slavin v. Comm.***, TCS 2016-28) For cash basis taxpayers, interest is only deductible if actually paid. (IRC §163(a))

### Purchase of home

The taxpayers purchased a vacation rental and financed the mortgage with a promissory note to the sellers for $975,000, under which the taxpayers were to make two interest-only payments per year, representing an annual interest rate of 6% ($58,500 annual total).

In 2007, the taxpayers made interest payments of $54,000. However, the vacation rental was not as profitable as they expected, and in 2008 and 2009, they did not make any interest payments. In mid-2008 and again in late 2009, the taxpayers and the sellers made a mortgage modification that capitalized those interest payments into the unpaid principal. Then, in 2010, the taxpayers and the sellers executed another agreement under which the interest rate was reduced to 3%, effective January 1, 2008.

### Mortgage interest deductions

For both 2008 and 2009, the taxpayers deducted $54,000 of mortgage interest on their Schedule E (the modification agreements refer to only $54,000 of interest for 2008 and 2009, rather than the full $58,500).

The taxpayers provided their CPA with the mortgage interest amounts but not with the mortgage modification documents. However, the CPA knew about the modifications because he advised the taxpayers that their mortgage had been substantially modified for the purposes of Treas. Regs. §1.1001-3, and they were qualified to take the mortgage expense deductions.

### Deductibility of postponed interest

When a lender capitalizes interest and adds it to the unpaid principal, a cash-basis taxpayer does not qualify for a current interest deduction for any interest that was added to principal. (***Heyman v. Comm.*** (1978) 70 TC 482) In this case, the mortgage interest modifications did not constitute payments. Instead, they merely allowed the taxpayers to postpone paying interest.

The taxpayers argued that under Treas. Regs. §1.1001-3, the promissory note had undergone a substantial modification, resulting in a discharge of interest. However, the court rejected this argument, noting that Treas. Regs. §1.1001-3 only addresses whether the modification of a debt instrument gives rise to gain or loss; it doesn't address the deductibility of interest payments.

In addition to denying the deductions, the court imposed accuracy-related penalties because the taxpayers should have known that as cash basis taxpayers, they were not entitled to deduct the unpaid interest.

The court also found that the taxpayers had not proven reasonable reliance on their tax professional because they had not provided him with the mortgage modification documents.

## Equitable ownership

### No mortgage interest deduction for cohabitating boyfriend

A home mortgage interest deduction was denied because the taxpayer was unable to show he had a legal or equitable interest in the residence for which he claimed the deduction. (***Jackson v. Comm.***, TCS 2016-33) Although he made mortgage payments, the mortgage and title were in his girlfriend's name.

For clients with less than stellar credit, this case is a lesson in documentation because the deduction might have been allowed had the taxpayer presented proof he had an equitable interest in the property.

The taxpayer's girlfriend purchased a residence in Nevada in 2005. The taxpayer did not join his girlfriend in obtaining the mortgage nor participate on the deed because of personal debt problems. The taxpayer claimed, but produced no convincing evidence, that he made the mortgage payments from the date the property was purchased in 2005 through 2012, the last year at issue in the case.

### Taxpayers fail equitable ownership test on rental properties

In an unusual twist on the equitable ownership issue, taxpayers lost their argument that they had equitable ownership in rental properties. (***Ghafouri v. Comm.***, TCM 2016-6) While equitable ownership issues arise often with respect to personal residences, it is very rare to see the issue arise with respect to business or investment property.

**Facts:** In 2005, the taxpayers' daughter purchased two residences in California. She was the sole mortgagor and was the only owner listed on the title. Both of the properties were intended to be rental properties.

In 2008, the daughter received notices of default on the properties and eventually disposed of them for less than the current mortgage balances. As a result of the sales, she filed for bankruptcy.

The taxpayers contended that they were the true equitable owners of the properties and that they just "borrowed" their daughter's good credit to purchase the properties because their own credit was poor. They alleged that they made all of the mortgage, property tax, and insurance payments and that they were responsible for the properties' upkeep. The taxpayers reported rental losses from the properties beginning in 2005 and generated net operating losses that they carried forward.

**Court's findings:** The Tax Court noted that under California law, the owner of the legal title to property is presumed to be the owner of the full beneficial title. This presumption may only be rebutted by clear and convincing proof. Such proof must include an agreement or understanding and assumption by the equitable owner of the benefits and burdens of property ownership. The taxpayers provided no evidence outside of their testimony that they provided funds used to make the down payments or that they were obligated to pay the mortgages, insurance premiums, or property taxes. There was also no evidence that they were responsible for the repair and maintenance of both properties or for all decisions related to renting out the properties.

Noting that the daughter was the one who was ultimately responsible for the mortgages and that she suffered the consequences when the properties were sold in short sales, the court found that the arrangement between the taxpayers and their daughter was not sufficient to elevate the taxpayers to equitable owners of the properties. Therefore, the NOL carryforward deduction for the year at issue was denied.

***The equitable owner***

Generally, for interest payments to be deductible:

- The taxpayer must make the payments; and
- The underlying debt must be the taxpayer's obligation.
  (Treas. Regs. §1.163-1(b); ***Uslu v. Comm.***, TCM 1997-551)

However, under the regulation, a taxpayer may deduct mortgage interest even if he or she does not hold the mortgage if the taxpayer is the legal or equitable owner. A taxpayer is the equitable or beneficial owner when he or she assumes the benefits and burdens of ownership. (***Baird v. Comm.*** (1977) 68 TC 115) Such ownership is determined under state law on a case-by-case basis. (***Daya v. Comm.***, TCM 2000-360)

The equitable owner of a property is entitled to a deduction for mortgage interest paid, even when they are not on the title or liable for the mortgage. Factors contributing to equitable ownership include:

- The right to possess the property and to enjoy its use, rents, or profits;
- A duty to maintain the property;
- Responsibility for insuring the property;
- Whether the taxpayer bears the property's risk of loss;
- An obligation to pay property taxes, assessments, or charges;
- The right to improve the property without the owner's consent; and
- The right to obtain legal title at any time by paying the balance of the purchase price.
  (***Blanche v. Comm.***, TCM 2001-63***;*** ***Usla v. Comm.***, TCM 1997-551)

It is important to note that these are only factors that weigh on a court's decision and do not represent an exhaustive list of requirements that must be met.

***State law is important***

State law determines the nature of property rights, and federal law determines the tax consequences of those rights (***United States v. Nat'l Bank of Commerce*** (1982) 472 U.S. 713, 722; ***Blanche v. Comm.***, TCM 2001-63), so it is important for a practitioner to become familiar with areas of state law that may affect property rights, such as community property and probate laws.

# CHARITABLE CONTRIBUTIONS — IRC §170

## Professor flunks charitable deduction rules with outlandish claim

The Tax Court denied a professor and his contract-specialist wife deductions of $79,000 and $90,000 in noncash charitable contributions. (***Payne v. Comm.***, TCS 2016-30) The Court also imposed accuracy penalties under IRC §6662(a) for the 2010 and 2011 years. The amount deducted was approximately 46% and 47% of the taxpayers' 2010 and 2011 income, respectively.

### IRS argument

In 2011, the taxpayers submitted 26 receipts with either generic or no descriptions of specified items. The Form 8283 contained no specific information about the individual items of property, the cost basis, the valuation method, or the date of acquisition. Similar deficient documentation was provided for 2010.

The IRS argued that the taxpayers did not meet the substantiation requirements of:

- Contemporaneous written acknowledgment: Of the receipts attached, only three of the 53 acknowledgments contained specific itemization. None of the receipts included a description of the property written by the donee organization; and
- An appraisal for items donated valued at $5,000 or more. The IRS argued that the aggregation rule of IRC §170(f)(11) must be applied.

Interestingly, the court noted that the taxpayers claimed noncash charitable contribution deductions in amounts exceeding $25,000 for the years 2006 through 2009, and they claimed $80,000, $36,000, and $52,000 for 2012, 2013, and 2014, respectively. The property contributed was similar to those in this case.

### Taxpayers' argument

The taxpayers presented the following losing arguments:

- First, the taxpayers argued that the aggregation rules should not apply because sellers such as Amazon use categories more specific than those used by the IRS. Therefore no appraisal was required;
- Second, the taxpayers claimed they did not have receipts for many of the items because the professor regularly found property that had been placed on the curb as unwanted. He took it to his home and/or to the charities. The IRS stated that he did not report the income when he found the property. In addition, the taxpayers valued most of the donations at 50% of cost and at court listed them as antiques; and
- Finally, the taxpayers argued that "congressional intent was to incentivize citizens to actually donate … Congress sets the limit pretty high (permitting) donations that reach up to 50% of your adjusted gross income." They further contended that congressional intent is a strong incentive to reach that 50% level.

### Penalties: of course

The court agreed with the IRS and sustained the accuracy penalties because the taxpayer, although not a practicing attorney, held a Juris Doctor degree.

**Practice Pointer**

### Requirements for an appraisal

Generally, an appraisal is (1) not required for items for which you claim a deduction of $5,000 or less, and (2) required for a deduction of $5,000 or more. (Treas. Regs. §1.170A-16(d)(1)(ii)) There are exceptions to both.

In figuring whether a deduction is over $5,000, combine the claimed deductions for all similar items donated to any charitable organization during the year. (IRS Publication 526) For example, if you give books to three schools and you deduct $2,000, $2,500, and $900, respectively, your claimed deduction is more than $5,000 for these books. You must get a qualified appraisal of the books and for each school you must attach a fully completed Form 8283, Section B, to your tax return. (IRS Publication 561)

The regulations spell out certain criteria for a qualified appraiser, including that the appraiser cannot be an "excluded individual" (i.e., the donor, the donee, a related party to either the donor or donee, or any individual preparing the appraisal under a contingent fee arrangement). (Treas. Regs. §1.170A-17(b))

The appraisal must be signed by the appraiser no earlier than 60 days before the date of the contribution and no later than the due date (including extensions) of the return on which the deduction is first claimed, or in the case of an amended return, the date on which the amended return is filed. (Treas. Regs. §1.170A-17(a)(4))

**Planning Pointer**

Inform your clients that they need to prove "good used condition or better" of their donated items. A detailed statement, complete with pictures, will better represent the item gifted. Remind them that most phones take great pictures, and that a picture is worth a thousand words. You may also suggest that they upload or print the pictures, because the phone that takes the pictures may not be the same phone they have when they are asked to prove what was donated. Receipts from the Salvation Army or Goodwill with vague descriptions will not be enough substantiation for a $1,000 or $2,000 (for example) noncash contribution.

## California conformity

California conforms to the federal substantiation requirements. (R&TC §§17201, 17275.5, 18631, 19186, 24357–24357.9)

| Charitable Contribution Substantiation Information Required | | |
|---|---|---|
| **Amount** | **Documentation** | **Substantiation** |
| Cash donations of less than $250 | Bank record | Includes canceled check, bank, credit union, or credit card statement showing name and transaction posting date (credit card) |
| | Written communication from charity | Name of charity, date, and amount of contribution |
| | Payroll deduction | Pledge card and pay stub, W-2 wage statement, or other document furnished by employer, including total amount withheld for charity |
| Cash donations of $250 or more | Written acknowledgment from the charity for each donation | Name of charity, date, amount paid, description, and estimate of value of goods or services provided by the charity |
| Noncash contributions of less than $250 | Receipt from donee or reliable records | |
| Property donations greater than $250 and not more than $500 | Contemporaneous written acknowledgment | Name of charity, date, amount paid, and description (but not value) of goods or services provided by the charity |
| Property donations greater than $500 and not more than $5,000 | Written acknowledgement | All of the above, plus:<br>• How you got the property;<br>• Date you got the property; and<br>• Cost or other basis<br>Must file Form 8283 |
| Donations of $5,000 or more excluding stock, certain works of art, and autos | Qualified appraisal | Attach appraisal to return and complete page 2 of Form 8283 |
| Donations of art valued at $20,000 or more | Signed appraisal and photograph | Attach signed appraisal to return and provide photograph of sufficient quality and size to fully show object if requested by the IRS |
| Stock of publicly traded corporation | No appraisal required if as of date of the contribution, market quotations are readily available on an established securities market | Attach Form 8283 to return |
| Nonpublicly traded stock | Contributions greater than $5,000 and less than or equal to $10,000 | A partially completed appraisal summary; complete Form 8283, Part I |
| | Contributions greater than $10,000 | Attach qualified appraisal to return |
| Vehicle, boat, and airplane with value of more than $500 | Value is the lesser of the gross sales proceeds or the FMV of the vehicle if no "significant use or material improvement" | Taxpayer needs contemporaneous written acknowledgement from donee organization; donee organization must use Form 1098-C to report value of vehicle donations if vehicle is sold; this can be used to provide acknowledgement to the donor |
| **Note:** These rules apply to individuals making qualified contributions to IRC §501(c)(3) organizations. Additional rules apply when gifting a partial or restricted interest, gifts via trusts, and gifts with remainder interest. | | |

# TAX CALCULATION

## ALTERNATIVE MINIMUM TAX AND CREDITS

### AMT exemption

The AMT exemption amount was made permanent and adjusted for inflation beginning in the 2012 tax year. (ATRA '12 §104)

| AMT Exemptions and Phaseouts | | | | |
|---|---|---|---|---|
| | | **2015** | **2016** | **2017** |
| **Single, HOH** | Exemption AMT:<br>Phaseout range: | \$53,600<br>\$119,200–\$333,600 | \$53,900<br>\$119,700–\$335,300 | \$54,300<br>\$120,700–\$337,900 |
| **MFJ, surviving spouse** | Exemption AMT:<br>Phaseout range: | \$83,400<br>\$158,900–\$492,500 | \$83,800<br>\$159,700–\$494,900 | \$84,500<br>\$160,900–\$498,900 |
| **MFS** | Exemption AMT:<br>Phaseout range: | \$41,700<br>\$79,450–\$246,250 | \$41,900<br>\$79,850–\$247,450 | \$42,250<br>\$80,450–\$249,450 |

#### California

California law provides for an annual inflation adjustment of AMT phaseout and exemption numbers. (R&TC §17062(b)(5)(A–C) and (b)(6)(A–C))

### Surviving spouse not entitled to minimum tax credits

A surviving spouse could not use minimum tax credit (MTC) carryforwards on her single return after the death of her spouse because the credits resulted from AMT paid in a year prior to their marriage. (***Vichich v. Comm.*** (April 21, 2016) 146 TC 12)

The Tax Court stated that "some tax attributes die with a taxpayer," and found that the carryforward MTC should be treated like an NOL carryover. A deceased taxpayer's unused NOLs must be used on the last tax return of the decedent, or they are forever lost. (Rev. Rul. 74-145)

A joint NOL can be split, with one-half being carried forward after the death of a spouse, but an NOL belonging solely to the decedent is lost. (***Rose v. Comm.***, TCM 1973-207)

#### Credit was the husband's

There was no question in this case that the MTC was generated by the deceased husband. He had exercised incentive stock options in 1998 while he was married to his prior spouse. The decedent and his then wife filed a joint return and paid AMT of \$708,181 because of exercising the options. It was this large AMT payment that resulted in the MTC in question.

The question presented in this case was whether any of the credit transferred from the decedent to the taxpayer upon her husband's death.

The Tax Court found that although the credit carryforward was reported on a joint return filed by the decedent and the taxpayer in this case, it was generated prior to their marriage and was not a joint credit. As a result, the taxpayer was not entitled to any benefit from the credit after her husband's death.

### Planning to use tax benefits before they disappear

This case serves as a reminder that a surviving spouse may have only a few months to take advantage of certain tax benefits before they disappear. In the year of death, the surviving spouse has one thing going for them — they get to file one last joint return and have one last chance to use carryovers attributable to the deceased spouse.

Consider accelerating income into the year of death to use up NOLs and charitable contribution carryovers. Sell appreciated stock to use capital loss carryovers.

# INDIVIDUAL TAX CREDITS

## ADOPTION CREDIT — IRC §§23, 137

Federal law provides for an Adoption Credit and exclusion from gross income for adoption benefits furnished under an employer's qualified adoption assistance. Generally taxpayers may take the credit when they pay the adoption expenses out of their own funds, and amounts paid to them by their employer under a qualified adoption assistance program are excludable.

| Adoption Credit | | | |
|---|---|---|---|
| | **Maximum credit** | **Maximum exclusion** | **Refundable** |
| | **IRC §23(b)(1)** | **IRC §137(b)(1)** | **IRC §36C** |
| **2010** | $13,170 | $13,170 | Yes |
| **2011** | $13,360 | $13,360 | Yes |
| **2012** | $12,650 | $12,650 | No |
| **2013** | $12,970 | $12,970 | No |
| **2014** | $13,190 | $13,190 | No |
| **2015** | $13,400 | $13,400 | No |
| **2016*** | $13,460 | $13,460 | No |
| **2017**** | $13,570 | $13,570 | No |
| * Rev. Proc. 2015-53; **Rev. Proc. 2016-55 | | | |

### Phaseout amounts

For 2016, both the Adoption Credit and the exclusion are phased out ratably when AGI is $201,920–$241,920. (Rev. Proc. 2015-53)

For 2017, the phaseout range is $203,540–$243,540. (Rev. Proc. 2016-55) For this purpose, AGI is computed without regard to the exclusions for foreign-earned income (IRC §911), but after application of the rules relating to:

- Social Security taxation (IRC §86);
- The exclusion from income for U.S. savings bond interest used for educational purposes (IRC 135);
- The exclusion for qualified adoption expenses (IRC §137);
- The deduction for IRA contributions (IRC §219); and
- Passive activity losses. (IRC §469)

### The credit

A credit for 100% of qualified adoption expenses, up to a specified limit, may be claimed for each eligible child, including a special needs child. (IRC §23) The Adoption Credit is no longer refundable. However, the unused portion may by carried forward for five years.

### California nonconformity

For years beginning on or after January 1, 2015, California fully conforms to the federal exclusion from income for employer-reimbursed adoption expenses. In 2014, California did not conform to the increase in the exclusion enacted by the Patient Protection Act of 2010, and adoption expenses were limited to the Economic Growth Tax Relief Reconciliation Act (EGTRRA) '01 amounts adjusted for inflation. California's Adoption Credit is completely different from the federal credit. (R&TC §17052.25)

## CHILD TAX CREDIT — IRC §24

### Enhanced credit made permanent

The enhanced Child Tax Credit is made permanent under the PATH Act. Prior to the Act, the refundable portion of the Child Tax Credit was 15% of the amount by which the taxpayer's earned income exceeds $3,000. This provision is made permanent.

### New under PATH Act: due diligence requirements expanded

The PATH Act subjects paid preparers completing forms claiming the Child Tax Credit to the same due diligence requirements to which they are currently subject with respect to the Earned Income Tax Credit and the same penalty of $510. See the discussion on page 1-44.

### New under PATH Act: timely TIN required to take the credit (IRC §24(e))

In order to claim the Child Tax Credit, a taxpayer must include the child's name and taxpayer identification number on the tax return.

For these purposes, a TIN includes a Social Security number, an individual taxpayer identification number (ITIN), or an adoption taxpayer identification number.

There are no specific rules regarding the TIN of the taxpayer claiming the credit. Rather, the taxpayer is subject to the general rules requiring an identification number on the return.

### PATH Act requires timely issued TIN

Under the PATH Act a taxpayer is ineligible to claim the Child Tax Credit for any tax year for which the taxpayer has a TIN that was issued after the due date for filing the return for the tax year. In addition a child cannot be a qualifying child for any tax year for which the child is associated with a TIN that was issued after the due date for filing the return for the year.

### Effective date

The provision is effective for any original tax return filed after December 18, 2015. However, it does not apply to any tax return (other than an amended return) for any tax year that includes December 18, 2015, if the return is filed by its due date. Therefore, timely filed 2015 returns were not subject to the provision.

### Amended returns

The provision prohibits a taxpayer from retroactively claiming the Child Tax Credit by amending a return (or filing an original return if the taxpayer failed to file) for a year in which he didn't have a valid TIN.

## New under PATH Act: improperly claimed credit

Under the PATH Act, the rules previously pertaining to the Earned Income Tax Credit are also now applicable to the Child Tax Credit:

- If there is a determination that the taxpayer's claim of the CTC is due to reckless or intentional disregard of the rules, no CTC is allowed for two years after the year of the claim;
- If there is a determination that the claim is due to fraud, no CTC is allowed for 10 years after the year of the claim; and
- If a taxpayer is denied the CTC as a result of the deficiency provisions, then no CTC is allowed for any later tax year unless the taxpayer provides the information that the IRS requires to demonstrate eligibility for the CTC. Presumably, the IRS will develop a form similar to Form 8862, Information to Claim Earned Income Credit After Disallowance.

## New under PATH Act: delayed refunds

Beginning for the 2016 tax year, refunds for tax returns claiming the Additional Child Tax Credit (ACTC — the refundable credit) will not be issued any earlier than February 15. See page 1-4 for further information.

## IRC §911 limitation

Under the Trade Preferences Extension Act of 2015, the Child Tax Credit is limited for taxpayers who exclude from gross income any amount of foreign-earned income or foreign housing costs under IRC §911. These taxpayers are no longer allowed to claim the refundable portion of the credit (the ACTC). This change is effective for tax years beginning after December 31, 2014.

## Qualifying child

A qualifying child is an individual for whom the taxpayer can claim a dependency exemption under IRC §152 and who is the taxpayer's son or daughter (or descendent thereof), stepchild (or descendent thereof), or eligible foster child.

**Note:** The IRS reminds us that only a qualifying child for purposes of IRC §152, and not a qualifying relative, may get a taxpayer the credit (see Notice 2008-5).

## Phaseout of credits

The credit is phased out for taxpayers with "modified AGI" above certain thresholds. Modified AGI is AGI increased by any amount excluded under the foreign-earned income exclusion (IRC §911) and amounts excluded under IRC §§931 and 933 pertaining to residents of Samoa and Puerto Rico.

The thresholds are:

| | |
|---|---|
| Married filing joint: | $110,000 |
| Single or head of household: | $ 75,000 |
| Married filing separate: | $ 55,000 |

**Note:** These thresholds are not adjusted for inflation.

## California nonconformity

California has no comparable credit.

# EARNED INCOME TAX CREDIT — IRC §32

Eligible low-income workers are able to claim a refundable Earned Income Tax Credit (EITC). The amount depends upon the taxpayer's income and whether the taxpayer has one, more than one, or no qualifying children. The EITC is not available to married individuals who file separate returns. In addition, no EITC is allowed if an eligible individual is the qualifying child of another taxpayer.

The credit is based on a percentage of earned income up to a "plateau" amount.

| Earned Income Amounts | | | |
|---|---|---|---|
| **Qualifying children** | **Credit Percentage** | **2016 (Rev. Proc. 2015-53)** | **2017 (Rev. Proc. 2016-55)** |
| None | 7.65% | $6,610 | $6,672 |
| One | 34% | $9,920 | $10,000 |
| Two | 40% | $13,930 | $14,040 |
| Three or more | 45% | $13,930 | $14,040 |

## Beginning point of phaseout range increased for joint filers

The EITC is reduced by a percentage of the amount by which earned income (or AGI, if higher) exceeds a phaseout amount.

| Phaseout Ranges | | | | | |
|---|---|---|---|---|---|
| | | 2016 (Rev. Proc. 2015-53) | | 2017 (Rev. Proc. 2016-55) | |
| **Qualifying children** | **Phaseout Percentage** | **Other than joint** | **Joint returns** | **Other than joint** | **Joint returns** |
| None | 7.65% | $8,270–$14,880 | $13,820–$20,430 | $8,340–$15,010 | $13,930–$20,600 |
| One | 15.98% | $18,190–$39,296 | $23,740–$44,846 | $18,340–$39,618 | $23,930–$45,207 |
| Two | 21.06% | $18,190–$44,648 | $23,740–$50,197 | $18,340–$45,007 | $23,930–$50,597 |
| Three or more | 21.06% | $18,190–$47,595 | $23,740–$53,505 | $18,340–$48,340 | $23,930–$53,930 |

## Enhanced credit made permanent

The enhanced credit for taxpayers with three or more qualifying children is made permanent under the PATH Act. In addition, the Act prohibits an individual from retroactively claiming the credit by amending a return in any prior year in which the individual for whom the credit is claimed did not have a valid Social Security number.

## New under PATH Act: timely TIN required to take the credit (IRC §32(m))

In order to claim the EITC, a taxpayer must include his or her taxpayer identification number (and that of his or her spouse, if married) on the tax return. In addition, the taxpayer must include the TIN of a qualifying child.

For these purposes, a TIN is a Social Security number issued by the Social Security Administration, other than a number issued to allow the receipt of federally funded benefits, such as Medicaid. So if the taxpayer's Social Security card says "Not valid for employment," the taxpayer can't claim the EITC. Similarly, if the child's Social Security card says "Not valid for employment," the child cannot be a qualifying child.

### PATH Act requires timely TIN

Under the PATH Act, a taxpayer is ineligible for the EITC for any tax year for which the taxpayer has a TIN that was issued after the due date for filing the return for the tax year. In addition, a child cannot be a qualifying child for any tax year for which the child is associated with a TIN that was issued after the due date for filing the return for the year.

### Due date not defined

The provision does not specify whether the due date includes extensions.

### Effective date

The provision is effective for any original tax return filed after December 18, 2015. However, it does not apply to any tax return (other than an amended return) for any tax year that includes December 18, 2015, if the return is filed by its due date. Therefore, timely filed 2015 returns were not subject to the provision.

### Amended returns

The provision prohibits a taxpayer from retroactively claiming the EITC by an amended tax return, or filing an original return if the taxpayer failed to file, for a year in which he didn't have a valid TIN.

## New under PATH Act: delayed refunds

Beginning for the 2016 tax year, refunds for tax returns claiming the EITC will not be issued any earlier than February 15. See page 1-4 for further information.

## California now has its own EITC

California's EITC is available for the 2016 taxable year. Key differences between the federal and state credits include:

- The state credit is determined by multiplying a modified federal credit amount by an "adjustment factor," which is set at "0" but may be increased by the Legislature in the Budget Act each year. (R&TC §17052(a)(2)(B)) For 2016, the adjustment factor is equal to 85%;
- To remain in effect, the Budget Act must also authorize resources for the FTB to oversee and audit returns on which the credit is claimed. (R&TC §17052(a)(2)(C)) This was authorized in both the 2015 and 2016 budgets;
- "Earned income" for purposes of the state credit does not include self-employment income; and
- The credit is only available to individuals who have a qualifying principal place of abode in California.

**California EITC Figures for 2016**

| For an eligible individual with | The credit percentage would be | The phaseout percentage would be | Earned income amount[1] | Phaseout amount[2] | Completely phased out at | Maximum CA EITC[3] | Maximum CA EITC[4] |
|---|---|---|---|---|---|---|---|
| No qualifying children | 7.65% | 7.65% | $3,359 | $3,359 | $6,718 | $256 | $217 |
| 1 qualifying child | 34% | 34% | $5,044 | $5,044 | $10,088 | $1,709 | $1,452 |
| 2 qualifying children | 40% | 40% | $7,081 | $7,081 | $14,162 | $2,830 | $2,406 |
| 3 or more qualifying children | 45% | 45% | $7,081 | $7,081 | $14,162 | $3,184 | $2,706 |

[1] Maximum credit fully phased in
[2] Greater of earned income or AGI
[3] Before EITC adjustment factor
[4] With 85% EITC adjustment factor

**California forms**

Form FTB 3514, California Earned Income Tax Credit, must be used for taxpayers to provide more detailed information in order to claim the credit. The form must be attached in order to claim the credit.

Form FTB 3596, Paid Preparer's California Earned Income Tax Credit Checklist, must be completed by paid preparers. California has a due diligence penalty similar to the federal penalty. California's penalty is $500 and is not adjusted for inflation. (R&TC §19167(a)(5) and (b))

See page 11-1 for information on processing returns containing the California EITC.

# AMERICAN OPPORTUNITY TAX CREDIT — IRC §25A

The American Opportunity Tax Credit (AOTC) was made permanent under the PATH Act.

## New due diligence requirements

The Act requires that paid preparers will be subject to the same due diligence requirements to which they are currently subject with respect to the EITC and the same penalty of $510. See the discussion on page 1-44.

## California nonconformity

California has no comparable credit. However, if a taxpayer elects to forgo the federal exemption deduction to allow the child to claim the credit, California grants the exemption credit to the parents. (R&TC §17024.5(e))

## Form 1098-T required

Under the Trade Preference Extension Act of 2015 and the Trade Priorities and Accountability Act of 2015, the AOTC, the Lifetime Learning Credit, and the tuition and fees deduction are no longer allowed unless the taxpayer is in possession of Form 1098-T, Tuition Statement, at the time the taxpayer files. This change is effective for tax years beginning after December 31, 2014.

## Overcoming incorrect 1098-T in Tax Court

In the ***Terrell*** case, a taxpayer registered in November 2010 for classes starting in 2011 and properly applied the AOTC to her 2011 return. (***Terrell v. Comm.***, TCM 2016-85) However, the Form 1098-T that the school issued showed only a supplemental tuition charge rather than the full amount paid, and the IRS disallowed the AOTC.

At trial, the taxpayer provided an account statement from the university showing the full tuition charges and payment via student loan disbursement. She noted that "My school kind of dropped the ball a little bit where they're supposed to verify the amount [of tuition paid]."

The court accepted the documentation and allowed the credit.

## Prepaid tuition not eligible for credit

In the ***McCarville*** case, a taxpayer was denied the AOTC on his 2012 tax return for tuition payments he made in December 2011 for the semester that began in January 2012. (***McCarville v. Comm.***, TCS 2016-14)

The taxpayer argued that it "just seemed kind of wrong" that had he made the payment a few weeks later, the payment would have qualified for the credit. The court was sympathetic but noted that the regulations are very clear that a cash basis taxpayer is only allowed a credit for the year in which the payment was made, and disallowed the credit.

If a taxpayer pays tuition in one year, and the semester to which the tuition applies begins during the first three months of the next taxable year, the taxpayer may take an education tax credit for the year in which the tuition is paid. (Treas. Regs. §1.25A-5(e)(2)(i))

So, in this case, the taxpayer may have been eligible to take the AOTC for the 2011 payment on his 2011 return, since the payment was made in December for the semester starting in January.

However, the taxpayer admitted that he had already taken the AOTC on his 2011 return for prior tuition payments, so it was likely he had already met the $2,500 credit cap for 2011.

## California nonconformity

California has no comparable credit. A taxpayer may elect to not include a child as a dependent on the federal return (so that the child may claim the AOTC) but include the child as a dependent on the California return.

| Comparison of Education Tax Benefits | | | |
|---|---|---|---|
| **Feature** | **American Opportunity Tax (Hope) Credit** | **Lifetime Learning Credit** | **Higher Education Tax/ Tuition Deduction** |
| **Type of benefit** | Refundable tax credit (up to 40% refundable) | Nonrefundable tax credit (cannot exceed tax liability) | Above-the-line tax deduction (filers do not need to itemize). This deduction is set to expire December 31, 2016, unless extended |
| **Maximum benefit** | $2,500 (100% of first $2,000 in qualified expenses, 25% of second $2,000) per student. Inflation adjusted | $2,000 (20% of first $10,000 in qualified expenses) per return | $4,000 deduction per return (but only $2,000 maximum deduction available for higher income taxpayers). **Note:** Value of the maximum deduction depends upon taxpayer's marginal tax rate |
| **Number of tax years credit available** | Available ONLY for 4 tax years per eligible student | Available for an unlimited number of years | N/A |
| **Income limit** | Credit begins to phase out at $80,000 modified AGI and is fully phased out at $90,000 ($160,000 and $180,000 thresholds for joint returns) | Credit begins to phase out at $56,000 modified AGI and is fully phased out at $66,000 ($112,000 and $132,000 thresholds for joint returns); phaseout is inflation-adjusted | Deduction available to taxpayers with up to $65,000 in modified AGI ($130,000 for joint returns); taxpayers with modified AGI or more than $65,000 but less than $80,000 can claim smaller maximum deduction ($130,000 and $160,000 thresholds for joint returns) |
| **Postsecondary education expenses qualifying for benefit** | Tuition, fees, computers, and course materials required for enrollment | Tuition and fees required for enrollment | Tuition and fees required for enrollment |
| **Type of postsecondary education** | First four years of undergraduate education when enrolled on at least a half-time basis in a program leading to a degree, credential, or certificate | For any year of undergraduate or graduate enrollment for one or more courses | For any year of undergraduate or graduate enrollment with no limit on the intensity of enrollment or the type of program |

## PREPARERS ARE REQUIRED TO FILE REVISED DUE DILIGENCE CHECKLIST

Form 8867 is expanded for the 2016 tax year to include due diligence with respect to claiming not only the EITC, but also the AOTC and the Child Tax Credit. Generally, tax professionals who prepare EITC claims must not only ask all the questions to get the information required on Form 8867, but they must also ask additional questions when the information their client provides seems incorrect, inconsistent, or incomplete. Tax preparers must keep copies for three years, either on paper or electronically, of any documents provided by the taxpayer that were relied on to determine whether any child is a qualifying child. Tax preparers must also keep all worksheets showing how the credit was computed.

There are three sources of information regarding the new due diligence requirements:

- New temporary regulations (Treas. Regs. §1.6695-2T) These regulations can be found at www.irs.gov/irb/2016-51_IRB/ar10.html;
- IRS Publication 4687, Refundable Credit Due Diligence; and
- "Due Diligence Training Module," an IRS one-hour program which can qualify a tax practitioner for one hour of CPE and is available at www.eitc.irs.gov/training/login/auth.

**Caution**

Don't assume that your computer software will correctly answer the questions on Form 8867. It is important for you, as the tax preparer, to make sure the answers to the questions are correct for each specific applicable client, and if not, change them accordingly prior to completing the return. Remember, you are assessed the penalty for failure to satisfy the EITC due diligence requirement, not the taxpayer.

Note, also, that the $510 penalty is *per credit;* that is, if all three credits are reported on the return and the tax preparer fails due diligence with respect to all three, the penalty is $1,530.

Form **8867**

Department of the Treasury
Internal Revenue Service

# Paid Preparer's Due Diligence Checklist

*Earned Income Credit (EIC), Child Tax Credit (CTC), and American Opportunity Tax Credit (AOTC)*

▶ **To be completed by preparer and filed with Form 1040, 1040A, 1040EZ, 1040NR, 1040SS, or 1040PR.**

▶ **Information about Form 8867 and its separate instructions is at *www.irs.gov/form8867*.**

OMB No. 1545-1629

2016

Attachment Sequence No. **177**

Taxpayer name(s) shown on return | **Taxpayer identification number**

Enter preparer's name and PTIN

## Due Diligence Requirements

| Please complete the appropriate column for all credits claimed on this return (check all that apply). | EIC | CTC/ACTC | AOTC |
|---|---|---|---|
| **1** Did you complete the return based on information for tax year 2016 provided by the taxpayer or reasonably obtained by you? . . . . . . . . | ☐ **Yes** ☐ **No** | ☐ **Yes** ☐ **No** | ☐ **Yes** ☐ **No** |
| **2** Did you complete the applicable EIC and/or CTC/ACTC worksheets found in the Form 1040, 1040A, 1040EZ, or 1040NR instructions, and/or the AOTC worksheet found in the Form 8863 instructions, or your own worksheet(s) that provides the same information, and all related forms and schedules for each credit claimed? . . . . . . . . . . . . . . . . . . . . . . | ☐ **Yes** ☐ **No** | ☐ **Yes** ☐ **No** | ☐ **Yes** ☐ **No** |
| **3** Did you satisfy the knowledge requirement? Answer “Yes” only if you can answer “Yes” to both 3a and 3b. To meet the knowledge requirement, did you: | ☐ **Yes** ☐ **No** | ☐ **Yes** ☐ **No** | ☐ **Yes** ☐ **No** |
| **a** Interview the taxpayer, ask adequate questions, and document the taxpayer’s responses to determine that the taxpayer is eligible to claim the credit(s)? . | ☐ **Yes** ☐ **No** | ☐ **Yes** ☐ **No** | ☐ **Yes** ☐ **No** |
| **b** Review adequate information to determine that the taxpayer is eligible to claim the credit(s) and in what amount? . . . . . . . . . . . . . . . . . | ☐ **Yes** ☐ **No** | ☐ **Yes** ☐ **No** | ☐ **Yes** ☐ **No** |
| **4** Did any information provided by the taxpayer, a third party, or reasonably known to you in connection with preparing the return appear to be incorrect, incomplete, or inconsistent? (If “Yes,” answer questions 4a and 4b. If “No,” go to question 5.) . . . . . . . . . . . . . . . . . . . . . . | ☐ **Yes** ☐ **No** | ☐ **Yes** ☐ **No** | ☐ **Yes** ☐ **No** |
| **a** Did you make reasonable inquiries to determine the correct or complete information? . . . . . . . . . . . . . . . . . . . . . . | ☐ **Yes** ☐ **No** | ☐ **Yes** ☐ **No** | ☐ **Yes** ☐ **No** |
| **b** Did you document your inquiries? (Documentation should include the questions you asked, whom you asked, when you asked, the information that was provided, and the impact the information had on your preparation of the return.) . . . . . . . . . . . . . . . . . . . . . . | ☐ **Yes** ☐ **No** | ☐ **Yes** ☐ **No** | ☐ **Yes** ☐ **No** |
| **5** Did you satisfy the record retention requirement? To meet the record retention requirement, did you keep a copy of any document(s) provided by the taxpayer that you relied on to determine eligibility or to compute the amount for the credit(s)? . . . . . . . . . . . . . . . . . . . . . | ☐ **Yes** ☐ **No** | ☐ **Yes** ☐ **No** | ☐ **Yes** ☐ **No** |
| In addition to your notes from the interview with the taxpayer, list those documents, if any, that you relied on. | | | |
| **6** Did you ask the taxpayer whether he/she could provide documentation to substantiate eligibility for and the amount of the credit(s) claimed on the return? | ☐ **Yes** ☐ **No** | ☐ **Yes** ☐ **No** | ☐ **Yes** ☐ **No** |
| **7** Did you ask the taxpayer if any of these credits were disallowed or reduced in a previous year? . . . . . . . . . . . . . . . . . . . . . . (If credits were disallowed or reduced, go to question 7a; if not, go to question 8.) | ☐ **Yes** ☐ **No** | ☐ **Yes** ☐ **No** | ☐ **Yes** ☐ **No** |
| **a** Did you complete the required recertification form(s)? . . . . . . . . | ☐ **Yes** ☐ **No** | ☐ **Yes** ☐ **No** | ☐ **Yes** ☐ **No** |
| **8** If the taxpayer is reporting self-employment income, did you ask adequate questions to prepare a complete and correct Form 1040, Schedule C? . . . | ☐ **Yes** ☐ **No** | ☐ **Yes** ☐ **No** | ☐ **Yes** ☐ **No** |

**For Paperwork Reduction Act Notice, see separate instructions.** Cat. No. 26142H Form **8867** (2016)

**Due Diligence Questions for Returns Claiming EIC** (If the return does not claim EIC, go to question 10.)

| | EIC | CTC/ACTC | AOTC |
|---|---|---|---|
| **9a** Did you explain to the taxpayer the rules about claiming the EIC when a child is the qualifying child of more than one person (tie-breaker rules), and have you determined that this taxpayer is, in fact, eligible to claim the EIC for the number of children for whom the EIC is claimed? . . . . . . . . . . . | ☐ **Yes** ☐ **No** | | |
| **b** Did you explain to the taxpayer that he/she may not claim the EIC if the taxpayer has not lived with the child for over half the year, even if the taxpayer has supported the child? . . . . . . . . . . . . . . . . . . . . . . | ☐ **Yes** ☐ **No** | | |

**Due Diligence Questions for Returns Claiming CTC and/or additional CTC** (If the return does not claim CTC or Additional CTC, go to question 11.)

| | EIC | CTC/ACTC | AOTC |
|---|---|---|---|
| **10a** Does the child reside with the taxpayer who is claiming the CTC/ACTC? (If "Yes," go to question 10c. If "No," answer question 10b.) . . . . . . . . | | ☐ **Yes** ☐ **No** | |
| **b** Did you ask if there is an active Form 8332, Release/Revocation of Claim to Exemption for Child by Custodial Parent, or a similar statement in place and, if applicable, did you attach it to the return? . . . . . . . . . . . . . | | ☐ **Yes** ☐ **No** | |
| **c** Have you determined that the taxpayer has not released the claim to another person? . . . . . . . . . . . . . . . . . . . . . . . . . . | | ☐ **Yes** ☐ **No** | |

**Due Diligence Questions for Returns Claiming AOTC** (If the return does not claim AOTC, go to *Credit Eligibility Certification*.)

| | EIC | CTC/ACTC | AOTC |
|---|---|---|---|
| **11** Did the taxpayer provide substantiation such as a Form 1098-T and receipts for the qualified tuition and related expenses for the claimed AOTC? . . . . . . | | | ☐ **Yes** ☐ **No** |

► **You have complied with all due diligence requirements with respect to the credits claimed on the return of the taxpayer identified above if you:**

A. Complete this Form 8867 truthfully and accurately and complete the actions described in this checklist for all credits claimed;

B. Submit Form 8867 in the manner required;

C. Interview the taxpayer, ask adequate questions, document the taxpayer's responses on the return or in your notes, review adequate information to determine if the taxpayer is eligible to claim the credit(s) and in what amount(s); **and**

D. Keep all five of the following records for 3 years from the latest of the dates specified in the Form 8867 instructions under *Document Retention.*

1. A copy of Form 8867,
2. The applicable worksheet(s) or your own worksheet(s) for any credits claimed,
3. Copies of any taxpayer documents you may have relied upon to determine eligibility for and the amount of the credit(s),
4. A record of how, when, and from whom the information used to prepare this form and worksheet(s) was obtained, and
5. A record of any additional questions you may have asked to determine eligibility for and amount of the credits, and the taxpayer's answers.

► **If you have not complied with all due diligence requirements for all credits claimed, you may have to pay a $510 penalty for each credit for which you have failed to comply.**

**Credit Eligibility Certification**

| | EIC | CTC/ACTC | AOTC |
|---|---|---|---|
| **12** Do you certify that all of the answers on this Form 8867 are, to the best of your knowledge, true, correct and complete? . . . . . . . . . . . . . . | | | ☐ **Yes** ☐ **No** |

Form **8867** (2016)

# SAVER'S CREDIT — IRC §25B

IRC §25B provides a nonrefundable tax credit for contributions made by an eligible taxpayer to a qualified plan. The credit offsets both regular tax and AMT and is in addition to any applicable deduction.

The maximum annual contribution eligible for the credit is $2,000. An eligible taxpayer must be:

- Age 18 or over; and
- Not a full-time student or claimed as a dependent on another's return.

The rate of credit is determined by modified AGI.

The credit is available for elective contributions to any of these plans:

- IRC §401(k) plan;
- IRC §403(b) annuity or eligible deferred compensation arrangement of a state or local government (IRC §457 plan);
- SIMPLE;
- SAR-SEP (not for a traditional SEP);
- Traditional IRA;
- Roth IRA; or
- Voluntary after-tax contributions to a qualified retirement plan.

With limited exceptions, the qualified contribution is reduced by distributions from the plan made:

- During the year the credit applies;
- During the two preceding years; or
- Prior to the due date of the return for the year in which the credit applies.

| **Saver's Credit Rate Chart** | | | | |
|---|---|---|---|---|
| | **AGI** | | | |
| **Year** | **Joint** | **Head of household** | **All other filers** | **Credit %** |
| 2016<br>2017 | \$0–\$37,000<br>\$0–\$37,000 | \$0–\$27,750<br>\$0–\$27,750 | \$0–\$18,500<br>\$0–\$18,500 | 50% |
| 2016<br>2017 | \$37,001–\$40,000<br>\$37,001–\$40,000 | \$27,751–\$30,000<br>\$27,751–\$30,000 | \$18,501–20,000<br>\$18,501–20,000 | 20% |
| 2016<br>2017 | \$40,001–\$61,500<br>\$40,001–\$62,000 | \$30,001–\$46,125<br>\$30,001–\$46,500 | \$20,001–\$30,750<br>\$20,001–\$31,000 | 10% |
| 2016<br>2017 | Over \$61,500<br>Over \$62,000 | Over \$46,125<br>Over \$46,500 | Over \$30,750<br>Over \$31,000 | 0% |
| 2016: Rev. Proc. 2015-53, 2017: Rev. Proc. 2016-55 | | | | |

## 2016 credit for 2017 action

The credit pertains to the year for which the contribution is made. Because a contribution may be made for a tax year up to the due date of the return, this credit may be the only one available that will provide a credit for action taken after the end of the taxable year. For example, a taxpayer may make an IRA contribution for the 2016 taxable year up until April 18, 2017, and be entitled to a 2016 credit.

### California nonconformity

California has no comparable credit.

## NONBUSINESS ENERGY CREDITS — IRC §25C

The credit was extended through 2016 under the PATH Act to apply to property placed in service after December 31, 2004, and before January 1, 2017.

### California nonconformity

California has no comparable credit.

## RESIDENTIAL ENERGY EFFICIENT (SOLAR) PROPERTY CREDIT — IRC §25D

The PATH Act extends the credit for qualified solar electric property and qualified solar water heating property to property placed in service before January 1, 2022:

- For property placed in service between January 1, 2017, and December 31, 2019, the credit amount is 30%;
- For property placed in service between January 1, 2020, and December 31, 2020, the credit amount is 26%; and
- For property placed in service between January 1, 2021, and December 31, 2021, the credit amount is 22%.

For property placed in service in 2016, the credit amount is 30%.

### California nonconformity

California has no comparable credit.

| Comparison Chart: Residential Energy-Efficiency Tax Credits | | |
|---|---|---|
| | **IRC §25C credit** | **IRC §25D credit** |
| Types of qualifying property | Qualifying energy-efficiency improvements:<br>• Insulation;<br>• Windows (including skylights);<br>• Doors;<br>• Qualifying metal roof; and<br>• Asphalt roof with cooling granules | Solar property:<br>• Solar electric; and<br>• Solar water heating<br>Other energy-efficient property:<br>• Fuel cell: $500 per 0.5kW of capacity;<br>• Small wind energy; and<br>• Geothermal heat pumps |
| Calculation of credit | 10% of qualifying energy-efficiency improvements plus qualifying energy property | 30% of solar property: other energy efficient property |
| Credit cap | $200 for windows (lifetime cap)<br>$500 (lifetime cap)<br>Energy property and associated caps:<br>• Electric heat pump; central air conditioner; natural gas, propane, or oil water heater; biomass stove: $300;<br>• Natural gas, propane, or oil furnace or hot water boiler: $150; and<br>• Advanced main air circulating fan: $50 | None. No limit to number of times credit may be claimed |
| Qualifying residence | Principal residence only as defined under IRC §121. Existing residence only. New residence does not qualify | Any residence of the taxpayer (except for fuel cell — principal residence only). Both existing residence and new residence qualify |
| Applicable against AMT? | Yes | Yes |
| Refundable? | No | No |
| Carryover? | No | Yes, indefinite |
| Scheduled expiration | December 31, 2016 | **Solar property:** December 31, 2021. Solar energy credit reduced to 26% in 2020 and 22% in 2021<br>**Other energy-efficient property:** December 31, 2016 |

# SOLAR ENERGY CREDIT

The Solar Energy Industries Association announced that total solar installations in the U.S. reached 1 million in early 2016 and estimates that the number will double within two years. California is leading the way with almost half of the solar power generating capacity among the states.

*Go Solar California*

The Go Solar California website provides California consumers information on solar programs, rebates, tax credits, and information on installing and interconnecting solar electric and solar thermal systems. The site has information on program rules, including eligible equipment and standards, as well as information on how to find an eligible, licensed solar contractor.

**Website**
www.gosolarcalifornia.org

## Energy credits generally

Energy credits are contained in three sections of the Internal Revenue Code: 25C, 25D, and 48. Solar credits are contained in IRC §§25D and 48.

### Comparing IRC §§25C and 25D in a nutshell

- Same types of real estate (nonbusiness); and
- Different types of energy improvements.

### Comparing IRC §§25D and 48 in a nutshell

- Different types of real estate (nonbusiness vs. business); and
- Same types of energy improvements.

*Comment*

Both IRC §§25D and 48 offer credits for energy property other than solar (small wind energy property, geothermal heat pump property, etc.). However, the discussion below is focused on credits for solar energy property for residential property under IRC §25D. IRC §48 property generally applies to business property rather than nonbusiness property and is a separate element of the investment credit. We will mention business credits under IRC §48 only when they have an effect on residential credits (for example, in the case of residential rental property or property that has both business and nonbusiness use).

**Caution**

The IRS has issued remarkably little guidance in this area. There are no regulations under IRC §25D, and the IRS has issued only a couple of notices and a small handful of PLRs. This is especially remarkable considering that the credit has been around for a while, there are significant dollars involved (there is no dollar limit on the credit), and promoters of solar equipment are making brash representations of the tax savings that buyers can receive (see, for example, the following discussion of roofs).

## Solar credits generally

The credit is:

1. A percentage of;
2. Expenditures for;
3. Qualified solar property;
4. Made by the taxpayer during the tax year (timing);
5. On a qualified property.

We will examine each of those five components.

The credit under IRC §25D for nonbusiness (residential) property is available only to individuals. (IRC §25D(a)) The credit under IRC §48 for business property is available to all entity types including individuals.

There is no AGI limitation on the credit. The credit can be used to offset AMT. Any unused credit may be carried forward indefinitely. (IRC §25D(c))

## 1. Credit percentages

The IRC §25D credit percentage for the 2016 taxable year is 30% of qualifying expenditures and remains at 30% through the 2019 taxable year. After 2019, the credit phases down through 2021, as discussed on page 1-48.

## 2. Expenditures

Generally, qualifying expenditures include the cost of the solar electric property system plus installation costs (see below). However, a taxpayer must reduce expenditures by the amount of any subsidies the taxpayer receives (see below).

### Installation costs

Labor and installation costs allocable to the onsite preparation, assembly, or original installation of the qualified solar electric property and for piping or wiring to interconnect such property to the dwelling unit can be taken into account in computing the credit. If a taxpayer finances the property, interest and expenses such as origination fees and extended warranty costs are not counted as part of the expenditure for the purposes of calculating the credit. (IRC §25D(e)(1)) However, see "Interest deduction" on page 1-58.

### What about the roof?

For residential purposes, solar panels are most commonly placed on the roof. This is of concern to homeowners for a number of reasons:

- The roof may require repairs to make it possible to install the solar panels; and
- The solar panels may outlive the roof. In that case, the panels will need to be removed and reinstalled, a process that can be costly (and for which there are no tax credits or other tax benefits).

Accordingly, many taxpayers will wait until they need a new roof to have solar panels installed. The IRS has never ruled as to whether any cost of roof repairs or the installation of a new roof for the purposes of placing solar panels will qualify as a cost for which the credit is eligible.

The IRS has, however, stated that "only the component part of a property that actual generates electricity for the dwelling unit is eligible for the §25D credit." While that may seem clear, remember that installation costs can be included. However, the only guidance is the Code itself, which states that "Expenditures for labor costs properly allocable to the onsite preparation, assembly, or original installation of the property … and for piping or wiring to interconnect such property to the dwelling unit shall be taken into account for purposes of this section."

***More confusion***

IRC §25D(e)(2) provides that "No expenditure relating to a solar panel or other property installed as a roof (or portion thereof) shall fail to be treated as property described in paragraph (1) or (2) of subsection (d) solely because it constitutes a structural component of the structure on which it is installed." The instructions to Form 5695 restate that in plainer English: "No costs relating to a solar panel or other property installed as a roof (or portion thereof) will fail to qualify solely because the property constitutes a structural component of the structure on which it is installed."

This is often taken to mean that the costs of any and all roof repairs or installation done in connection with installing solar panels can be counted in total expenditures. This is not the case. This clause addresses the case in which the *roof itself* will substantially improve the performance of the solar panels (such as specialized highly-reflective shingles).

***Bulls get rich and pigs get slaughtered***

Anecdotally, there are taxpayers who are including the entire cost of a new roof in expenditures for purposes of computing the credit.

It would seem that an aggressive, but arguable (although not guaranteed) stance, would be to allocate roofing costs to energy property based on:

- Would I replace the roof were it not for the solar unit?
- What would the replacement cost be if I were not adding a solar unit?
- Are there components of the roof designed for efficiency of, or support of, the solar unit?
- What is the covered area of the solar units vs. the area of the entire roof?

### New construction

A taxpayer may claim the credit if a qualifying property is installed in or on an existing home or a newly constructed home. For property installed on a new home, the taxpayer may request that the homebuilder make a reasonable allocation — or the taxpayer may use any other reasonable method — to determine the cost of the property that is eligible for the credit. (Notice 2013-70)

The expenditure is treated as made when the use of the structure as a residence begins. This is true even if the home was a model home and the energy property was used by the seller during the time it was marketed for sale. Thus, the buyer gets the credit at the time he begins to use the home as his residence.

### Subsidies

There is no credit allowed for energy efficient property to the extent that an energy conservation subsidy for that expenditure was excluded from income. (IRC §136(b)) An excluded subsidy is one that a public utility or state or local government provides to a customer to buy or install energy conservation property. The rule applies whether a third-party contractor receives the subsidy on behalf of the taxpayer or the taxpayer receives the subsidy directly. (Notice 2013-70; PLR 201607004)

The subsidy is not taxable income to the taxpayer. (IRC §136; PLR 201607004)

### California conformity

California conforms to the IRC §136 exclusion for energy subsidies. (R&TC §§17131, 24326)

#### Business use

If the taxpayer uses residential property 80% or more for personal nonbusiness purposes, the taxpayer may take the full credit. However, if the taxpayer's nonbusiness use exceeds 20%, the taxpayer must allocate expenditures between business and nonbusiness for purposes of computing the residential energy credit. (IRC §25D(e)(7))

**Note:** In that case, the taxpayer may be able to claim the business energy credit under IRC §48 for the business portion of the residence.

#### Sales tax

Sales tax may generally be included in calculating expenditures eligible for the credit. (Notice 2013-70)

#### Warranties

Qualifying expenditures do not include the cost of any extended warranties. (Notice 2013-70)

#### State tax credit

The taxpayer does not reduce the amount of the qualified expenditure by the amount of any state tax credit claimed. (Notice 2013-70) As previously mentioned, California does not currently have a comparable state tax credit.

#### Basis adjustment

The taxpayer must reduce basis by the amount of credit taken in the case of the residential energy credit. (IRC §25D(f))

***Example of basis adjustment for residential property***

Rachel owns a home with a basis of $200,000. In 2016, she spends $15,000 to purchase and install qualified solar panels, and qualifies for a credit of $4,500 ($15,000 × 30%). The $15,000 is a capital expenditure that would otherwise increase the basis in her home. Rachel's basis in her home after this expenditure is $210,500:

$200,000 + ($15,000 expenditure – $4,500 credit)

In the case of the business energy credit under IRC §48, the taxpayer must reduce basis by one-half of the credit. (IRC §50(c)(3))

## 3. Qualified solar property

#### General requirements

For the purposes of the both the residential and business energy credit, qualified property must use solar energy to generate electricity or heat water. (IRC §§25D(a), 48(a)(3)(A)(i))

In the case of solar water heating property, the property must be certified for performance by the Solar Rating Certification Corporation or a comparable entity endorsed by the government of the state in which the property is installed. The taxpayer may rely on the manufacturer's certification. In the absence of such certification, the taxpayer may still qualify for the credit if the taxpayer can show that the property meets the required efficiency standards. The taxpayer should retain documentation to establish this. (Notice 2013-70)

In the case of the IRC §48 business energy credit, the property must also be property for which depreciation or amortization is allowable. (IRC §48(a)(3)(C))

### Air heaters and exhaust fan

Generally, no credit is allowed for expenditures for solar air heaters or solar powered exhaust fans. (Notice 2013-70)

### Swimming pools

To qualify for the credit, the property must be used exclusively for purposes other than heating swimming pools and hot tubs. (IRC §25D(e)(3)); IRS Notice 2013-70)

## 4. Timing of credit

In the case of energy property installed on an existing residence, the credit is available in the taxable year in which original installation of the equipment is completed (not in the year purchased). (IRC §25D(e)(8)(A))

In the case of a new residence, the expenditure is treated as made when the original use of the structure *as a residence* begins. (IRC §25D(e)(8)(B); Notice 2013-70)

***Example of new construction***

A homebuilder constructed a house in which qualifying property was installed in Year 1. The house was not sold and used as a residence until Year 2: The taxpayer takes the credit in Year 2.

A homebuilder constructed a house in which qualifying property was installed in Year 1. The house was used as a model home, during which time the qualifying property was used. The home was sold in Year 2: The taxpayer takes the credit in Year 2.

In the case of business property under IRC §48, the credit is available the year the property is first placed in service.

### Original use only

The credit may only be taken when the original installation of the property is completed. Thus if Taxpayer A installs the property in 2010 and takes the credit and sells the property to Taxpayer B in 2013, Taxpayer B may not take the credit. (Notice 2013-70)

## 5. Qualified real estate

In the case of the IRC §25D residential energy credit, the taxpayer may take the credit for energy property installed for use in a dwelling unit in the United States and used as a residence by the taxpayer. (IRC §25D(d)(1) and (2)) There is no limit on the number of residences that may qualify for the taxpayer (it doesn't have to be the primary residence).

### "For use in"

Though the solar energy property is most commonly installed on the roof of the qualifying residence, there is no requirement that the energy property be installed on the premises of the taxpayer's residence so long as it is "for use in" that residence.

### Residential rental property

A residential rental property does not qualify for the residential energy credit under IRC §25D because it is not used as a residence by the taxpayer. However, the taxpayer may qualify for the business energy credit under IRC §48 via IRC §50.

***Commonly misunderstood***

The IRS has issued no guidance specifically stating that residential rental property qualifies for the credit as business property under IRC §48, and the determination is made through an especially circuitous statutory analysis:

- IRC §48(a)(3)(C) provides that the property must be depreciable property.
  *We're looking good so far.*
- IRC §50(b)(2) provides that the property cannot be property used for lodging.
  *Uh oh. It's not looking so great now.*
- IRC §50(b)(2)(D) provides an exception to the lodging exception: energy property.
  *Bingo!*

***Converted property***

The determination as to whether property is qualifying residential property is made at the time of installation, and there are no recapture provisions under IRC §25D. Therefore, there would be no tax consequences to a taxpayer who takes the credit on a qualifying residence and in a later year converts that residence to a rental.

## Leased solar panels

A taxpayer must purchase the qualifying property to claim the credits under IRC §§25C and 25D. (Notice 2013-70) Therefore, a homeowner who leases solar equipment is not eligible for the credits. However, the lessor may be eligible for the credits as business energy property under IRC §48.

***Nontax considerations of leasing***

Leases usually run for 15–20 years. Taxpayers generally have four options at the end of the lease:

- Request to renew the agreement (for example, SolarCity renews in five-year increments up to two times);
- Have the solar provider remove the system;
- Purchase the system (varies by state and provider); or
- Upgrade to a new system.

In addition, there may be further considerations when the lessee sells the residence. See page 1-57 for further discussion.

The following website compares the benefits of leasing versus buying:

**Website**
https://ilsr.org/ultimate-solar-calculator/

| Comparison of Purchasing Versus Leasing | |
|---|---|
| **Purchasing** | **Leasing** |
| Maximizes the financial benefits of installing a solar panel system, rather than solely benefitting from the system's environmental benefits | Primarily interested in using electricity generated from renewable resources, rather than maximizing the financial benefits of installing a solar panel system |
| Eligible to reduce your federal tax liability through the federal credit | Avoid the responsibility of maintenance or repairs for a solar panel system |
| If a business, can realize tax benefits by treating the solar panel system as a depreciable asset | Ineligible for federal or state investment tax credits resulting from your investment in a solar panel system |
| Increase the market value of your home by installing a solar panel system | Get immediate benefit of reduced costs. Don't need to wait until the following year to receive the financial benefits of tax credits |
| www.energysage.com/solar/financing/should-you-buy-or-lease-your-solar-panel-system | |

## Financing the purchase

Without a doubt, the taxpayer may claim the credit based on the full cost of the property if the property is financed. The taxpayer, however, may not claim a credit for the amount of any interest owed or any loan origination fees. (Notice 2013-70)

## Selling the property

When selling a property with solar equipment installed, the tax ramifications depend on whether the panels were purchased or leased. In either case, the credit is available only for the original installation; the buyer of the property does not get the credit.

### Energy property is owned

If the seller owns the energy property attached to the residence, the energy property is treated as part of the residence (assuming, of course, that the seller leaves the energy property in place and doesn't remove it and have it installed on another residence).

There is no credit recapture in the case of the residential energy credit under IRC §25D. However, there is credit recapture in the case of the business energy credit under IRC §48.

A taxpayer may continue claiming carryover credits even after the taxpayer sells the property.

***Example of sale of residence with owned energy property***

Emily purchased her residence in 1980 for $150,000 and has owned and used it as her principal residence since. The only substantial improvement she's ever made to the house occurred in 2013 when she purchased and installed solar panels on her roof at a cost of $20,000. She took a tax credit under IRC §25D for $6,000 (30% × $20,000).

In 2016 she sold the house for $600,000 when she was single. Her taxable gain on the house is:

| | |
|---|---|
| Sales price | $600,000 |
| Purchase price | (150,000) |
| Cost of solar net of credit ($20,000 - $6,000) | ( 14,000) |
| IRC §121 exclusion | (250,000) |
| Taxable gain | $186,000 |

### Energy property is leased

If the energy property is leased, there are no tax ramifications upon the sale of the property. However, there may be substantial nontax ramifications, and there are horror stories of residential sales that have fallen through because of complications due to leased panels on the roof.

***Nontax problems with selling residence with leased solar panels***

Leased panels are considered personal property rather than part of a house. For potential buyers, a solar lease may be a liability rather than an asset and may drive some buyers away. Typically, the buyer must assume the lease payments for what could be a lengthy period of time, depending on how far into the lease the seller is.

If a buyer does want to take over the lease contract, the solar provider must approve the new leaseholder. If the buyer's credit score is short of the solar company's minimum, it could be rejected. However, in the majority of cases, buyers who qualify for a mortgage will also qualify to take over a solar lease.

When selling a solar home, taxpayers may have the following options, depending on their solar provider:

- Transfer the solar energy contract and monthly payments to the new homeowner;
- Prepay the agreement with a one-time discounted payment, which equals all remaining payments and applicable tax under the solar agreement; or
- Move the system to the new home, which may be possible within the same utility district and if the utility company allows it. There may be a fee to move the panels and damage to the roof during removal. (www.bloomberg.com/news/articles/2014-06-23/rooftop-solar-leases-scaring-buyers-when-homeowners-sell; www.latimes.com/business/realestate/la-fi-harney-20150322-story.html; www.solarcity.com/residential/solar-energy-faqs/buying-selling-solar-homes)

## PACE and HERO programs

Both the PACE (Property Assessed Clear Energy) and HERO (Home Energy Renovation Opportunity) programs allow homeowners to finance solar panels through their property tax bills. Although the payments are made through the property tax bill, they are not deductible as property tax payments.

Both programs provide financing for eligible energy-efficient, water-efficient, and renewable energy products. They finance 100% of the cost to purchase and install eligible products. They offer fixed interest rates with amortization periods of 5, 10, 15, or 20 years. The loans are secured by the property.

The HERO program states that it can provide financing for over 50 different energy- and water-efficient products including attic insulation, fuel cell generation systems, air sealing electric vehicle charging stations, attic fans, high-efficiency toilet fixtures, artificial turf, etc.

### Property taxes

Although payments of the loans in the programs are made through the taxpayer's property taxes, the payments are not deductible property taxes. (IRS Information Letter 2012-0018)

### Interest deduction

Note that the loans meet one of the requirements to be deductible as home mortgage interest: They are secured by the residence. In virtually all cases, solar panels would qualify as a substantial improvement to the property, and therefore, associated debt would be acquisition indebtedness.

### The nuts and bolts

In theory, handling this will be simple. If the interest paid on the loan in a tax year is $600 or more, the taxpayer will receive a Form 1098, Mortgage Interest Statement. On the property tax statement, a separate line will show the total amount of payment, including both principal and interest (for example, in San Bernardino County, the line shows "SANBAG Hero Funded 13-14").

In that case, the taxpayer will report the interest payment on Schedule A, line 10, for home mortgage interest reported on Form 1098. The taxpayer will also subtract the amount of payment from the total amount of property tax paid in reporting real estate taxes on Schedule A.

However, two complications may arise that make this relatively simple matter more difficult:

- The interest on the loan may be under $600 due either to the fact that the initial loan was small, or the loan has amortized to the point that interest payments have decreased. Therefore, the taxpayer won't receive a Form 1098; and
- Many clients pay their taxes through an impound account and throw away their "memo copy" of the tax bill.

If the client doesn't receive a Form 1098, the client may need to contact the lender to get the amount of interest paid, or, in the alternative, the taxpayer or (more likely) the preparer will need to prepare a loan amortization schedule to calculate the interest. The taxpayer reports home mortgage interest not reported on a Form 1098 on Schedule A, line 11.

If the client throws away their memo copy of the property tax bill, the client may need to contact the property tax division of the county. In the absence of concrete documentation, the taxpayer (or tax preparer) may need to develop estimates based on amortization schedules for interest and past history for the property tax deduction (these loans are all fixed rates, so the payment and, therefore, the subtraction, should remain the same from year to year).

***Example of HERO program***

Allison makes energy-efficient improvements to her principal residence at a cost of $25,000 and finances the improvements through the HERO program. She gets a 20-year loan at 8%. (**Note:** These are realistic numbers.) In 2016, her payment is $2,500, $2,000 of which is interest. Her total property tax bill for 2016 is $7,600. She receives a 1098 for the $2,000 interest, and there is a line item on her property tax bill for HERO payments of $2,500. All of the work done qualifies as substantial improvements, and she is not over the $1 million limit for home acquisition indebtedness.

Allison will combine the $2,000 interest reported on Form 1098 with other qualifying home mortgage interest reported on Form 1098 and report it on line 10 of Schedule A. If there is no Form 1098, she will report the interest on line 11.

She will subtract the $2,500 HERO payment from her property tax bill of $7,600 and she will report $5,100 for real estate taxes on Schedule A.

## Property tax exclusion

Although the solar panel payments are not deductible as property taxes, the installation of the panels will not result in an increased property tax assessment. In California, a qualified solar energy system is not considered new construction that is subject to reassessment. (R&TC §73)

***Solar client letter***

Dear Client:

Solar energy is growing, and California is leading the way. More and more Californians each year are having solar panels put on their roofs, and the energy cost savings can be substantial.

There can also be substantial tax savings as you may get a tax credit of up to 30% of the cost of buying and installing the panels.

If you are considering putting solar panels on your home, beware that there are many aggressive salespeople who are misrepresenting the tax savings that you may be entitled to. Note the following:

- If you choose to lease panels, that may be the most economical way to go; however, if you lease, you do not get the tax credits;
- If you must install a new roof in connection with installing solar panels, you may not get a tax credit for all or part of the cost of the roof; and
- If you finance the purchase of the solar panels through any of the programs that allow you to make your finance payments through your property taxes, that portion of your property taxes is not deductible as property tax.

There are other tax and nontax considerations regarding whether you should lease or buy your panels or whether you should go with solar at all. Please contact us to discuss.

Sincerely,

Your tax professional

# QUALIFIED PLUG-IN ELECTRIC DRIVE VEHICLES CREDIT — IRC §30D

IRC §30D allows a credit for new qualified plug-in electric drive vehicles (plug-in credit) purchased after December 31, 2010.

The IRS provides on their website a list of vehicles that qualify and the credit amounts:

**Website**
www.irs.gov/Businesses/Qualified-Vehicles-Acquired-after-12-31-2009

***More people going green***

Electric drive vehicle sales figures are on the rise and will likely continue in that direction. In all of 2010, 335 were sold in the U.S., but 118,773 were sold in 2014. (www.electricdrive.org/index.php?ht=d/sp/i/20952/pid/20952)

## The requirements for the credit

In order to qualify for the credit, the vehicle must meet the following specifications:

- The vehicle must be new and must have been acquired by the taxpayer for use or to lease as a lessor (not for resale);
- It must be made by a manufacturer (as opposed to a conventional vehicle that was converted to electric drive after-market);
- It must be treated as a motor vehicle for the purposes of Title II of the Clean Air Act;
- The vehicle must be used predominantly in the United States;
- It must have a gross vehicle weight rating of not more than 14,000 pounds; and
- It must be propelled by a battery that:
  - Has a minimum capacity of five kilowatt hours; and
  - Can be recharged from an external source of electricity.

  (IRC §30D)

For new qualified plug-in electric drive motor vehicles, a motor vehicle is defined as any vehicle manufactured primarily for use on public streets, roads, and highways (not including a vehicle operated exclusively on a rail or rails) and that has at least four wheels.

## $7,500 maximum credit

The *base* credit amount is $2,500 and applies for each qualifying vehicle placed in service by the taxpayer during the tax year.

The second part of the credit is calculated based on the size of the battery. For a vehicle that uses a battery that has at least five kilowatt hours of capacity, the credit is increased by $417, plus $417 for each kilowatt hour of battery capacity over five kilowatt hours. This additional credit amount may not exceed $5,000. So, the maximum credit allowed is $7,500.

A phaseout of the credit begins with respect to a particular manufacturer's vehicles when that manufacturer has sold a total of 200,000 new qualified plug-in electric drive motor vehicles for use in the United States after December 31, 2009.

## Effective dates

The current credit is valid for cars purchased between January 1, 2010, and the end of the phaseout period, which has not yet begun.

## Limitations

The plug-in vehicle credit is not refundable, and excess amounts cannot be carried forward or back. For individual taxpayers, the credit is applied against the taxpayer's AMT and regular tax liability. (IRC §30D(c)(2))

## Form to file

For qualifying vehicles purchased for personal use, claim the credit using Form 8936.

For qualifying vehicles purchased for business use, the credit is claimed on Form 8936 and carried to Form 3800, General Business Credit.

For taxpayers who use a qualifying vehicle for both personal and business purposes, the percentages of each are allocated on Form 8936.

## What if you lease the car?

The credit is available to the owner of the vehicle, which includes the lessor of a vehicle subject to lease. So, if a qualifying vehicle is leased to a taxpayer, the leasing company may claim the credit.

## California offers rebate

California has no comparable credit.

California has implemented the Clean Vehicle Rebate Project (CVRP), funded by the California Environmental Protection Agency's Air Resources Board, which offers a $2,500 rebate to taxpayers who purchase a qualified plug-in electric drive vehicle.

***Federal and California benefit***

Therefore, a qualifying car purchaser can get both a $7,500 federal tax credit and a $2,500 rebate from California. Note that the two benefits are derived differently: The federal credit is claimed on a tax return, and the rebate is claimed by filing a claim with a nontax government agency.

A total of $63.7 million was appropriated for FY 2009–2023 to promote the production and use of zero-emission vehicles (ZEVs), including electric, plug-in hybrid electric, and fuel cell vehicles. These funds were exhausted, and an additional $133 million was approved in 2016. It is anticipated that CVRP rebates will be issued once again starting in December 2016. Funds are available on a first come, first served basis. The CVRP program averages about 100 applications per day, and there has been a waiting list since June. Rebates are available for individuals, nonprofits, government entities, and business owners.

Taxpayers with qualifying vehicles may apply for the rebate directly through the CVRP website:

**Website**
https://cleanvehiclerebate.org/eng

***Home charging installation in California: Contact your local utility***

If you or your clients are thinking about buying a new plug-in vehicle, you may want to contact your local utility to find out what you need to know about utility rates before your purchase. Each utility has different rates for your vehicle and programs to help you get ready. Here is a list:

**San Diego Gas and Electric**

(800) 411-7343
www.sdge.com/clean-energy/residential/home-charging

**Pacific Gas and Electric**

(800) 743-5000
www.pge.com/en_US/residential/solar-and-vehicles/options/clean-vehicles/electric/checklist-for-prospective-buyers.page

**Southern California Edison**

(800) 438-4636
www.sce.com/wps/portal/home/residential/electric-cars

**Sacramento Municipal Utility District (SMUD)**

(888) 742-7683
www.smud.org/en/residential/environment/plug-in-electric-vehicles/

**Los Angeles Department of Water and Power**

(800) 342-5397
www.socalev.org

# SELF-EMPLOYMENT TAX

## RETIREMENT PAYMENTS FROM MARY KAY WERE SUBJECT TO SELF-EMPLOYMENT TAX

Payments that a retired Mary Kay Cosmetics sales consultant received were taxable as self-employment income because the payments were characterized as IRC §409A deferred compensation payments. (***Peterson v. Comm.*** (May 24, 2016) U.S. Court of Appeals, Eleventh Circuit, Case No. 14-15773)

### Background

Christine Peterson was an independent beauty consultant for Mary Kay who reached the level of national sales director (NSD) before she retired in 2009. She earned commissions from purchases of Mary Kay products from her network of independent beauty consultants. She was treated as an independent contractor for tax purposes.

She was eligible to participate in a Mary Kay program called the Family Security Program, under which participating NSDs receive payments after they retire based on a reduced percentage of the sales commissions they received while working at the company. The program agreement stated that the program was a nonqualified deferred compensation arrangement that was intended to meet the requirements of IRC §409A.

The IRS determined that the payments, as nonqualified deferred compensation payments under IRC §409A, were subject to self-employment tax and assessed the taxpayer $33,594. The taxpayer took the case to Tax Court, which upheld the IRS's determination. The taxpayer appealed the Tax Court's decision to the Eleventh Circuit.

### Taxpayer's argument

The taxpayer argued that the payments were not "deferred compensation" but, instead, constituted consideration for the goodwill she developed in her business and for a covenant not to compete. In essence, she argued that it was a sale of her business.

### Court's decision

In response to the taxpayer's argument, the court noted that there was no sales agreement or any other evidence to show a sale of the taxpayer's business. On the contrary, the payments were being made under an agreement that expressly characterized the plan as a deferred compensation plan under IRC §409A. The taxpayer was bound to that characterization under the ***Danielson*** rule, which permits the IRS to bind a taxpayer to the tax consequences of an agreement unless the taxpayer produces "proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc." (***Comm. v. Danielson*** (1967) 378 F.2d 771)

## OIL AND GAS INTEREST SUBJECT TO SELF-EMPLOYMENT TAX

A taxpayer's minority working interest in oil and gas ventures was subject to self-employment tax even though he wasn't actively involved in the operation of the wells. (***Methvin v. Comm.***, TCM 2015-81)

The interests were managed by a partnership in which the taxpayer was a partner, but he had no right of involvement in the management or operation of the ventures. In its operating agreement, the partnership had elected out of partnership treatment (see IRC §761). The taxpayer received income from the working interests on a 1099-MISC and did not receive a K-1. The taxpayer reported income from the oil and gas wells on line 21, but he did not pay self-employment tax on the income.

### Active involvement

The taxpayer argued that his minority working interests were investments that did not rise to the level of a trade or business and that he was not a partner in a partnership. He claimed that his day-to-day involvement with the venture was minimal, and he lacked the knowledge and expertise needed to operate the wells.

However, the court pointed out that even if a taxpayer is not active in the management of a trade or business, the taxpayer may still be liable for self-employment tax if the business is carried out on the taxpayer's behalf by an agent.

### Partnership treatment

Regarding the partnership's election out of Subchapter K (Partners and Partnerships), the court noted that the election did not negate the fact that the entity was still a partnership under IRC §7701(a), and therefore the earnings from the partnership were subject to self-employment tax at the partner level. (IRC §§1401(a), 1402(a))

## Past years under audit

The taxpayer's final argument pointed to two previous tax years that had been under audit. During those years, the taxpayer had income from the same wells, and the IRS did not assess self-employment tax on that income. He maintained the IRS should make the same concession for the tax year at issue in this case.

He lost on this point, too, with the court holding that a concession in a previous year does not preclude the IRS from pursuing the same issue in a later year.

# ELDER ABUSE CASE IS CRACKED OPEN BY VANGUARD CUSTOMER SERVICE REPRESENTATIVE

A taxpayer who worked as a caregiver for an elderly man was found liable for income and self-employment taxes on approximately $1 million in unreported income that she coerced out of him over two years. (***Alhadi v. Comm.***, TCM 2016-74) The taxpayer argued that the payments were all gifts or loans, but the payments failed to meet the definition of either.

## Background

The taxpayer was employed by an elderly man to provide basic care services after his doctors determined that his health had deteriorated to the point that he could no longer care for himself; he suffered from heart problems, hearing and vision loss, mobility problems, and dementia. The taxpayer initially was hired to work for $6,000 per month, but soon she convinced her charge to write checks to her in increasing amounts. She convinced him to pay for her mortgage on a $1 million home she purchased and $73,000 for a pool to be installed.

Her actions were ultimately discovered and reported by the customer service team at Vanguard, where the elderly man's accounts were kept. During a series of phone calls regarding five $100,000 checks that had been written on the man's account, the customer service representatives heard the taxpayer yelling at the man in the background, as well as feeding him information about his accounts and prompting him to sell shares. Vanguard suspended the account and alerted the California Department of Health and Human Services.

## Gift or loan?

Despite the words "gift" and "loan" being written in the memo line of some of the checks, the payments didn't rise to meet the definition of either. The court found that there was no debtor–creditor relationship between the two, and there was no schedule for repayment. Because the taxpayer had used the man's dementia against him to convince him to continue to write checks to her in excess of her wages, the court found no evidence of gifts being made and determined the payments were taxable income.

## Self-employment tax

Self-employment income is income arising from the performance of personal services where an employer–employee relationship does not exist between the payor and the payee. (IRC §§1401, 1402) The elderly man had consistently referred to the money he gave to the taxpayer as payments for her services, and so the court determined that the taxpayer owed self-employment tax on the income as well.

## DISPOSAL OF ASSETS WAS NOT A TRADE OR BUSINESS

A taxpayer's sales of scrap metal were not sales of property held for sale to customers as part of a trade or business. (***Ryther v. Comm.***, TCM 2016-56) Therefore, the income from these sales was not considered net earnings for the purposes of self-employment tax.

The taxpayer was selling off scrap metal that was left over after closing his steel fabricating business. Over the course of many years, the taxpayer generated $300,000 in income from selling off the scrap metal and reported it as miscellaneous income.

### Self-employment income

Generally, sale of property is not included in self-employment income, unless such property is either:

- Stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year; or
- Property held primarily for sale to customers in the ordinary course of the trade or business. (IRC §1402(a)(3)(C)(i) and (ii))

The court determined that the scrap metal sales didn't fall into either of the exceptions, which meant that the taxpayer was not liable for self-employment tax.

The court noted that the taxpayer was not engaged in a trade or business while executing these sales — while they were scrap left over from his defunct business, he was selling the scrap in his individual capacity. The scrap sat in a heap in an empty lot for seven years before the taxpayer began selling it, which the court took to mean that he wasn't holding it for sale in the ordinary course of business. The taxpayer also did not advertise the scrap, nor did he do anything to make it attractive to buyers. Finally, he used the proceeds from the sales to cover living expenses rather than to purchase more inventory to sell.

# HOUSEHOLD EMPLOYEES ("NANNY TAX")

## NANNY TAX THRESHOLD

For 2016, the nanny tax threshold is $2,000. For 2017, it remains $2,000.

This is the applicable wage threshold for purposes of FICA withholding for wages paid to household employees (butlers, maids, drivers, cleaning people, gardeners, babysitters, etc.).

Report and pay the federal nanny tax on Schedule H.

The filing due date for Forms W-2 and Forms W-3 with the Social Security Administration has been accelerated to January 31. (PATH Act of 2015)

**Practice Pointer**

Here are some key points to remember:

- The $2,000 applies to each worker. So, if an individual pays two individuals $1,000 each, there is no requirement to withhold FICA;
- The $2,000 is cumulative, so if the worker earns $2,000, the household employer must withhold on the entire $2,000 (not just the portion that exceeds $2,000);
- The employer also must pay his or her share of FICA;
- The $2,000 is increased each year for inflation;
- If the total cash wages earned by all domestic employees is $1,000 or more in any quarter, the employer must pay FUTA on each worker;
- A household employer is not required to withhold income tax, but the employer and employee may agree to have income taxes withheld; and
- If the worker is the employee of a company hired to perform care, the payments are not subject to payroll taxes. This does not include an individual who is self-employed, even if that individual performs services for multiple employers.

## California nonconformity

California does not allow household employers to pay household employment taxes on the California income tax return. Household employers must register with the EDD and report household employees by filing Form DE 1HW, Registration Form for Employers of Household Workers, when they employ one or more individuals and pay cash wages of $750 or more in a calendar quarter. (UIC §684) Household employers must also file Form DE 34, Report of New Employee(s), for each new employee within 20 days of hire.

Household employers who pay less than $20,000 in wages per year may elect to pay taxes annually by checking the “yes” box in Item I on Form DE 1HW or, if previously registered with the EDD, may complete Form DE 89, Employer of Household Worker Election.

| 2016 AGI Phaseout (2017 in italics where changed from 2016) | | | | | |
|---|---|---|---|---|---|
| **Provision** | **IRC §** | **Joint return** | **Single** | **Head of household** | **Married filing separate** |
| Adoption Credit | 23, 137 | $201,920–$241,920<br>*$203,540–$243,540* | $201,920–$241,920<br>*$203,540–$243,540* | $201,920–$241,920<br>*$203,540–$243,540* | None allowed |
| AMT Exemption Phaseout | 55(d) | $159,700–$494,500<br>*$160,700–$498,900* | $119,700–$335,300<br>*$120,700–$337,900* | $119,700–$335,300<br>*$120,700–$337,900* | $79,850–$247,450<br>*$80,450–$249,450* |
| Child Credit | 24 | $110,000 | $75,000 | $75,000 | $55,000 |
| Dependent Care Credit | 21 | $15,000–$43,000 | $15,000–$43,000 | $15,000–$43,000 | None allowed |
| Education Savings Account | 530 | $190,000–$220,000 | $95,000–$110,000 | $95,000–$110,000 | $95,000–$110,000 |
| Exemption Phaseout | 151 | $311,300<br>*$313,800* | $259,400<br>*$261,500* | $285,350<br>*$287,650* | $155,650<br>*$156,900* |
| American Opportunity Tax Credit (Hope) | 25A | $160,000–$180,000 | $80,000–$90,000 | $80,000–$90,000 | None allowed |
| IRA Deduction with Pension | 219(g) | $98,000–$118,000<br>*$99,000–$119,000* | $61,000–$71,000<br>*$62,000–$72,000* | $61,000–$71,000<br>*$62,000–$72,000* | $0–$10,000 |
| IRA Deduction with Spouse Covered | 219(g)(7) | $184,000–$194,000<br>*$186,000–$196,000* | N/A | N/A | N/A |
| Itemized Deduction Phaseout | 68 | $311,300<br>*$313,800* | $259,400<br>*$261,500* | $285,350<br>*$287,650* | $155,650<br>*$156,900* |
| Lifetime Learning Credit | 25A | $111,000–$131,000<br>*$112,000–$132,000* | $55,000–$65,000<br>*$56,000–$66,000* | $55,000–$65,000<br>*$56,000–$66,000* | None allowed |
| Passive Rental Loss | 469(i) | $100,000–$150,000 | $100,000–$150,000 | $100,000–$150,000 | $50,000–$75,000 |
| | | | | | *(continued)* |

| 2016 AGI Phaseout *(continued)* | | | | | |
|---|---|---|---|---|---|
| **Provision** | **IRC §** | **Joint return** | **Single** | **Head of household** | **Married filing separate** |
| Retirement Contribution<br>50% Credit<br>20% Credit<br>10% Credit | 25B | Up to $37,000<br>Up to $40,000<br>Up to $61,500<br>*$62,000* | Up to $18,500<br>Up to $20,000<br>Up to $30,750<br>*$31,000* | Up to $27,750<br>Up to $30,000<br>Up to $46,125<br>*$46,500* | Up to $18,500<br>Up to $20,000<br>Up to $30,750<br>*$31,000* |
| Roth Conversion | 408A | No limit | No limit | No limit | No limit |
| Roth IRA Contribution | 408A | $184,000–$194,000<br>*$186,000–$196,000* | $117,000–$132,000<br>*$118,000–$133,000* | $117,000–$132,000<br>*$118,000–$133,000* | 0–$10,000 |
| Savings Bond Interest | 135 | $116,300–$146,300<br>*$117,250–$147,250* | $77,550–$92,550<br>*$78,150–$93,150* | $77,550–$92,550<br>*$78,150–$93,150* | None allowed |
| Social Security Benefits | 86(a) | (50%) $32,000<br>(85%) $44,000 | (50%) $25,000<br>(85%) $32,000 | (50%) $25,000<br>(85%) $32,000 | $0 unless live apart |
| Student Loan Interest | 221(b)(2) | $130,000–$160,000<br>*$135,000–$165,000* | $65,000–$80,000<br>*$65,000–$80,000* | $65,000–$80,000<br>*$65,000–$80,000* | None allowed |
| $4,000 Tuition Deduction | 222 | Less than $130,000 | Less than $65,000 | Less than $65,000 | None allowed |
| $2,000 Tuition Deduction | 222 | $130,000–$160,000 | $65,000–$80,000 | $65,000–$80,000 | None allowed |

| Chart of Expiring Tax Provisions | | |
|---|---|---|
| **Expiring December 31, 2016** | | |
| | | |
| **Provision** | **Code section** | **Page reference** |
| Credit for nonbusiness energy property | 25C | 1-48 |
| Credit for qualified fuel cell motor vehicles | 30B | |
| Credit for alternative fuel cell refueling property | 30C | 4-50 |
| Credit for two-wheeled plug-in electric vehicles | 30D | 4-50 |
| Second generation biofuel producer credit | 40 | |
| Incentives for biodiesel and renewable diesel | 40A, 6426, 6427 | |
| Credit for production of Indian coal | 45 | |
| Indian employment tax credit | 45A | 4-50 |
| Credit for construction of new energy efficient homes | 45L | |
| Credit for hybrid solar lighting | 45N | |
| Credit for geothermal heat pump property, small wind property and combined heat and power property | 48 | |
| Credit for qualified fuel cell | 48 | |
| Discharge of indebtedness on principal residence | 108 | 1-13 |
| Deduction of mortgage insurance premiums on qualified residence | 163 | 1-27 |
| Three-year depreciation on race horses | 168 | 4-49 |
| Five-year cost recovery for certain energy property | 168 | |
| Seven-year depreciation for motorsports entertainment complexes | 168 | 4-49 |
| Accelerated depreciation for business property on an Indian reservation | 168 | 4-49 |
| Special depreciation for second generation biofuel plant property | 168 | |
| Energy efficient commercial buildings deduction | 179D | |
| Election to expense mine safe equipment | 179E | 4-49 |
| Expensing costs of film and TV production | 181 | 4-49 |
| Medical expense deduction, age 65 | 213 | 1-24 |
| Deduction for qualified tuition | 222 | 1-20 |
| | | *(continued)* |

| Chart of Expiring Tax Provisions (continued) | | |
|---|---|---|
| **Expiring December 31, 2019** | | |
| **Provision** | **Code section** | **Page reference** |
| New Markets Tax Credit | 45D | |
| Work Opportunity Tax Credit | 51 | |
| Bonus depreciation (begins to phase down for property placed in service after 2017) | 168 | 4-4 |
| Election to accelerate AMT credits in lieu of additional first-year depreciation | 168 | |
| Election of additional depreciation for certain plants bearing fruits and nuts (subject to phasedown) | 168 | |
| **Expiring December 31, 2021** | | |
| **Provision** | **Code section** | **Page reference** |
| Residential energy credit (begins to phase down for property placed in service after 2019) | 25D | 1-48 |
| Business energy credit (begins to phase down for property placed in service after 2019) | 48 | 1-50 |

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Chapter 2

# Foreign Reporting

# FOREIGN REPORTING

## FBAR

### DUE DATES FOR REPORT OF FOREIGN BANK AND FINANCIAL ACCOUNTS (FBAR) CHANGING IN 2017

H.R. 3236, the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (P.L. 114-41) (the Act), changes the due date for FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR), filings. The change is effective for taxable years beginning **after** December 31, 2015.

Under the new law, the due date is April 15, and a taxpayer may file for a six-month extension. Previously, the FBAR was due June 30, and no extensions were available.

#### April 18, 2017

Section 2006(b)(11) of the Act changes the FBAR due date to April 15 to "coincide with the Federal income tax filing." Accordingly, FinCEN has announced that the due date for 2016 FBARs will be April 18, 2017, to be "consistent with the Federal income tax filing due date. Apparently, this means that the original due date for FBARs will coincide with the original due date for personal returns in the future.

**Website**
www.fincen.gov/news/news-releases/new-due-date-fbars-0

#### Extensions

The FinCEN announcement, above, notes that the "Act mandates a maximum six-month extension of the filing deadline." The announcement further states that FinCEN will grant filers "an **automatic** extension to October 15 each year. Accordingly, specific requests for this extension are not required.

**Caution**

Note the sloppiness and inconsistencies in the FinCEN announcement. Strictly speaking, a six-month extension would give filers an extension until October 18, 2017. To be consistent with personal tax filing, filers would get an extension until October 16, 2017 (the extended due date for 2016 personal returns). Thus, it is not clear whether the extended deadline is October 15, 16, or 18.

Further, it is not clear what they mean by "automatic"; that is, do you have to file an extension which is automatically granted or is no filing of an extension required at all? As of this writing, no extension form is available and instructions on the FinCEN website indicate "specific requests for this extension are not required." Further guidance as we approach the deadline would be anticipated and most welcome considering the penalties involved for not filing the form.

#### Taxpayers living abroad

Under the new law, the FBAR filing deadline for U.S. citizens and residents residing abroad will be automatically extended until June 15, with an additional four-month extension available until October 15. Generally, the June 15 FBAR filing deadline will apply to any taxpayer who qualifies for the June 15 deadline to file their income tax return. The law does not provide a second two-month extension until December 15, which was previously available upon request to taxpayers residing abroad to file their income tax returns.

## Must be e-filed

Electronic FBARs are filed through the BSA E-Filing System, not through the IRS. Instructions and registration are available at:

**Website**
http://bsaefiling.fincen.treas.gov/NoRegFBARFiler.html

## Filing by representative (including tax preparer)

Attorneys, CPAs, and enrolled agents can file an FBAR on a client's behalf if the attorney, CPA, or EA has documented authority by the legally obligated filer to sign and submit the FBAR on the filer's behalf. (http://bsaefiling.fincen.treas.gov/FAQs.html#categ_01_quest_04) The attorney, CPA, or EA must enroll with the BSA E-Filing System (however, see Practice Pointer below regarding using tax software to file).

### Authorization

Authorization for a third-party representative to electronically file an FBAR is granted on FinCEN Form 114a, Record of Authorization to Electronically File FBARs, (previously Form 108). (www.fincen.gov/forms/files/FBARE-FileAuth114aRecordSP.pdf) The form is not filed with FinCEN; it is retained by the third-party filer for a minimum of five years.

**Practice Pointer**

Many tax software packages have the ability to e-file FBARs, including printing the authorization form for clients to sign. In using tax software, the preparer is not required to enroll with the BSA E-Filing System.

**Caution**

The penalties for failure to file the FBAR are extreme. A tax professional should get a signed statement from clients as to whether or not the tax professional is going to prepare the FBAR.

# GUIDANCE ISSUED ON OFFSHORE STREAMLINED ACCOUNT COMPLIANCE FOR ELIGIBLE RETIRED CANADIANS

In recently released FAQs, the IRS explains how Canadian retirement plan participants may qualify for FBAR and Foreign Account Tax Compliance Act (FATCA) penalty relief under the IRS's offshore streamlined account compliance program. (Streamlined Filing Compliance Procedures for U.S. Taxpayers Residing in the United States Frequently Asked Questions and Answers, FAQs Nos. 8–11) The FAQs apply to participants in:

- A Canadian registered retirement savings plan (RRSP);
- A registered retirement income fund (RRIF); or
- Other similar Canadian retirement plan.

 

## Background

Under a longstanding treaty between the U.S. and Canada, U.S. citizens or residents who are beneficiaries of a Canadian retirement plan may elect to defer taxes on income accrued in the plan until the income is actually distributed (similar to IRA treatment). (Article XVIII(7), U.S.-Canada Income Tax Treaty) In Rev. Proc. 2014-55, the IRS announced that taxpayers are no longer required to make an affirmative election to defer the tax on the accrued benefits.

Canadian retirement plan participants are still required to disclose these accounts under the various FATCA and FBAR reporting requirements and are also subject to the severe penalties for failure to comply with these mandates. However, they may qualify as "low risk" taxpayers eligible for penalty relief available under the IRS's offshore streamlined account compliance program.

Under this program, U.S. taxpayers residing outside the U.S. may have all penalties waived, while eligible U.S. taxpayers residing in the U.S. are only subject to the miscellaneous offshore penalty. (IR-2014-73) This latter relief is available under the Streamlined Domestic Offshore Procedures. The miscellaneous penalty is equal to 5% of the highest aggregate balance/value of the taxpayer's foreign financial assets that gave rise to the compliance issue.

The FAQs outline the procedures that Canadian retirement plan participants should follow to qualify for relief depending on whether they are residing in the U.S.

## Procedures for U.S. taxpayers residing in the U.S.

An eligible individual under Rev. Proc. 2014-55 who did not make a timely election under the U.S.–Canadian treaty:

- Should not include the Canadian retirement plan in the 5% penalty base;
- Should state that he or she is an "eligible individual" in the narrative statement of facts on Form 14654, Certification by U.S. Person Residing in the United States for Streamlined Domestic Offshore Procedures; and
- May need to report the Canadian retirement plan on FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR), or Form 8938, Statement of Specified Foreign Financial Assets.

However, if the Canadian retirement plan is the taxpayer's only foreign financial asset, the taxpayer does not need to report that interest under the Streamlined Domestic Offshore Procedures but must file any delinquent FBARs and Forms 8938.

Unless the taxpayer receives IRS consent to use the streamlined procedures, the taxpayer is also not eligible to use them if he or she:

- Included the accrued but undistributed earnings in the plan for one or more tax years outside the streamlined process (however, he or she may be able to simply file amended returns in order to be eligible if otherwise eligible for the streamlined process); or
- Failed to report any distributions received from the plan.

A taxpayer who was eligible to defer the accrued plan income and complied with the program requirements but who erroneously included the plan in his or her highest account balance/asset value amount for purposes of computing the 5% miscellaneous offshore penalty may request reconsideration of the penalty amount by completing and signing Form 14708, Streamlined Domestic Penalty Reconsideration Request Related to Canadian Retirement Plans.

### Procedures for U.S. taxpayers residing outside the U.S.

Procedures similar to those outlined above are followed by U.S. taxpayers residing outside the U.S., except that the taxpayer would submit a Form 14653, Certification by U.S. Persons Residing Outside the U.S. For Streamlined Foreign Offshore Procedures, rather than Form 14654.

## ONLINE GAMBLING ACCOUNTS NOT SUBJECT TO FBAR

The Court of Appeals for the Ninth Circuit has found that the account an online gambler used to facilitate transfers of money to an online gambling site is subject to FBAR reporting. However, the actual online gambling services are not financial companies that would subject the taxpayer to FBAR reporting. (***U.S. v. Hom*** (July 26, 2016), U.S. Court of Appeal, Ninth Circuit, Case No. 14-16214)

### Facts

John Hom gambled online and had accounts worth more than $10,000 during the years in question with two online poker companies. During 2006, he gambled online with PokerStars.com and PartyPoker.com.

In 2007, he continued to gamble online, but only through his PokerStars account. He used his account at FirePay.com, an online financial organization that receives, holds, and pays funds on behalf of its customers, to fund his online PokerStars and PartyPoker accounts.

In 2006, FirePay ceased allowing U.S. customers to transfer funds from their FirePay accounts to offshore internet gambling sites, so he used Western Union to transfer money from his Wells Fargo bank accounts.

For 2006, the IRS assessed a $30,000 penalty for each of the three accounts and a $10,000 penalty for 2007 based solely on his PokerStars account.

### Issue

Under the Bank Secrecy Act, U.S. persons must file an FBAR disclosing any financial account in a foreign country with assets in excess of $10,000. (31 USC §5314) The issues in the ***Hom*** case were:

- Whether Hom's accounts with the poker companies were "a bank, securities, or other financial account"; and
- Whether each of these accounts was in a foreign country.

### District court's ruling

Citing the Fourth Circuit's finding in ***Clines*** (***Clines v. Comm.*** (February 27, 1992) 958 F.2d 578), the court stated that under 31 USC §5314, an account with a financial agency is a financial account. Under 31 USC §5312(a)(1), a "person acting for a person" as a financial institution or a person who is "acting in a similar way related to money" is considered a "financial agency."

The court said the same reasoning applied here. Hom opened all three accounts in his name, controlled the accounts, and could carry balances in the accounts. Therefore, FirePay, PokerStars, and PartyPoker functioned as banks.

### Appeals court's ruling

The Ninth Circuit agreed with the district court that the taxpayer's FirePay account fit within the definition of a financial institution for purposes of FBAR filing requirements. FirePay was a money transmitter that served as an intermediary between the taxpayer's personal checking account and the online gambling sites. The taxpayer could carry a balance in his FirePay account, and he could transfer funds at will between his personal checking account and his online gambling accounts. Accordingly, Firepay met the definition of "financial institution" under 31 USC §5321(a)(2)(R).

However, the court found that PokerStars and PartyPoker primarily facilitated online gambling. The taxpayer could carry a balance in his PokerStars and PartyPoker accounts. and, in fact, he needed a balance in order to join online poker games and tournaments. But the funds were used solely to play poker, and the PokerStars and PartyPoker accounts served no other financial purpose. Accordingly, looking to the plain meaning of the term "bank," the court rejected the argument that these entities were functioning as financial institutions.

# FOREIGN ASSET DISCLOSURE — FATCA — FORM 8938

## ENTITIES WILL BE REQUIRED TO FILE FORM 8938 WITH 2016 RETURNS

The filing requirement for Form 8938, Statement of Specified Foreign Financial Assets, previously only applied to individuals. However, the IRS has issued final regulations under IRC §6038D that require certain domestic entities to report their interests in certain foreign financial assets. The final regulations are effective for tax years beginning after December 31, 2015. Accordingly, specified domestic entities will be required to file Form 8938 beginning with their 2016 tax year (their 2016 returns).

***No change until 2016***

Corporations and partnerships were not required to file Form 8938 with the 2015 return.

***Background***

Under FATCA — a part of the 2010 HIRE Act — a U.S. taxpayer who, during the tax year, holds an interest in a specified foreign financial asset must attach to his or her income tax return for that tax year the "required information" (aka Form 8938) for each such asset if the aggregate value of all the individual's specified foreign financial assets exceeds $50,000 on the last day of the tax year or $75,000 at any time during the year. (IRC §6038D)

The regulations and law refer to a "specified person." This term refers to either an individual (specified individual) or a business (specified domestic entity) taxpayer.

FATCA requires disclosure on Form 8938 for:

- Specified persons; *who have an interest in*
- Specified foreign financial assets; *with*
- Values above certain dollar thresholds.

A specified person is a specified individual or a specified domestic entity (see below).

Specified individuals were required to file beginning in 2011. However reporting requirements for specified domestic entities were delayed until after final regulations could be issued. They have now been issued.

## Specified domestic entity

Disclosure requirements apply to domestic entities that are formed or availed of to hold specified foreign financial assets. (Treas. Regs. §1.6038D-6)

A domestic partnership or corporation is formed or availed of to hold specified foreign financial assets if and only if:

- It has an interest in specified foreign financial assets with an aggregate value exceeding $50,000 on the last day of the taxable year or $75,000 at any time during the taxable year;
- It is closely held by a specified individual; and
- At least 50% of its gross income for the year is passive income, or at least 50% of the assets held by it at any time during the year are assets that produce or are held to produce passive income.

The final regulations eliminated the principal purpose test. Under the proposed regulations, a domestic partnership was formed or availed of if:

- At least 10% of its gross income is passive income; or
- At least 10% of its assets held by it at any time during the year are assets that produce passive income; and
- It is formed by a specified individual with a principal purpose of avoiding Form 8938 reporting.

An entity is closely held if at least 80% of the ownership is with one specified individual on the last day of the tax year. (Treas. Regs. §1.6038D-6(b)(1)(ii)) Thus, a domestic corporation is closely held by a specified individual if at least 80% of the total combined voting power of all classes of stock or 80% of the total value of the stock of the corporation is owned by one specified individual. A domestic partnership is closely held if at least 80% of the capital or profits interest in the partnership is held by one specified individual.

In either case, aggregation rules apply. (Treas. Regs §1.6038D-6(b)(3)(iii))

## Passive income

Under the proposed regulations, passive income was defined by listing specific items of income that are treated as passive. (Prop. Treas. Regs. §1.6038D-6(b)(2)) Passive income included:

- Dividends;
- Interest;
- Rents and royalties other than rents and royalties derived in the active conduct of a trade or business;
- Annuities;
- Gains on the sale of passive assets;
- Foreign currency gains; and
- Net income from notional principal contracts.

The final regulations modify slightly the original list by including several modifications to the term passive income in the final IRC §1472 regulations.

For example, the proposed regulations did not specify how to determine whether 50% of a corporation's or partnership's assets are passive assets. The final regulations specify that the passive asset percentage is determined based on a weighted average approach similar to the rule in Treas. Regs. §1.1472-1(c)(1)(iv) using either fair market value or book value.

 

Additionally, the final regulations make clear that rents and royalties derived in the active conduct of a trade or business conducted at least in part by employees of the corporation or partnership will not be considered passive income.

## California conformity — new!

For taxable years beginning on or after January 1, 2016, California conforms to the FATCA information reporting requirements for individuals and certain domestic entities with foreign financial assets, including the minimum $10,000 penalty for failure to file Form 8938 without reasonable cause. (IRC §6038D; AB 154 (Ch. 15-359); R&TC §19141.5(d)) This requirement applies to all individuals and certain domestic entities required to file California income tax returns (not just California residents).

California previously conformed to some of the other foreign information reporting requirements and associated penalties for failure to report:

- Controlling ownership in foreign business entities (Forms 5471 and 8865), with a reduced penalty of $1,000 (from $10,000) (IRC §6038; R&TC §19141.2);
- Foreign-owned U.S. corporations, including the minimum $10,000 penalty (Form 5472) (IRC §6038A; R&TC §19141.5(a));
- Transfers to foreign persons (Form 8865), including the minimum $10,000 penalty (IRC §6038B; R&TC §19141.5(b)); and
- Foreign corporations involved in U.S. business (Form 5472), including the minimum $10,000 penalty. (IRC §6038C; R&TC §19141.5(c))

Again, these penalties apply to all taxpayers required to file California returns, including individual residents, nonresidents, and part-year residents.

In all cases, the information required to be filed with the FTB is a copy of the information filed with the IRS. (R&TC §19141.5(e)) This means taxpayers who are required to file California returns may be subject to penalties of $20,000 ($10,000 federal and $10,000 California) for failures to comply with these information reporting requirements. California conforms to the federal reasonable cause exception, but that is a difficult test to meet.

## How and what do you file?

Taxpayers subject to this new filing requirement are generally those who file federal Form 8938.

For individuals, in most cases, the FTB requires a copy of the federal tax return to be attached to the California return. If the federal return is attached, that will include Form 8938, which will meet the requirement. If not, you must attach the form. We do not believe the FTB will have its own form.

For entity returns, you must attach the appropriate form if a complete federal return is not being filed.

## FATCA AND FBAR REQUIREMENTS

The Form 8938 filing requirement does not replace or otherwise affect a taxpayer's obligation to file Form 114, Report of Foreign Bank and Financial Accounts. Individuals must file each form for which they meet the relevant reporting threshold.

| Comparison of Form 8938 and FBAR Requirements | | |
|---|---|---|
| | **Form 8938, Statement of Specified Foreign Financial Assets** | **Form 114, Report of Foreign Bank and Financial Accounts (FBAR)** |
| **Who must file?** | Specified individuals, which include U.S. citizens, resident aliens, and certain nonresident aliens that have an interest in specified foreign financial assets and meet the reporting threshold<br><br>Domestic entities that are formed or availed of to hold specified foreign financial assets | U.S. persons, which include U.S. citizens, resident aliens, trusts, estates, and domestic entities that have an interest in foreign financial accounts and meet the reporting threshold |
| **Does the United States include U.S. territories?** | No | Yes, resident aliens of U.S. territories and U.S. territory entities are subject to FBAR reporting |
| **Reporting threshold (total value of assets)** | $50,000 on the last day of the tax year or $75,000 at any time during the tax year (higher threshold amounts apply to married individuals filing jointly and individuals living abroad) | $10,000 at any time during the calendar year |
| **When do you have an interest in an account or asset?** | If any income, gains, losses, deductions, credits, gross proceeds, or distributions from holding or disposing of the account or asset are or would be required to be reported, included, or otherwise reflected on your income tax return | **Financial interest:** You are the owner of record or holder of legal title; the owner of record or holder of legal title is your agent or representative; you have a sufficient interest in the entity that is the owner of record or holder of legal title<br>**Signature authority:** You have authority to control the disposition of the assets in the account by direct communication with the financial institution maintaining the account<br>See instructions for further details |

*(continued)*

 

| Comparison of Form 8938 and FBAR Requirements (continued) | | |
|---|---|---|
| | **Form 8938, Statement of Specified Foreign Financial Assets** | **Form 114, Report of Foreign Bank and Financial Accounts (FBAR)** |
| **What is reported?** | Maximum value of specified foreign financial assets, which include financial accounts with foreign financial institutions and certain other foreign nonaccount investment assets | Maximum value of financial accounts maintained by a financial institution physically located in a foreign country |
| **How are maximum account or asset values determined and reported?** | Fair market value in U.S. dollars in accord with the Form 8938 instructions for each account and asset reported<br>Convert to U.S. dollars using the end of the taxable year exchange rate and report in U.S. dollars | Use periodic account statements to determine the maximum value in the currency of the account<br>Convert to U.S. dollars using the end of the calendar year exchange rate, and report in U.S. dollars |
| **When due?** | By due date, including extension, if any, for income tax return | April 15 for 2016 tax year (with nonautomatic six-month extension) |
| **Where to file?** | File with income tax return pursuant to instructions for filing the return | E-file |
| **Penalties** | Up to $10,000 for failure to disclose and an additional $10,000 for each 30 days of nonfiling after IRS notice of a failure to disclose, for a potential maximum penalty of $60,000; criminal penalties may also apply | If nonwillful, up to $10,000; if willful, up to the greater of $100,000 or 50% of account balances; criminal penalties may also apply |

| Types of Foreign Assets and Whether They Are Reportable | | |
|---|---|---|
| | **Form 8938, Statement of Specified Foreign Financial Assets** | **Form 114, Report of Foreign Bank and Financial Accounts (FBAR)** |
| **Financial (deposit and custodial) accounts held at foreign financial institutions** | Yes | Yes |
| **Financial account held at a foreign branch of a U.S. financial institution** | No | Yes |
| **Financial account held at a U.S. branch of a foreign financial institution** | No | No |
| **Foreign financial account for which you have signature authority** | No, unless you otherwise have an interest in the account as described above | Yes, subject to exceptions |
| **Foreign stock or securities held in a financial account at a foreign financial institution** | The account itself is subject to reporting, but the contents of the account are not required to be separately reported | The account itself is subject to reporting, but the contents of the account are not required to be separately reported |
| **Foreign stock or securities not held in a financial account** | Yes | No |
| **Foreign partnership interests** | Yes | No |
| **Indirect interests in foreign financial assets through an entity** | No | Yes, if sufficient ownership or beneficial interest (i.e., a greater than 50% interest) in the entity. See instructions for further detail |
| **Foreign mutual funds** | Yes | Yes |
| **Domestic mutual fund investing in foreign stocks and securities** | No | No |
| **Foreign accounts and foreign non-account investment assets held by foreign or domestic grantor trust for which you are the grantor** | Yes, as to both foreign accounts and foreign nonaccount investment assets | Yes, as to foreign accounts |
| **Foreign-issued life insurance or annuity contract with a cash value** | Yes | Yes |
| **Foreign hedge funds and foreign private equity funds** | Yes | No |
| **Foreign real estate held directly** | No | No |
| **Foreign real estate held through a foreign entity** | No, but the foreign entity itself is a specified foreign financial asset, and its maximum value includes the value of the real estate | No |
| **Foreign currency held directly** | No | No |
| **Precious metals held directly** | No | No |
| **Personal property, held directly, such as art, antiques, jewelry, cars, and other collectibles** | No | No |
| **"Social Security"-type program benefits provided by a foreign government** | No | No |

| **FBAR/FATCA Examples Chart** | | |
|---|---|---|
| **Example facts** | **FBAR** | **Form 8938** |
| Allegra from Alhambra married Jerrold, a prince from Tasmania, and took up residence there. She maintains her U.S. citizenship and files a separate return. All assets are held in Tasmania and Australia in her husband's name, and nothing is owned jointly. She has signature authority over all his accounts, which are collectively worth hundreds of millions of dollars (she uses her signature authority very frequently on shopping sprees) | **Yes**<br>She has signature authority over accounts with aggregate values in excess of $10,000 | **No**<br>She is a specified person. But she has no assets of her own and, therefore, has no specified foreign financial assets. Jerrold is not a U.S. citizen or resident and is not required to file |
| John is a specified person who operates a sole proprietorship that has offices in Canada. The business has checking accounts in Canada with balances aggregating $500,000 at year's end. The accounts are used for purposes of meeting immediate business needs | **Yes**<br>John has financial accounts with balances exceeding $10,000. There is no exception for assets used in business | **No**<br>The checking accounts are foreign financial assets. However, the assets are not held for investment; they are held directly for use in his trade or business |
| Jerry is a specified person who owns stock, not through a U.S. brokerage firm, in a Belgian corporation with a year-end value of $2 million | **No**<br>Stock in a foreign corporation is not a foreign financial asset for FBAR purposes | **Yes**<br>Stock in a foreign corporation is a specified foreign financial asset for Form 8938 purposes |
| Bob is a specified person who lives in Italy and holds cash of $1 million in a savings account in Italy | **Yes**<br>Bob's account is a foreign financial asset valued at more than $10,000 | **Yes**<br>Bob's account is a specified foreign financial asset that exceeds his threshold for a single person living abroad of $200,000 at year-end |
| Larry is a specified person living in Temecula who has 200 Kruggerands in a drawer hidden under his socks (total value of about $340,000) | **No**<br>Foreign currency is not a financial asset for FBAR purposes | **No**<br>Foreign currency is not a specified foreign financial asset for 8938 purposes |
| Jenny is a specified person who owns a condo in Hong Kong and uses it just for vacation purposes. She also keeps a car there along with jewelry and other personal effects. She maintains a checking account with a balance of $3,000 | **No**<br>Directly owned real estate and other personal assets are not foreign financial assets. At no time during the year did the checking account have a value of $10,000 or more | **No**<br>Directly owned real estate and other personal assets are not specified foreign financial assets. At no time during the year did the checking account have a value of $50,000 or more |

***Foreign asset disclaimer***

My (Our) 2016 federal and California income tax returns have been prepared by you.

You have made me aware that U.S. taxpayers are required to report their worldwide income, that is, income from both U.S. and foreign sources. In addition, taxpayers who own, have an interest in, or have signature or other authority over assets in a foreign country may be required to report the existence of the asset.

I (We) have reported to you any and all foreign assets in which we have either ownership or signature authority. This includes, but is not limited to, funds in foreign financial institutions, real estate, rights to foreign pension plans, rights to distributions from foreign estates or trusts, life insurance with cash surrender values, or any other foreign assets. It does not include stocks in foreign countries held by U.S. brokerage companies.

Date: _______________ Taxpayer: ____________________ Spouse: ____________________

*Please read, date, and sign this letter.*

**Caution**

While the above disclaimer may provide limited "CYA" for the tax preparer, the preparer is never allowed to ignore implications or actual knowledge and cannot engage in willful blindness. (Circ. 230, §10.34(c)) For example, if a client seems to live well beyond the means that might be implied by the income reported, and the preparer is aware of the client's strong foreign connections, the preparer is obligated to make reasonable inquiries. (Circ. 230, §10.34(d))

SPIDELL
Tax • Analysis • Education

Chapter 3

# Affordable Care Act

# AFFORDABLE CARE ACT

## INDIVIDUALS

### INDIVIDUAL SHARED RESPONSIBILITY PAYMENTS (PENALTIES) GO UP AGAIN IN 2016

The Patient Protection and Affordable Care Act of 2010 (ACA) provides that U.S. citizens and legal residents must maintain qualifying health coverage for themselves and their dependents or be subject to a "shared responsibility penalty." The penalty began phasing in starting in 2014. (IRC §5000A) The penalty is reported and paid on the individual's personal tax return. The penalty is computed on a monthly basis, although annualized threshold amounts are used for the applicable dollar amount computation. The applicable dollar amount is the *greater* of a flat dollar amount ($695 per person for 2016 and capped at three times that amount) or a percentage (2.5% for 2016) of the taxpayer's household income over the taxpayer's filing threshold.

For most uninsured individuals over the age of 18, the penalty is the greater of the following:

- For 2014, $95 or 1% of household income in excess of the filing threshold, limited to the cost of premiums;
- For 2015, $325 or 2% of household income in excess of the filing threshold;
- **For 2016, $695 or 2.5%** of household income in excess of the filing threshold; and
- For 2017 and thereafter, these amounts will be indexed for inflation.

**Note 1:** The applicable dollar amounts are per member of the household without qualifying coverage where:

- Dependents under the age of 18 are counted as one-half of a member; and
- The maximum applicable dollar amount is 300% ($2,085 or the equivalent of three members of the household).

**Note 2:** For 2016, the filing threshold amounts are $10,350 (single) and $20,700 (joint).

The penalty is capped at the average cost of a bronze health plan. For 2016, the amount is $223 (up from $207) per month per member of the household with a maximum of $1,115 (up from $1,035) for a shared responsibility family with five or more members. (Rev. Proc. 2016-43)

***Example of penalty with dependents***

Jack and Amber file joint in 2014, 2015, and 2016. They have a 10-year-old daughter, Annie, they claim as a dependent. They don't have insurance during the entire year. Their household income in 2014 is $40,300, in 2015 it's $40,600, and in 2016 it's $40,700. For purposes of this example, assume the taxpayer does not qualify for an exemption from the penalty for lack of affordability or for any other reason.

| | 2014 | 2015 | 2016 |
|---|---|---|---|
| Income | $40,300 | $40,600 | $40,700 |
| Filing threshold amount | - 20,300 | - 20,600 | - 20,700 |
| Excess | 20,000 | 20,000 | 20,000 |
| Applicable percentage | 1% | 2% | 2.5% |
| Penalty based on income | 200 | 400 | 500 |
| Applicable dollar amount | 95 | 325 | 695 |
| Household size* | × 2.5 | × 2.5 | × 2.5 |
| Penalty based on dollar amount | 238 | 813 | 1,738 |
| Greater net (penalty amount) | $ 238 | $ 813 | $ 1,738 |

* For purposes of the individual shared responsibility payment, a member of the household under age 18 counts as one-half of a family member.

***Example of penalty for high-income individuals***

Madison and Abby are married in 2016 and have three dependent children all under the age of 18. They earn $820,700. They don't purchase health insurance because "we can't afford to purchase it and also maintain our lifestyle."

| | |
|---|---|
| Income | $820,700 |
| Threshold amount | - 20,700 |
| Excess | 800,000 |
| Applicable percentage | 2.5% |
| Net | 20,000 |
| Applicable dollar amount | 2,085 |
| Greater | 20,000 |
| Bronze plan (5 × 12 × $223) | 13,380 |
| Lesser (penalty) | $ 13,380 |

## TAXPAYERS WHO MARRY DURING THE TAXABLE YEAR

Taxpayers who got married during the year must combine their amounts and may be eligible for an alternative calculation. Like other taxpayers, newly married taxpayers compute their Premium Tax Credit (PTC) using family size and household income as reported on the joint return regardless of whether the taxpayers were married or single during the entire year.

 

## The marriage penalty

A problem exists for the newly married. The problem pertains to the fact that the PTC is computed based on the taxpayer's household income relative to the poverty line. Taxpayers with household incomes at or below 400% of the poverty line for a family of their size are eligible for the credit. For a single person, 400% of the poverty line is at $47,520 of household income. Thus, two single individuals can make, collectively, up to $95,040. However, if they get married, their family size increases to two, and 400% of the poverty line for a family of two is only $64,080.

| **2016 Federal Poverty Line for D.C. Plus All States Except Alaska and Hawaii** | | |
|---|---|---|
| **Size of family** | **Poverty line** | **400%** |
| 1 | $11,880 | $47,520 |
| 2 | $16,020 | $64,080 |
| 3 | $20,160 | $80,640 |
| 4 | $24,300 | $97,200 |

## Alternative method

The regulations provide an alternative computation method. (Treas. Regs. §1.36B-4(b)(2))

Under this alternative method, the credit for the single months is computed separately for each spouse as if each taxpayer's annual income was one-half of the actual household income for the year, the credit for the married months is computed using actual household income for the year, and the PTC is the sum of the credits computed for the single months and the married months.

However, to avoid allowing taxpayers an increased amount of additional PTC resulting from marriage, the final regulations cap any additional PTC allowed to a taxpayer under this alternative computation method at the amount of additional credit that results from computing the credit under the general rule.

**Caution**

In other words, the alternative method cannot be used to increase a PTC refund over any amount computed under the general rule; it can only reduce an amount owed.

**Practice Pointer**

Generally, the alternative method will result in a lower excess PTC.

## Eligibility for the alternative method

A newly married couple is eligible for the alternative method if:

- They were both unmarried on January 1 of the tax year;
- They were married as of the last day of the tax year;
- They file a joint return; and
- Anyone in either premarriage tax family received an advance PTC.

## Why the alternative calculation works

Using the alternative methods, their joint incomes are split and considered separately.

## Electing the alternative calculation

Qualifying taxpayers elect the alternative method by completing Part 5 of Form 8962. The instructions to Form 8962 state that the worksheet to compute the alternative calculation is contained in Publication 964.

**Part 5: Alternative Calculation for Year of Marriage**

Complete line(s) 35 and/or 36 to elect the alternative calculation for year of marriage. For eligibility to make the election, see the instructions for line 9. To complete line(s) 35 and/or 36 and compute the amounts for lines 12–23, see the instructions for this Part 5.

| | | | | | |
|---|---|---|---|---|---|
| 35 | **Alternative entries for your SSN** | **a** Alternative family size | **b** Monthly contribution | **c** Alternative start month | **d** Alternative stop month |
| 36 | **Alternative entries for your spouse's SSN** | **a** Alternative family size | **b** Monthly contribution | **c** Alternative start month | **d** Alternative stop month |

### *Example of newly married*

Tiger Kobe and Elin are unmarried at the beginning of the year. They both go on the exchange and get an advanced PTC. They get married in December of the year. Neither has any dependents.

Their only income is W-2 income.

| | **Tiger** | **Elin** |
|---|---|---|
| W-2 income | $19,000 | $30,000 |
| Annual premiums | $7,200 | $7,200 |
| Second lowest cost silver plan | $6,000 | $6,300 |
| Advanced credit | $4,800 | $5,100 |

**Results**

**Exhibits 1a and 1b:** Had they not gotten married, Tiger would have received a refundable credit of $330, and Elin would have a payback of $750. The net is a payback amount of $420. (They did get married; therefore, they cannot use this outcome.)

**Exhibit 2:** Without using the alternative calculation, they have a payback amount of $2,284.

**Exhibit 3:** With the alternative calculation, they have a payback amount of $864.

# Exhibit 1a — Tiger single

Form **8962**

Department of the Treasury
Internal Revenue Service

## Premium Tax Credit (PTC)

▶ Attach to Form 1040, 1040A, or 1040NR.
▶ Information about Form 8962 and its separate instructions is at *www.irs.gov/form8962.*

OMB No. 1545-0074
2015
Attachment Sequence No. 73

Name shown on your return: TIGER KOBE
Your social security number: 565-55-5555

You cannot claim the PTC if your filing status is married filing separately unless you are eligible for an exception (see instructions). If you qualify, check the box. ☐

## Part I Annual and Monthly Contribution Amount

| | | | |
|---|---|---|---|
| 1 | Tax family size. Enter the number of exemptions from Form 1040 or Form 1040A, line 6d, or Form 1040NR, line 7d | 1 | 1 |
| 2a | Modified AGI. Enter your modified AGI (see instructions) . . . . . 2a 19,000. **b** Enter the total of your dependents' modified AGI (see instructions) . . . | 2b | |
| 3 | Household income. Add the amounts on lines 2a and 2b | 3 | 19,000. |
| 4 | Federal poverty line. Enter the federal poverty line amount from Table 1-1, 1-2, or 1-3 (see instructions). Check the appropriate box for the federal poverty table used. **a** ☐ Alaska **b** ☐ Hawaii **c** ☒ Other 48 states and DC | 4 | 11,670. |
| 5 | Household income as a percentage of federal poverty line (see instructions) | 5 | 162 % |
| 6 | Did you enter 401% on line 5? (See instructions if you entered less than 100%.)<br>☒ **No.** Continue to line 7.<br>☐ **Yes.** You are not eligible to receive PTC. If advance payment of the PTC was made, see the instructions for how to report your excess advance PTC repayment amount. | | |
| 7 | Applicable Figure. Using your line 5 percentage, locate your "applicable figure" on the table in the instructions | 7 | 0.0458 |
| 8a | Annual contribution amount. Multiply line 3 by line 7 . . . . . . . 8a 870. **b** Monthly contribution amount. Divide line 8a by 12. Round to whole dollar amount | 8b | 73. |

## Part II Premium Tax Credit Claim and Reconciliation of Advance Payment of Premium Tax Credit

9 Are you allocating policy amounts with another taxpayer or do you want to use the alternative calculation for year of marriage (see instructions)?
☐ **Yes.** Skip to Part IV, Shared Policy Allocation, or Part V, Alternative Calculation for Year of Marriage. ☒ **No.** Continue to line 10.

10 See the instructions to determine if you can use line 11 or must complete lines 12 through 23.
☒ **Yes.** Continue to line 11. Compute your annual PTC. Then skip lines 12–23 and continue to line 24.
☐ **No.** Continue to lines 12–23. Compute your monthly PTC and continue to line 24.

| Annual Calculation | (a) Annual enrollment premiums (Form(s) 1095-A, line 33a) | (b) Annual applicable SLCSP premium (Form(s) 1095-A, line 33b) | (c) Annual contribution amount (line 8a) | (d) Annual maximum premium assistance (subtract (c) from (b), if zero or less, enter -0-) | (e) Annual premium tax credit allowed (smaller of (a) or (d)) | (f) Annual advance payment of PTC (Form (s) 1095-A, line 33c) |
|---|---|---|---|---|---|---|
| 11 Annual Totals | 7,200. | 6,000. | 870. | 5,130. | 5,130. | 4,800. |
| **Monthly Calculation** | **(a)** Monthly enrollment premiums (Form(s) 1095-A, lines 21–32, column a) | **(b)** Monthly applicable SLCSP premium (Form (s) 1095-A, lines 21–32, column b) | **(c)** Monthly contribution amount (amount from line 8b or alternative marriage monthly contribution) | **(d)** Monthly maximum premium assistance (subtract (c) from (b), if zero or less, enter -0-) | **(e)** Monthly premium tax credit allowed (smaller of (a) or (d)) | **(f)** Monthly advance payment of PTC (Form(s) 1095-A, lines 21–32, column c) |
| 12 January | | | | | | |
| 13 February | | | | | | |
| 14 March | | | | | | |
| 15 April | | | | | | |
| 16 May | | | | | | |
| 17 June | | | | | | |
| 18 July | | | | | | |
| 19 August | | | | | | |
| 20 September | | | | | | |
| 21 October | | | | | | |
| 22 November | | | | | | |
| 23 December | | | | | | |

| | | | |
|---|---|---|---|
| 24 | Total premium tax credit. Enter the amount from line 11(e) or add lines 12(e) through 23(e) and enter the total here | 24 | 5,130. |
| 25 | Advance payment of PTC. Enter the amount from line 11(f) or add lines 12(f) through 23(f) and enter the total here | 25 | 4,800. |
| 26 | Net premium tax credit. If line 24 is greater than line 25, subtract line 25 from line 24. Enter the difference here and on Form 1040, line 69; Form 1040A, line 45; or Form 1040NR, line 65. If you elected the alternative calculation for marriage, enter zero. If line 24 equals line 25, enter zero. Stop here. If line 25 is greater than line 24, leave this line blank and continue to line 27 | 26 | 330. |

## Part III Repayment of Excess Advance Payment of the Premium Tax Credit

| | | | |
|---|---|---|---|
| 27 | Excess advance payment of PTC. If line 25 is greater than line 24, subtract line 24 from line 25. Enter the difference here | 27 | |
| 28 | Repayment limitation (see instructions) | 28 | |
| 29 | Excess advance premium tax credit repayment. Enter the smaller of line 27 or line 28 here and on Form 1040, line 46; Form 1040A, line 29; or Form 1040NR, line 44 | 29 | |

**For Paperwork Reduction Act Notice, see your tax return instructions.** Form **8962** (2015)

 REV 12/04/15 PR

# Exhibit 1b — Elin single

Form **8962** | Department of the Treasury Internal Revenue Service

# Premium Tax Credit (PTC)

▶ Attach to Form 1040, 1040A, or 1040NR.
▶ Information about Form 8962 and its separate instructions is at *www.irs.gov/form8962.*

OMB No. 1545-0074 | **2015** | Attachment Sequence No. **73**

Name shown on your return: ELIN KOBE | Your social security number: 565-55-5555

You cannot claim the PTC if your filing status is married filing separately unless you are eligible for an exception (see instructions). If you qualify, check the box. ☐

## Part I Annual and Monthly Contribution Amount

| | | | |
|---|---|---|---|
| 1 | Tax family size. Enter the number of exemptions from Form 1040 or Form 1040A, line 6d, or Form 1040NR, line 7d | 1 | 1 |
| 2a | Modified AGI. Enter your modified AGI (see instructions) . . . . . 2a 30,000. **b** Enter the total of your dependents' modified AGI (see instructions) . . . | 2b | |
| 3 | Household income. Add the amounts on lines 2a and 2b | 3 | 30,000. |
| 4 | Federal poverty line. Enter the federal poverty line amount from Table 1-1, 1-2, or 1-3 (see instructions). Check the appropriate box for the federal poverty table used. **a** ☐ Alaska **b** ☐ Hawaii **c** ☒ Other 48 states and DC | 4 | 11,670. |
| 5 | Household income as a percentage of federal poverty line (see instructions) | 5 | 257 % |
| 6 | Did you enter 401% on line 5? (See instructions if you entered less than 100%.)<br>☒ **No.** Continue to line 7.<br>☐ **Yes.** You are not eligible to receive PTC. If advance payment of the PTC was made, see the instructions for how to report your excess advance PTC repayment amount. | | |
| 7 | Applicable Figure. Using your line 5 percentage, locate your "applicable figure" on the table in the instructions | 7 | 0.0830 |
| 8a | Annual contribution amount. Multiply line 3 by line 7 . . . . 8a 2,490. **b** Monthly contribution amount. Divide line 8a by 12. Round to whole dollar amount | 8b | 208. |

## Part II Premium Tax Credit Claim and Reconciliation of Advance Payment of Premium Tax Credit

9 Are you allocating policy amounts with another taxpayer or do you want to use the alternative calculation for year of marriage (see instructions)?
☐ **Yes.** Skip to Part IV, Shared Policy Allocation, or Part V, Alternative Calculation for Year of Marriage. ☒ **No.** Continue to line 10.

10 See the instructions to determine if you can use line 11 or must complete lines 12 through 23.
☒ **Yes.** Continue to line 11. Compute your annual PTC. Then skip lines 12–23 and continue to line 24. ☐ **No.** Continue to lines 12–23. Compute your monthly PTC and continue to line 24.

| Annual Calculation | (a) Annual enrollment premiums (Form(s) 1095-A, line 33a) | (b) Annual applicable SLCSP premium (Form(s) 1095-A, line 33b) | (c) Annual contribution amount (line 8a) | (d) Annual maximum premium assistance (subtract (c) from (b), if zero or less, enter -0-) | (e) Annual premium tax credit allowed (smaller of (a) or (d)) | (f) Annual advance payment of PTC (Form (s) 1095-A, line 33c) |
|---|---|---|---|---|---|---|
| 11 Annual Totals | 7,200. | 6,300. | 2,490. | 3,810. | 3,810. | 5,100. |

| Monthly Calculation | (a) Monthly enrollment premiums (Form(s) 1095-A, lines 21–32, column a) | (b) Monthly applicable SLCSP premium (Form (s) 1095-A, lines 21–32, column b) | (c) Monthly contribution amount (amount from line 8b or alternative marriage monthly contribution) | (d) Monthly maximum premium assistance (subtract (c) from (b), if zero or less, enter -0-) | (e) Monthly premium tax credit allowed (smaller of (a) or (d)) | (f) Monthly advance payment of PTC (Form(s) 1095-A, lines 21–32, column c) |
|---|---|---|---|---|---|---|
| 12 January | | | | | | |
| 13 February | | | | | | |
| 14 March | | | | | | |
| 15 April | | | | | | |
| 16 May | | | | | | |
| 17 June | | | | | | |
| 18 July | | | | | | |
| 19 August | | | | | | |
| 20 September | | | | | | |
| 21 October | | | | | | |
| 22 November | | | | | | |
| 23 December | | | | | | |

| | | | |
|---|---|---|---|
| 24 | Total premium tax credit. Enter the amount from line 11(e) or add lines 12(e) through 23(e) and enter the total here | 24 | 3,810. |
| 25 | Advance payment of PTC. Enter the amount from line 11(f) or add lines 12(f) through 23(f) and enter the total here | 25 | 5,100. |
| 26 | Net premium tax credit. If line 24 is greater than line 25, subtract line 25 from line 24. Enter the difference here and on Form 1040, line 69; Form 1040A, line 45; or Form 1040NR, line 65. If you elected the alternative calculation for marriage, enter zero. If line 24 equals line 25, enter zero. Stop here. If line 25 is greater than line 24, leave this line blank and continue to line 27 | 26 | |

## Part III Repayment of Excess Advance Payment of the Premium Tax Credit

| | | | |
|---|---|---|---|
| 27 | Excess advance payment of PTC. If line 25 is greater than line 24, subtract line 24 from line 25. Enter the difference here | 27 | 1,290. |
| 28 | Repayment limitation (see instructions) | 28 | 750. |
| 29 | Excess advance premium tax credit repayment. Enter the smaller of line 27 or line 28 here and on Form 1040, line 46; Form 1040A, line 29; or Form 1040NR, line 44 | 29 | 750. |

**For Paperwork Reduction Act Notice, see your tax return instructions.** Form **8962** (2015)

# Exhibit 2 — Married, no alternative calculation

Form **8962**

Department of the Treasury
Internal Revenue Service

## Premium Tax Credit (PTC)

▶ Attach to Form 1040, 1040A, or 1040NR.

▶ Information about Form 8962 and its separate instructions is at *www.irs.gov/form8962.*

OMB No. 1545-0074

**2015**

Attachment Sequence No. **73**

| Name shown on your return | Your social security number |
|---|---|
| TIGER & ELIN KOBE | 565-55-5555 |

You cannot claim the PTC if your filing status is married filing separately unless you are eligible for an exception (see instructions). If you qualify, check the box. ☐

**Part I** **Annual and Monthly Contribution Amount**

| | | | |
|---|---|---|---|
| 1 | Tax family size. Enter the number of exemptions from Form 1040 or Form 1040A, line 6d, or Form 1040NR, line 7d | 1 | 2 |
| 2a | Modified AGI. Enter your modified AGI (see instructions) . . . . . 2a 49,000. **b** Enter the total of your dependents' modified AGI (see instructions) . . . | 2b | |
| 3 | Household income. Add the amounts on lines 2a and 2b . . . | 3 | 49,000. |
| 4 | Federal poverty line. Enter the federal poverty line amount from Table 1-1, 1-2, or 1-3 (see instructions). Check the appropriate box for the federal poverty table used. **a** ☐ Alaska **b** ☐ Hawaii **c** ☒ Other 48 states and DC | 4 | 15,730. |
| 5 | Household income as a percentage of federal poverty line (see instructions) . . . | 5 | 311 % |
| 6 | Did you enter 401% on line 5? (See instructions if you entered less than 100%.)<br>☒ **No.** Continue to line 7.<br>☐ **Yes.** You are not eligible to receive PTC. If advance payment of the PTC was made, see the instructions for how to report your excess advance PTC repayment amount. | | |
| 7 | Applicable Figure. Using your line 5 percentage, locate your "applicable figure" on the table in the instructions . . | 7 | 0.0956 |
| 8a | Annual contribution amount. Multiply line 3 by line 7 . . . . . . . 8a 4,684. **b** Monthly contribution amount. Divide line 8a by 12. Round to whole dollar amount . . | 8b | 390. |

**Part II** **Premium Tax Credit Claim and Reconciliation of Advance Payment of Premium Tax Credit**

9 Are you allocating policy amounts with another taxpayer or do you want to use the alternative calculation for year of marriage (see instructions)?

☐ **Yes.** Skip to Part IV, Shared Policy Allocation, or Part V, Alternative Calculation for Year of Marriage. ☒ **No.** Continue to line 10.

10 See the instructions to determine if you can use line 11 or must complete lines 12 through 23.

☒ **Yes.** Continue to line 11. Compute your annual PTC. Then skip lines 12–23 and continue to line 24.

☐ **No.** Continue to lines 12–23. Compute your monthly PTC and continue to line 24.

| Annual Calculation | (a) Annual enrollment premiums (Form(s) 1095-A, line 33a) | (b) Annual applicable SLCSP premium (Form(s) 1095-A, line 33b) | (c) Annual contribution amount (line 8a) | (d) Annual maximum premium assistance (subtract (c) from (b), if zero or less, enter -0-) | (e) Annual premium tax credit allowed (smaller of (a) or (d)) | (f) Annual advance payment of PTC (Form (s) 1095-A, line 33c) |
|---|---|---|---|---|---|---|
| 11 Annual Totals | 14,400. | 12,300. | 4,684. | 7,616. | 7,616. | 9,900. |
| **Monthly Calculation** | **(a)** Monthly enrollment premiums (Form(s) 1095-A, lines 21–32, column a) | **(b)** Monthly applicable SLCSP premium (Form (s) 1095-A, lines 21–32, column b) | **(c)** Monthly contribution amount (amount from line 8b or alternative marriage monthly contribution) | **(d)** Monthly maximum premium assistance (subtract (c) from (b), if zero or less, enter -0-) | **(e)** Monthly premium tax credit allowed (smaller of (a) or (d)) | **(f)** Monthly advance payment of PTC (Form(s) 1095-A, lines 21–32, column c) |
| 12 January | | | | | | |
| 13 February | | | | | | |
| 14 March | | | | | | |
| 15 April | | | | | | |
| 16 May | | | | | | |
| 17 June | | | | | | |
| 18 July | | | | | | |
| 19 August | | | | | | |
| 20 September | | | | | | |
| 21 October | | | | | | |
| 22 November | | | | | | |
| 23 December | | | | | | |

| | | | |
|---|---|---|---|
| 24 | Total premium tax credit. Enter the amount from line 11(e) or add lines 12(e) through 23(e) and enter the total here | 24 | 7,616. |
| 25 | Advance payment of PTC. Enter the amount from line 11(f) or add lines 12(f) through 23(f) and enter the total here | 25 | 9,900. |
| 26 | Net premium tax credit. If line 24 is greater than line 25, subtract line 25 from line 24. Enter the difference here and on Form 1040, line 69; Form 1040A, line 45; or Form 1040NR, line 65. If you elected the alternative calculation for marriage, enter zero. If line 24 equals line 25, enter zero. Stop here. If line 25 is greater than line 24, leave this line blank and continue to line 27 . | 26 | |

**Part III** **Repayment of Excess Advance Payment of the Premium Tax Credit**

| | | | |
|---|---|---|---|
| 27 | Excess advance payment of PTC. If line 25 is greater than line 24, subtract line 24 from line 25. Enter the difference here | 27 | 2,284. |
| 28 | Repayment limitation (see instructions) . . . | 28 | 2,500. |
| 29 | Excess advance premium tax credit repayment. Enter the smaller of line 27 or line 28 here and on Form 1040, line 46; Form 1040A, line 29; or Form 1040NR, line 44 . . . | 29 | 2,284. |

**For Paperwork Reduction Act Notice, see your tax return instructions.** Form **8962** (2015)



REV 12/04/15 PR

# Exhibit 3 — Married, alternative calculation

Form **8962** | **Premium Tax Credit (PTC)** | OMB No. 1545-0074

Department of the Treasury
Internal Revenue Service

▶ Attach to Form 1040, 1040A, or 1040NR.
▶ Information about Form 8962 and its separate instructions is at *www.irs.gov/form8962*.

**2015**
Attachment Sequence No. **73**

Name shown on your return: TIGER & ELIN KOBE

Your social security number: 565-55-5555

You cannot claim the PTC if your filing status is married filing separately unless you are eligible for an exception (see instructions). If you qualify, check the box. ☐

## Part I Annual and Monthly Contribution Amount

1 Tax family size. Enter the number of exemptions from Form 1040 or Form 1040A, line 6d, or Form 1040NR, line 7d — **1** 2

2a Modified AGI. Enter your modified AGI (see instructions) . . . . . — **2a** 49,000.

b Enter the total of your dependents' modified AGI (see instructions) . . . — **2b**

3 Household income. Add the amounts on lines 2a and 2b . . . — **3** 49,000.

4 Federal poverty line. Enter the federal poverty line amount from Table 1-1, 1-2, or 1-3 (see instructions). Check the appropriate box for the federal poverty table used. a ☐ Alaska b ☐ Hawaii c ☒ Other 48 states and DC — **4** 15,730.

5 Household income as a percentage of federal poverty line (see instructions) . . . — **5** 311 %

6 Did you enter 401% on line 5? (See instructions if you entered less than 100%.)

☒ **No.** Continue to line 7.

☐ **Yes.** You are not eligible to receive PTC. If advance payment of the PTC was made, see the instructions for how to report your excess advance PTC repayment amount.

7 Applicable Figure. Using your line 5 percentage, locate your "applicable figure" on the table in the instructions . . — **7** 0.0956

8a Annual contribution amount. Multiply line 3 by line 7 . . . . . . . — **8a** 4,684.

b Monthly contribution amount. Divide line 8a by 12. Round to whole dollar amount . . — **8b** 390.

## Part II Premium Tax Credit Claim and Reconciliation of Advance Payment of Premium Tax Credit

9 Are you allocating policy amounts with another taxpayer or do you want to use the alternative calculation for year of marriage (see instructions)?

☒ **Yes.** Skip to Part IV, Shared Policy Allocation, or Part V, Alternative Calculation for Year of Marriage. ☐ **No.** Continue to line 10.

10 See the instructions to determine if you can use line 11 or must complete lines 12 through 23.

☐ **Yes.** Continue to line 11. Compute your annual PTC. Then skip lines 12–23 and continue to line 24.

☐ **No.** Continue to lines 12–23. Compute your monthly PTC and continue to line 24.

| Annual Calculation | (a) Annual enrollment premiums (Form(s) 1095-A, line 33a) | (b) Annual applicable SLCSP premium (Form(s) 1095-A, line 33b) | (c) Annual contribution amount (line 8a) | (d) Annual maximum premium assistance (subtract (c) from (b), if zero or less, enter -0-) | (e) Annual premium tax credit allowed (smaller of (a) or (d)) | (f) Annual advance payment of PTC (Form (s) 1095-A, line 33c) |
|---|---|---|---|---|---|---|
| 11 Annual Totals | | | | | | |

| Monthly Calculation | (a) Monthly enrollment premiums (Form(s) 1095-A, lines 21–32, column a) | (b) Monthly applicable SLCSP premium (Form (s) 1095-A, lines 21–32, column b) | (c) Monthly contribution amount (amount from line 8b or alternative marriage monthly contribution) | (d) Monthly maximum premium assistance (subtract (c) from (b), if zero or less, enter -0-) | (e) Monthly premium tax credit allowed (smaller of (a) or (d)) | (f) Monthly advance payment of PTC (Form(s) 1095-A, lines 21–32, column c) |
|---|---|---|---|---|---|---|
| 12 January | 1,200. | 1,025. | 272. | 753. | 753. | 825. |
| 13 February | 1,200. | 1,025. | 272. | 753. | 753. | 825. |
| 14 March | 1,200. | 1,025. | 272. | 753. | 753. | 825. |
| 15 April | 1,200. | 1,025. | 272. | 753. | 753. | 825. |
| 16 May | 1,200. | 1,025. | 272. | 753. | 753. | 825. |
| 17 June | 1,200. | 1,025. | 272. | 753. | 753. | 825. |
| 18 July | 1,200. | 1,025. | 272. | 753. | 753. | 825. |
| 19 August | 1,200. | 1,025. | 272. | 753. | 753. | 825. |
| 20 September | 1,200. | 1,025. | 272. | 753. | 753. | 825. |
| 21 October | 1,200. | 1,025. | 272. | 753. | 753. | 825. |
| 22 November | 1,200. | 1,025. | 272. | 753. | 753. | 825. |
| 23 December | 1,200. | 1,025. | 272. | 753. | 753. | 825. |

24 Total premium tax credit. Enter the amount from line 11(e) or add lines 12(e) through 23(e) and enter the total here — **24** 9,036.

25 Advance payment of PTC. Enter the amount from line 11(f) or add lines 12(f) through 23(f) and enter the total here — **25** 9,900.

26 Net premium tax credit. If line 24 is greater than line 25, subtract line 25 from line 24. Enter the difference here and on Form 1040, line 69; Form 1040A, line 45; or Form 1040NR, line 65. If you elected the alternative calculation for marriage, enter zero. If line 24 equals line 25, enter zero. Stop here. If line 25 is greater than line 24, leave this line blank and continue to line 27 . — **26**

## Part III Repayment of Excess Advance Payment of the Premium Tax Credit

27 Excess advance payment of PTC. If line 25 is greater than line 24, subtract line 24 from line 25. Enter the difference here — **27** 864.

28 Repayment limitation (see instructions) . . . — **28** 2,500.

29 Excess advance premium tax credit repayment. Enter the smaller of line 27 or line 28 here and on Form 1040, line 46; Form 1040A, line 29; or Form 1040NR, line 44 . . . — **29** 864.

**For Paperwork Reduction Act Notice, see your tax return instructions.** Form **8962** (2015)

## Part IV Shared Policy Allocation

Complete the following information for up to four shared policy allocations. See instructions for allocation details.

**Shared Policy Allocation 1**

| | | | | |
|---|---|---|---|---|
| 30 | (a) Policy Number (Form 1095-A, line 2) | (b) SSN of other taxpayer | (c) Allocation start month | (d) Allocation stop month |
| | | | | |
| | **Allocation percentage applied to monthly amounts** | (e) Premium Percentage | (f) SLCSP Percentage | (g) Advance Payment of the PTC Percentage |
| | | | | |

**Shared Policy Allocation 2**

| | | | | |
|---|---|---|---|---|
| 31 | (a) Policy Number (Form 1095-A, line 2) | (b) SSN of other taxpayer | (c) Allocation start month | (d) Allocation stop month |
| | | | | |
| | **Allocation percentage applied to monthly amounts** | (e) Premium Percentage | (f) SLCSP Percentage | (g) Advance Payment of the PTC Percentage |
| | | | | |

**Shared Policy Allocation 3**

| | | | | |
|---|---|---|---|---|
| 32 | (a) Policy Number (Form 1095-A, line 2) | (b) SSN of other taxpayer | (c) Allocation start month | (d) Allocation stop month |
| | | | | |
| | **Allocation percentage applied to monthly amounts** | (e) Premium Percentage | (f) SLCSP Percentage | (g) Advance Payment of the PTC Percentage |
| | | | | |

**Shared Policy Allocation 4**

| | | | | |
|---|---|---|---|---|
| 33 | (a) Policy Number (Form 1095-A, line 2) | (b) SSN of other taxpayer | (c) Allocation start month | (d) Allocation stop month |
| | | | | |
| | **Allocation percentage applied to monthly amounts** | (e) Premium Percentage | (f) SLCSP Percentage | (g) Advance Payment of the PTC Percentage |
| | | | | |

34 Have you completed shared policy allocation information for all allocated Forms 1095-A?

☐ **Yes.** Multiply the amounts on Form 1095-A by the allocation percentages entered by policy. Add allocated amounts across all allocated policies with amounts for non-allocated policies from Forms 1095-A, if any, to compute a combined total for each month. Enter the combined total for each month on lines 12–23, columns (a), (b), and (f). Compute the amounts for lines 12–23, columns (c)–(e), and continue to line 24.

☐ **No.** See the instructions to report additional shared policy allocations.

## Part V Alternative Calculation for Year of Marriage

Complete line(s) 35 and/or 36 to elect the alternative calculation for year of marriage. For eligibility to make the election, see the instructions for line 9. To complete line(s) 35 and/or 36 and compute the amounts for lines 12–23, see the instructions for this Part V.

| | | (a) Alternative family size | (b) Monthly contribution | (c) Alternative start month | (d) Alternative stop month |
|---|---|---|---|---|---|
| 35 | **Alternative entries for your SSN** | 1 | 136. | 1 | 12 |
| 36 | **Alternative entries for your spouse's SSN** | 1 | 136. | 1 | 12 |

# Smart Worksheets from your 2015 Federal Tax Return

SMART WORKSHEET FOR: Form 8962 Premium Tax Credit

**Month of Marriage for Alternate Marriage Calculation Smart Worksheet**

**A.** If the taxpayer and spouse got married during the year, enter the month they were married. If the alternate marriage calculation produces a better result it will be used . . . . . . . 12

SMART WORKSHEET FOR: Form 8962 Premium Tax Credit

**Alternative Calculation for Year of Marriage Smart Worksheet**

Enter information for alternative calculation for year of marriage. The alternate calculation will be used if it produces a better result.

| | | a. Alternative family size | b. Monthly Contribution | c. Alternative Start Month | d. Alternative End Month |
|---|---|---|---|---|---|
| A | Alternative entries for your SSN | 1 | | 01 | 12 |
| B | Alternative entries for your spouse's SSN | 1 | | 01 | 12 |

| | Monthly Calculation | A. Premium Amount (1095A Lines 21-32A) | B. SLSCP (1095A Lines 21-32B) | C. Monthly Contribution (Line 8b or alt) | D. Monthly Max Prem Assist (B -C) | E. Monthly Prem Tx Cr (Min A or D) | F. Monthly Adv Pmt PTC (1095A Lines 21-32C) |
|---|---|---|---|---|---|---|---|
| 1 | JANUARY | 1,200. | 1,025. | 390. | 635. | 635. | 825. |
| 2 | FEBRUARY | 1,200. | 1,025. | 390. | 635. | 635. | 825. |
| 3 | MARCH | 1,200. | 1,025. | 390. | 635. | 635. | 825. |
| 4 | APRIL | 1,200. | 1,025. | 390. | 635. | 635. | 825. |
| 5 | MAY | 1,200. | 1,025. | 390. | 635. | 635. | 825. |
| 6 | JUNE | 1,200. | 1,025. | 390. | 635. | 635. | 825. |
| 7 | JULY | 1,200. | 1,025. | 390. | 635. | 635. | 825. |
| 8 | AUGUST | 1,200. | 1,025. | 390. | 635. | 635. | 825. |
| 9 | SEPTEMBER | 1,200. | 1,025. | 390. | 635. | 635. | 825. |
| 10 | OCTOBER | 1,200. | 1,025. | 390. | 635. | 635. | 825. |
| 11 | NOVEMBER | 1,200. | 1,025. | 390. | 635. | 635. | 825. |
| 12 | DECEMBER | 1,200. | 1,025. | 390. | 635. | 635. | 825. |
| 13 | **Totals:** Enter the total of column E, lines 1-12, and the total of column F, lines 1-12 . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | | | | | 7,620. | 9,900. |

14 Is line 13, column E, less than line 13, column F?

[X] **Yes.** Excess APTC was paid in 2015. You are eligible to elect the alternative calculation. See Alternative Calculation for Year of Marriage in Pub. 974 to determine if electing the alternative calculation reduces your repayment amount.

[ ] **No.** There was no excess APTC paid in 2015. You are not eligible to elect the alternative calculation.

## Newly married to high-income spouse

The most common question that arises is: What happens if an individual who has low income and is single at the start of the year marries a high-income individual? What seems fair is that the low-income person ought to be able to consider their income and the credit separately for the period before they were married.

Although that method might seem fair, the law wasn't that generous. Unfortunately for those individuals, the best break the law would give them is to allow them to split their income. But, if half of the combined income is over 400% of the poverty line, not only is no credit allowed but there is no payback limitation.

***Example of newly married to high-income earner***

Assume from the example above that Elin doesn't get an advanced credit and has W-2 income of $300,000.

### Results

**Exhibit 4:** They must pay back all of Tiger's advanced credit.

# Exhibit 4 — Married, high income

Form **8962**

Department of the Treasury
Internal Revenue Service

## Premium Tax Credit (PTC)

► Attach to Form 1040, 1040A, or 1040NR.
► Information about Form 8962 and its separate instructions is at *www.irs.gov/form8962.*

OMB No. 1545-0074
2015
Attachment Sequence No. 73

Name shown on your return: TIGER & ELIN KOBE
Your social security number: 565-55-5555

You cannot claim the PTC if your filing status is married filing separately unless you are eligible for an exception (see instructions). If you qualify, check the box. ☐

**Part I Annual and Monthly Contribution Amount**

| | | | |
|---|---|---|---|
| 1 | Tax family size. Enter the number of exemptions from Form 1040 or Form 1040A, line 6d, or Form 1040NR, line 7d | 1 | 2 |
| 2a | Modified AGI. Enter your modified AGI (see instructions) . . . . . | 2a | 319,000. |
| b | Enter the total of your dependents' modified AGI (see instructions) . . . | 2b | |
| 3 | Household income. Add the amounts on lines 2a and 2b . . . | 3 | 319,000. |
| 4 | Federal poverty line. Enter the federal poverty line amount from Table 1-1, 1-2, or 1-3 (see instructions). Check the appropriate box for the federal poverty table used. a ☐ Alaska b ☐ Hawaii c ☒ Other 48 states and DC | 4 | 15,730. |
| 5 | Household income as a percentage of federal poverty line (see instructions) . . . | 5 | 401 % |
| 6 | Did you enter 401% on line 5? (See instructions if you entered less than 100%.) ☐ **No.** Continue to line 7. ☒ **Yes.** You are not eligible to receive PTC. If advance payment of the PTC was made, see the instructions for how to report your excess advance PTC repayment amount. | | |
| 7 | Applicable Figure. Using your line 5 percentage, locate your "applicable figure" on the table in the instructions . . | 7 | |
| 8a | Annual contribution amount. Multiply line 3 by line 7 . . . . . . . . | 8a | |
| b | Monthly contribution amount. Divide line 8a by 12. Round to whole dollar amount . . | 8b | |

**Part II Premium Tax Credit Claim and Reconciliation of Advance Payment of Premium Tax Credit**

9 Are you allocating policy amounts with another taxpayer or do you want to use the alternative calculation for year of marriage (see instructions)?
☐ **Yes.** Skip to Part IV, Shared Policy Allocation, or Part V, Alternative Calculation for Year of Marriage. ☒ **No.** Continue to line 10.

10 See the instructions to determine if you can use line 11 or must complete lines 12 through 23.
☒ **Yes.** Continue to line 11. Compute your annual PTC. Then skip lines 12–23 and continue to line 24.
☐ **No.** Continue to lines 12–23. Compute your monthly PTC and continue to line 24.

| Annual Calculation | (a) Annual enrollment premiums (Form(s) 1095-A, line 33a) | (b) Annual applicable SLCSP premium (Form(s) 1095-A, line 33b) | (c) Annual contribution amount (line 8a) | (d) Annual maximum premium assistance (subtract (c) from (b), if zero or less, enter -0-) | (e) Annual premium tax credit allowed (smaller of (a) or (d)) | (f) Annual advance payment of PTC (Form (s) 1095-A, line 33c) |
|---|---|---|---|---|---|---|
| 11 Annual Totals | | | | | | 5,100. |

| Monthly Calculation | (a) Monthly enrollment premiums (Form(s) 1095-A, lines 21–32, column a) | (b) Monthly applicable SLCSP premium (Form (s) 1095-A, lines 21–32, column b) | (c) Monthly contribution amount (amount from line 8b or alternative marriage monthly contribution) | (d) Monthly maximum premium assistance (subtract (c) from (b), if zero or less, enter -0-) | (e) Monthly premium tax credit allowed (smaller of (a) or (d)) | (f) Monthly advance payment of PTC (Form(s) 1095-A, lines 21–32, column c) |
|---|---|---|---|---|---|---|
| 12 January | | | | | | |
| 13 February | | | | | | |
| 14 March | | | | | | |
| 15 April | | | | | | |
| 16 May | | | | | | |
| 17 June | | | | | | |
| 18 July | | | | | | |
| 19 August | | | | | | |
| 20 September | | | | | | |
| 21 October | | | | | | |
| 22 November | | | | | | |
| 23 December | | | | | | |

| | | | |
|---|---|---|---|
| 24 | Total premium tax credit. Enter the amount from line 11(e) or add lines 12(e) through 23(e) and enter the total here | 24 | |
| 25 | Advance payment of PTC. Enter the amount from line 11(f) or add lines 12(f) through 23(f) and enter the total here | 25 | 5,100. |
| 26 | Net premium tax credit. If line 24 is greater than line 25, subtract line 25 from line 24. Enter the difference here and on Form 1040, line 69; Form 1040A, line 45; or Form 1040NR, line 65. If you elected the alternative calculation for marriage, enter zero. If line 24 equals line 25, enter zero. Stop here. If line 25 is greater than line 24, leave this line blank and continue to line 27 . | 26 | |

**Part III Repayment of Excess Advance Payment of the Premium Tax Credit**

| | | | |
|---|---|---|---|
| 27 | Excess advance payment of PTC. If line 25 is greater than line 24, subtract line 24 from line 25. Enter the difference here | 27 | 5,100. |
| 28 | Repayment limitation (see instructions) . . . | 28 | |
| 29 | Excess advance premium tax credit repayment. Enter the smaller of line 27 or line 28 here and on Form 1040, line 46; Form 1040A, line 29; or Form 1040NR, line 44 . . . | 29 | 5,100. |

**For Paperwork Reduction Act Notice, see your tax return instructions.** Form **8962** (2015)

# BUSINESS

## SHARED RESPONSIBILITY FOR EMPLOYERS IN FULL SWING IN 2016

After a "transition" year in 2015, the shared responsibility for employers in 2016 is in full swing:

- A large employer is one with 50 or more full-time employees (100 in 2015);
- A large employer must offer coverage to 95% of its full-time employees (70% in 2015); and
- The threshold number of employees for purposes of computing the penalty is 30 (80 in 2015).

Beginning in 2015, an applicable large employer (ALE) is liable for an "assessable payment" (technically, a nondeductible excise tax) for not offering affordable basic health insurance coverage to its employees. (IRC §4980H) Generally, an applicable large employer is one with 50 or more full-time employees (or "full-time equivalents") in 2016 and beyond (was 100 in 2015). For purposes of the ACA, a full-time employee is an employee who is employed on average at least 30 hours per week.

Specifically, the assessable payment will be assessed by the IRS if any full-time employee is certified to the employer to have purchased health insurance through a state exchange with respect to which a PTC is allowed to the employee *if* the employer either:

- Does not offer qualified health care coverage for all its full-time employees; or
- Offers minimum essential coverage that is either:
  - Unaffordable to that employee; or
  - Consists of a plan under which the plan's share of the total allowed costs of benefits fails the "minimum value" test.

### What is "unaffordable"?

Coverage is unaffordable to an employee if the employee's share of the premium would cost the employee more than 9.5% of that employee's "household income." It should be noted that the 9.5% is adjusted for inflation after 2014. The rate for 2015 was 9.56% (Rev. Proc. 2014-37), the rate for 2016 is 9.66% (Rev. Proc. 2014-62), and the rate for 2017 is 9.69%. (Rev. Proc. 2016-24)

### W-2 safe harbor

Coverage is treated as affordable to a full-time employee if that employee's required contribution does not exceed 9.5% of the employee's W-2 wages reported in box 1. Application of this safe harbor is determined after the end of the calendar year on an employee-by-employee basis. (Treas. Regs. §54.4980H-5(e)(2)(ii))

### Computing the assessment

Under IRC §4980H, there are two types of assessments that can be imposed. An employer cannot be subject to both for the same calendar month. The penalty is the lesser of:

- **The "(a) penalty":** Large employers that do not offer health insurance (IRC §4980H(a); Treas. Regs. §54.4980H-4); or
- **The "(b) penalty":** Large employers that offer health insurance but have one or more employee(s) who qualify for PTCs. (IRC §4980H(b); Treas. Regs. §54.4980H-5)

## Employers who fail to meet the rules for offering coverage

If an employer fails to offer coverage to its full-time employees and even one employee is certified to have purchased insurance through an exchange and is allowed a PTC, the assessable payment is equal to the product of:

- The "applicable payment amount"; and
- The number of individuals employed by the employer in excess of 30 (80 for 2015) as full-time employees during any month.

The "applicable payment amount" is $166.67 for any month (the equivalent of $2,000 per year). The amount is adjusted for inflation after 2014. The inflation-adjusted amounts are $2,080 for 2015 and $2,160 for 2016.

***Example of assessment for no coverage offered to any employee***

Big Employer fails to offer minimum essential coverage for the entire years of 2015 and 2016 and has 150 full-time employees in both years. Ten of the employees receive the PTC after enrolling in an exchange.

For 2015 and 2016, Big Employer will be assessed an excise tax of $145,600 calculated as follows:

| | **2015** | **2016** |
|---|---|---|
| Total full-time employees | 150 | 150 |
| Threshold | 80 | 30 |
| Subject number | 70 | 120 |
| Applicable payment amount (annualized) | × $ 2,080 | × $ 2,160 |
| Total assessment | $145,600 | $259,200 |

**Note:** The assessment would be the same even if only one employee received the PTC.

## Employers who offer coverage

If an employer offers coverage but one or more employees qualify for health coverage assistance, the assessable payment, computed on a monthly basis, is equal to the product of:

- The number of full-time employees for any month who receive health coverage assistance; and
- 1/12 of $3,000. After 2014, the $3,000 amount is adjusted for inflation. The inflation-adjusted amounts are $3,120 for 2015 and $3,240 for 2016.

The amount is limited to the amount that would be paid if the employer offered no coverage to any employee (as computed above).

***Example of assessment for employer that offers coverage***

Assume from the previous example that Big Employer offers coverage to employees but that 10 of the employees buy insurance on an exchange and receive PTCs because Big Employer's coverage is unaffordable to them.

On an annualized basis, the excise tax in 2016 would be $3,240 × 10 employees = $32,400. The tax is limited to the tax that would be assessed if Big Employer offered no coverage ($259,200 as computed in the previous example).

Therefore, Big Employer's tax is $32,400.

 

### How will an employer know that it owes an employer shared responsibility payment?

Employers will not be required to include the employer shared responsibility payment on any tax return that they file.

The IRS will adopt procedures that ensure employers receive certification that one or more employees have received a PTC. The IRS will contact employers to inform them of their potential liability and provide them an opportunity to respond before any liability is assessed or notice and demand for payment is made. The contact for a given calendar year will not occur until after the due date for employees to file individual tax returns for that year claiming PTCs and after the due date for applicable large employers to file the information returns identifying their full-time employees and describing the coverage that was offered (if any).

If it is determined that an employer is liable for an employer shared responsibility payment after the employer has responded to the initial IRS contact, the IRS will send a notice and demand for payment. That notice will instruct the employer on how to make the payment.

### What does it mean to offer coverage?

An applicable large employer is treated as offering health insurance coverage to its full-time employees and their dependents for a calendar month if, for that month, the employer offers the coverage to at least 95% of its full-time employees. Transition relief provided that it was 70% for 2015 only.

# RECENT NEWS

## DEADLINE FOR PROVIDING HEALTH COVERAGE FORMS EXTENDED

The IRS has extended the deadline for providers of health coverage to furnish individual taxpayers Form 1095-B, Health Coverage, and Form 1095-C, Employer-Provided Health Insurance Offer and Coverage. (Notice 2016-70) Generally, the due date is January 31. However, for the 2016 season, the IRS has extended the due date to March 2, 2017.

The IRS emphasizes that a taxpayer can file their personal returns before receiving the forms. It is up to the professional judgment of a paid preparer to determine whether the client has sufficient documentation in determining whether the client has insurance.

However, a taxpayer must have Form 1095-A in order to claim a Premium Tax Credit. Forms 1095-A, however, are expected to be delivered by January 31, 2017.

## PRESIDENT SIGNS BILL GIVING RELIEF TO HEALTH REIMBURSEMENT ACCOUNTS

On December 13, 2016, the President signed the 21st Century Cures Act (HR 34). Among its almost 1,000 pages of provisions, the bill exempts certain employers who operate Health Reimbursement Accounts (HRAs) from penalties imposed by the ACA.

### Background

Businesses have long relied on Revenue Ruling 61-146, under which reimbursements to an employee for the employee’s share of premiums for medical insurance were treated as contributions by the employer to the health plan. Therefore, they were deductible by the employer and excluded from employee income, much like the direct payments by the employer to the insurance company. The ruling required that the employee provide proof to the employer that the insurance is in force.

However, the IRS issued Notice 2013-54, which stated that health reimbursement plans that cover more than one employee are considered "group health plans" and are subject to the requirements of the ACA. Under the ACA, group health plans are required to provide certain minimum essential benefits. By their very nature, health reimbursement plans cannot meet some of the requirements, including prohibitions on annual limits and preventive care rules.

Employers were shocked to learn that if they continued using such arrangements, starting in 2014 they risked a penalty of $100 per day per participating employee. (IRC §4980D)

The IRS issued Notice 2015-17 providing relief from the penalties, but only for employers that are not applicable large employers and only through June 30, 2015.

***Comment***

One of the principal concerns regarding a cash-for-insurance arrangement was that an employee could get a double tax benefit: the employee could get tax-free cash to buy insurance and then get a Premium Tax Credit by purchasing the insurance on an exchange.

## What was still allowed

There were still two categories of arrangements that remain permissible: HIPAA-excepted arrangements and fully-integrated arrangements.

## HIPAA-excepted arrangements

Generally, HIPAA-excepted benefits include retiree-only plans or plans that cover only dental and vision. Therefore, an employer that does not offer an ACA-compliant health insurance plan to its employees can offer an HRA or flexible spending account (FSA) that offers just HIPAA-excepted benefits to its employees without running afoul of Notice 2013-54.

## Fully-integrated arrangements

An arrangement will qualify if it is integrated with a qualified health plan that is ACA-compliant. There are two integration methods that depend on whether the qualified health plan (QHP) offers minimum value (i.e., whether the plan covers at least 60% of the total allowed cost of benefits).

## HR 34

HR 34 amends the Internal Revenue Code to allow qualified HRAs to operate for small businesses without penalty. The rules require adherence to certain limits, including:

- Funding solely by employer contributions (no salary reduction contributions);
- Benefits capped at $4,950 per year ($10,000 for families);
- Proration of benefits for partial years; and
- Notification and reporting requirements.

Small businesses are businesses that are not "applicable large employers." Therefore, qualifying businesses are generally those with fewer than 50 employees.

The employee must provide documentation to the employer to prove that the employee used the funds to purchase health insurance that provides minimum essential coverage.

In addition, the employee is not eligible for a Premium Tax Credit for any month in which the employee is a participant in a qualifying HRA.

## Retroactive penalty relief

HR 34 retroactively extends the relief provided to small businesses in Notice 2015-17 to any plan year beginning on or before December 31, 2016. The provisions of the bill are effective for years beginning after December 31, 2016.

## Can't mix and match

One provision of HR 34 is that an employer cannot provide a qualifying cash-for-insurance HRA to any employee if the employer provides health coverage to even one employee. This caused alarm among small employers who thought this provision meant that an employer may no longer provide health coverage and have an HRA.

This is not the case. Notice 2013-54 still applies and an employer may provide health insurance and have either an arrangement providing only excepted benefits or a fully-integrated arrangement.

This provision only means that an employer cannot provide health insurance to some employees and a cash-for-insurance HRA to other employees.

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SPIDELL

TAX • ANALYSIS • EDUCATION

Chapter 4

# Business

# BUSINESS

## BUSINESS FILING

### DUE DATES FOR BUSINESS RETURNS CHANGING

H.R. 3236, the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (the Act), changes the due dates for partnership and corporate tax returns, as well as filings of FinCEN Form 114, Individuals Filing the Report of Foreign Bank and Financial Accounts (FBAR). The Act makes the following return due date changes for **taxable years beginning after December 31, 2015:**

- **Partnership returns (Form 1065):** Moved up one month from April 15 to March 15 (two and one-half months after the end of the taxable year). Partnerships will be allowed a six-month extension;
- **C corporation returns (Form 1120):** Moved back one month from March 15 to April 15 (three and one-half months after the end of the taxable year). However, C corporations with tax years ending on June 30 will continue to have a due date of September 15 until taxable years beginning after December 31, 2025 (2025 is not a typo).
- **C corporations extensions:** Automatic extension of six months except June 30 C corporations, which will get a seven-month extension (until 2026 when they revert to six months);
- **S corporations (Form 1120S):** The due date continues to be March 15 (two and one-half months after the end of the taxable year). S corporations may also request a six-month extension (September 15 for calendar year taxpayers); and
- **FBAR (FinCEN Form 114):** Changed from June 30 to April 15, and taxpayers will now be allowed a six-month extension. The taxpayer must request an extension. It is not automatic under rules similar to the rules in Treas. Regs. §25.6075-1(b). The Act also provides specific penalty waiver relief for taxpayers required to file an FBAR for the first time if they file it late by mistake.

These changes are meant to line up with the realities of business. Partnership returns are moved up one month to give partners time to prepare their personal returns (and, for the same reason, S corporation returns continue to be due on March 15).

**Fiduciary returns (trusts, decedent's estates, etc.):** These returns are still due on April 15 (three and one-half months after the end of the tax year).

***Reminder***

The April due date is pushed back to April 18, 2017, because April 15, 2017, falls on a Saturday, and Monday April 17, 2017, is the day Emancipation Day is observed in Washington, D.C.

**Caution**

Notice the two exceptions:

- The original due dates for C corporations is three and one-half months except for June 30 year-ends which get only two and one-half months;
- The extended due date for C corporations is six months except for June 30 C corporations, which get seven months.

The exceptions end in 2026 when those dates fall in line with the original and extended due dates for all other C corporations; that is, three and one-half months for the original due date and six additional months for the extended due dates.

## California partial conformity

AB 1775, signed by the Governor on September 14, 2016, (Ch. 16-348), conforms to most of the federal changes to the original due dates for business entity returns.

Beginning with the 2017 filing season, for both federal and California tax purposes, the due dates for business entity returns are as follows:

**Partnerships:** 15th day of the third month following the close of the taxable year;

**C corporations:** Generally, the 15th day of the fourth month following the close of the taxable year; and

**S corporation:** Remain due by the 15th day of the third month of the taxable year.

### Nonconformity

California does not conform to the federal due dates in two ways:

- No two and one-half month deadline for June 30 C corporations; and
- Different extended deadlines for trusts.

### June 30 C corporations

California has not conformed to the federal delay in the due-date change for C corporations with a fiscal year ending on June 30. For *federal* purposes, these C corporations will continue to file their returns by the 15th day of the *third* month following the close of the fiscal year until taxable years beginning after December 31, 2025.

For *California* purposes, these corporations are not required to file their returns until the 15th day of the *fourth* month following the close of their fiscal year.

### Extended due dates

California has its own extended due date provisions that are independent of the federal extended due date provisions. For the 2016 tax year, California provides an automatic six-month extension for partnerships, S corporations, and C corporations.

| **Business Entity Due Date and Filing Extensions**<br>(*Due dates for 2016 returns in italics*) | | | |
|---|---|---|---|
| **Entity type** | **Due Date** | **Extension period** | **Extension forms** |
| **Partnerships (including SMLLCs owned by a partnership)** | 2½ months<br>*March 15, 2017* | 6 months<br>*September 15, 2017* | **Federal:** Must file Form 7004 by original due date<br>**CA:** Automatic. No form required, but must submit any tax due with Form FTB 3538 |
| **S corporations (including SMLLCs owned by an S corporation)** | 2½ months<br>*March 15, 2017* | 6 months<br>*September 15, 2017* | **Federal:** Must file Form 7004 by original due date<br>**CA:** Automatic. No form required, but must submit any tax due with Form FTB 3539 |
| **C corporations**<br>**(calendar year)** | 3½ months<br>*April 18, 2017* | **Federal:** 6 months<br>*October 16, 2017* | **Federal:** Must file Form 7004 by original due date<br>**CA:** Automatic. No form required, but must submit any tax due with Form FTB 3539 |
| **C corporations (June 30 year)** | **Federal:** 2½ months until 2026, then 3½ months<br>*September 15, 2017*<br>**CA:** 3½ months<br>*October 16, 2017* | **Federal:** 7 months until 2026, then 6 months<br>*April 17, 2018*<br>**CA:** 6 months<br>*April 17, 2018* | See above |
| **C corporations (other than calendar-year and June 30)** | 3½ months | 6 months | See above |
| **Exempt corporations** | 4½ months<br>*May 15, 2017* | 6 months<br>*November 15, 2017* | **Federal:** Must file Form 8868 by original due date<br>**CA:** Automatic. No form required, but must submit any tax due with Form FTB 3539 |
| **Trusts** | 3½ months<br>*April 18, 2017* | **Federal:** 5½ months<br>*September 30, 2017*<br>**CA:** 6 months<br>*October 16, 2017* | **Federal:** Must file Form 7004 by original due date<br>**CA:** Automatic. No form required, but must submit any tax due with Form FTB 3563 |

## W-2s and 1099s

For calendar years after 2015, Forms W-2 and W-3 must be filed with the Social Security Administration by January 31, not February 28. In addition, under the Protecting Americans from Tax Hikes Act of 2015 (PATH Act), Forms 1099-MISC (and related Form 1096) containing nonemployee compensation in box 7 must be filed with the IRS by no later than January 31, no longer February 28. The filing date for IRS Form 1096 and Forms 1099 that do not contain nonemployee compensation remains February 28.

There is a $260 per return federal penalty for failure to file these information returns. If filed within 30 days of the due date, the federal penalty is reduced to $50 per return. (IRC §6721)

### California conformity

California conforms to these due dates.

The corresponding per-return California penalties are as follows:

- **1099s:** $100 for failure to file, $30 if filed within 30 days of the due date; and
- **W-2s:** $50 for failure to file.
  (R&TC §19175; UIC §13052)

# IRC §179 AND DEPRECIATION

## BONUS DEPRECIATION

The PATH Act of 2015 retroactively extended 50% bonus depreciation. Thus, it applies to qualified property placed in service before January 1, 2018 (before January 1, 2019, for certain longer-lived property and transportation property). Unless additional legislation is enacted, bonus depreciation will expire after 2019.

After 2017, bonus depreciation is phased down:

- 40% in 2018; and
- 30% in 2019.

### Rev. Proc. 2016-48

Prior to the PATH Act, bonus depreciation was set to expire for assets placed in service after December 31, 2014. Thus, taxpayers with tax years beginning in 2014 and ending in 2015 may have placed in service otherwise qualifying assets in 2015 and filed their returns unable to claim bonus depreciation on those assets.

Rev. Proc. 2016-48 provides that a taxpayer that did not affirmatively elect out of bonus depreciation on a timely filed return for the 2014 fiscal tax year return for otherwise qualifying assets (i.e., assets that were placed in service in calendar year 2015) may claim bonus depreciation on such assets by either:

- Filing an amended return by the time the taxpayer files the tax return for the immediately succeeding tax year; or
- Filing Form 3115, Application for Change in Accounting Method, under §6.01 of Rev. Proc. 2016-29 for the taxpayer's first or second tax year following its 2014 fiscal tax year.

### Qualified improvement property

Bonus depreciation is enhanced to include as qualified property certain improvements to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date that building was first placed in service.

For detailed discussion on qualified improvement property, see page 4-9.

# IRC §179

The PATH Act of 2015 retroactively made permanent the $500,000 expense limitation and the $2 million phaseout threshold.

In addition, both limitations will be indexed for inflation for tax years beginning after 2015.

### 2016 inflation-adjusted figures

For 2016, the maximum expenses amount remains at $500,000. However, the phaseout threshold is increased by $10,000 to $2,010,000. (Rev. Proc. 2016-14) For 2017, the expense amount increases to $510,000 and the threshold to $2,030,000 (Rev. Proc. 2016-55)

## IRC §179 for real estate

IRC §179 for qualified real estate is made permanent under the PATH Act. As a consequence, the limitation on carryovers of disallowed expensing to tax years beginning after 2015 is removed.

In addition, the $250,000 limitation with respect to qualifying real property is eliminated for tax years beginning after 2015.

For detailed discussion on IRC §179 for real estate, see page 4-7.

## Other IRC §179 provisions

### Computer software

Computer software as qualifying property for IRC §179 purposes is made permanent.

### Revoke election

The ability to revoke an IRC §179 election without the consent of the IRS is made permanent.

## Heating and air conditioning units now qualifying property

The PATH Act of 2015 provides that for property placed in service after December 31, 2015, portable heating and air conditioning units are treated as eligible property for purposes of IRC §179. Heating, ventilating, and air conditioning units used to cool and heat a building do not qualify for expensing because they are permanently affixed structural components generally considered to be section 1250 property. In general, only section 1245 property may be expensed under IRC §179.

## Qualified restaurant, leasehold improvement, and retail improvement property

The PATH Act of 2015 retroactively makes permanent the 15-year straight-line recovery period for qualified restaurant property, leasehold improvements, and retail improvements. For detailed discussion see page 4-7.

## California nonconformity

California never conformed to the enhanced IRC §179 deduction but continues to have a maximum $25,000 expense limit and a $200,000 qualified asset placed-in-service threshold. (R&TC §§17255, 24356)

California never conformed to the federal revocation election or to the computer software provisions. (R&TC §§17255(e) and (f), 24356(b)(6) and (7))

California does not conform to the expansion of the deduction to include heating and air conditioning units.

| Federal/California Comparison of Bonus Depreciation and IRC §179 | | | | | |
|---|---|---|---|---|---|
| | Federal | | | California | |
| **Year** | **IRC §179 maximum** | **Threshold** | **Maximum bonus %** | **IRC §179 maximum** | **Threshold** |
| **2000** | $20,000 | $200,000 | 30%[1] | $20,000 | $200,000 |
| **2001** | $24,000 | $200,000 | 30%[1] | $24,000 | $200,000 |
| **2002** | $24,000 | $200,000 | 30%[1] or 50%[2] | $24,000 | $200,000 |
| **2003** | $100,000 | $400,000 | 50%[2] | $25,000 | $200,000 |
| **2004** | $102,000 | $410,000 | N/A | $25,000 | $200,000 |
| **2005** | $105,000 | $420,000 | N/A | $25,000 | $200,000 |
| **2006** | $108,000 | $430,000 | N/A | $25,000 | $200,000 |
| **2007** | $125,000 | $500,000 | N/A | $25,000 | $200,000 |
| **2008–9/8/10** | $250,000 | $800,000 | 50% | $25,000 | $200,000 |
| **9/9/10–12/31/10** | $500,000 | $2,000,000 | 100%[3] | $25,000 | $200,000 |
| **2011** | $500,000 | $2,000,000 | 100% | $25,000 | $200,000 |
| **2012–2015** | $500,000 | $2,000,000 | 50% | $25,000 | $200,000 |
| **2016** | $500,000 | $2,010,000 | 50% | $25,000 | $200,000 |
| **2017** | $510,000 | $2,030,000 | 50% | $25,000 | $200,000 |
| **2018** | TBA[4] | TBA[4] | 40% | $25,000 | $200,000 |
| **2019** | TBA[4] | TBA[4] | 30% | $25,000 | $200,000 |

[1] 30% was generally for purchases after September 10, 2001, and before May 6, 2003
[2] Generally, for purchases after May 5, 2003, and before January 1, 2005
[3] May elect 50%
[4] Amounts adjusted for inflation annually. Actual amounts are TBA

# ANTIQUES NOT DEPRECIABLE

## CPA not allowed deduction for antique office furniture

A CPA purchased chairs, a desk, paintings, and a clock among other items from antique stores and attempted to deduct the items as office expenses in the year purchased. (***Kilpatrick v. Comm.***, TCM 2016-166) The court disallowed the immediate deduction of the items, but the court also disallowed the capitalization and depreciation of the antique furniture and paintings.

The court noted that relevant provisions of the Code have been interpreted to preclude a depreciation deduction for an asset the value of which is not reduced by the passage of time or by use. (See, e.g., ***Hawkins v. Comm.*** (1983) 713 F.2d 347, aff'g TCM 1982-451.) The court disallowed this CPA a deduction because he could not prove the assets were subject to any wear and tear. The Second Circuit Court of Appeals has held that even though an antique may retain significant value, use of the antique in a taxpayer's trade or business that subjects the asset to any level of wear and tear or obsolescence brings the antique under the purview of the Internal Revenue Code under which it may be depreciated as any other asset used in the taxpayer's trade or business. (***Simon v. Comm.*** (1995) 68 F3d 41)

## PATH ACT ENHANCES DEDUCTIONS FOR QUALIFIED REAL PROPERTY

Prior to 2004, all nonresidential real estate, including improvements, had to be depreciated over a painfully long 39 years. However, the American Jobs Creation Act of 2004 allowed "qualified leasehold improvements" to be depreciated over 15 years.

Subsequent tax acts allowed 15-year depreciation for qualified retail improvements and qualified restaurant property, and opened the door to IRC §179 expensing and bonus depreciation on some or all of those three categories of property. Generally, these were all contained in extender provisions.

The PATH Act of 2015, however, made those provisions permanent and enhanced them with additional changes:

- The $250,000 IRC §179 limit on those three types of property was eliminated;
- It created a new type of property with its own set of rules: "qualified improvement property";
- It made qualified retail improvement property eligible for bonus depreciation; and
- It made air conditioning and heating units eligible as qualified property.

Thus, there are now four categories of qualified real property, each with its own set of requirements and limitations. There are also four possible treatments, each of which may be allowed or required: 39-year depreciation, 15-year depreciation, bonus depreciation, and IRC §179 expensing. To complicate matters further, any improvement may fall into more than one category. Moreover, a project may have multiple improvements, and each of those improvements may fall into multiple categories.

### Qualified leasehold improvement property

A qualified leasehold improvement is any improvement to an interior portion of a building which is nonresidential real estate if:

- The improvement is IRC §1250 property;
- The improvement is made under or pursuant to a lease by the lessee, lessor, or sub-lessee. Leases between related persons aren't treated as leases;
- The portion of the building is to be occupied exclusively by the lessee and/or sub-lessee; and
- The improvement is placed in service more than three years after the building is first placed in service.
  (IRC §168(e)(6)(A); Treas. Regs. §1.168(k)-1(c)(1))

Certain improvements do not qualify:

- Enlargement of the building;
- Any escalator or elevator;
- The internal structural framework of the building; and
- Any improvement to the common area of the building.
  (IRC §168(e)(6)(B))

If a lessor makes improvements that are qualified leasehold improvements, those improvements cannot be qualified leasehold improvements to any subsequent owner (subject to exceptions for nonrecognition and death transfers). (IRC §168(e)(6)(D))

### What can qualify?

Examples of eligible improvements include new non-load-bearing walls, doors, ceilings, floors, and other components used to create new space inside the building. New bathrooms, remodeled lobbies (not common areas), and new offices fall under this category as well.

Improvements for energy efficiency may also qualify and may allow the taxpayer to enjoy other tax benefits. These improvements may include improvements to heating and air conditioning systems, lighting systems, and windows.

### What are the benefits?

Qualified leasehold improvements are eligible for the hat trick: §179 expensing, bonus depreciation, and 15-year depreciation.

***Example of qualified leasehold improvement property***

A calendar-year landlord spends $1 million in 2016 on qualified leasehold improvements for a new tenant. The taxpayer placed in service $100,000 of other property eligible for §179 expensing consisting of office equipment.

The taxpayer elects to take §179 on the leasehold improvements and not the office equipment because the office equipment has shorter recovery periods.

Thus, under §179, the taxpayer can expense $500,000 of the improvements. The taxpayer can then take bonus depreciation of $250,000 (50% of the basis after the §179 deduction). The remaining $250,000 is depreciated over 15 years.

## Qualified retail improvement property

Qualified retail improvement property is any improvement to an interior portion of a nonresidential building if (subject to general exclusions above):

- That portion of the building is open to the general public and is used in the retail trade or business of selling tangible personal property; and
- The improvement is placed in service more than three years after the date the building was first placed in service (aka the three-year rule).
  (IRC §168(e)(8))

Certain improvements do not qualify (same as for qualified leasehold improvements):

- Enlargement of the building;
- Any escalator or elevator;
- The internal structural framework of the building; and
- Any improvement to the common area of the building.
  (IRC §168(e)(8)(C))

### What can qualify?

Improvements made by tenants, or owners even when the building is owner-occupied, qualify.

Retail establishments that qualify include those primarily engaged in the sale of goods, such as grocery stores, clothing stores, and conveniences stores. Establishments primarily engaged in providing services (such as professional services, entertainment, etc.) aren't eligible.

### What are the benefits?

Qualified retail improvements are also eligible for the hat trick: §179 expensing, bonus depreciation, and 15-year depreciation (see the previous example).

## Qualified restaurant property

Qualified restaurant property is any building or improvement to a building if more than 50% of the building's square footage is devoted to the preparation of, and seating for, on-premises consumption of prepared meals. (IRC §168(e)(7))

### What can qualify?

Qualified restaurant property is unique in that it allows the building itself, and not just improvements, to qualify. In addition, a qualifying improvement need not be placed in service more than three years after the building was first placed in service, as is the case with qualified leasehold improvements and qualified retail improvement property.

### What are the benefits?

Qualified restaurant property is eligible for 15-year depreciation and for §179 expensing. It is not eligible for bonus depreciation. However, property that also qualifies as qualified leasehold improvements or qualified improvement property may be eligible for bonus depreciation.

***Example of qualified restaurant property***

Taco Tuesday completes construction on a new restaurant and places it in service in 2016. It is qualified restaurant property. Construction costs are $1 million. The company has no other §179 eligible property. They may expense $500,000 of the construction costs. They will depreciate the balance over 15 years.

## Qualified improvement property

The PATH Act created a new category of qualified real property eligible for bonus depreciation. Qualified improvement property is any improvement to an interior portion of a building that is nonresidential real property if the improvement is placed in service after the date the building was first placed in service. (IRC §168(k)(3)(A))

However, qualified improvement property does not include:

- Enlargement of the building;
- Any escalator or elevator; and
- The internal structural framework of the building.
  (IRC §168(k)(3)(B))

Note that these exclusions are the same as for qualified leasehold improvement and qualified retail improvement property *except that* they don't include the exclusion for common areas.

### What can qualify?

Thus, qualified improvement property liberalizes the rules for property eligible for bonus depreciation in three ways:

- Improvements to common areas are eligible;
- Improvements are eligible for bonus depreciation regardless of whether the property is subject to a lease. Thus, a business that improves property it owns is eligible; and
- Improvements need not be placed in service more than three years after the building is first placed in service.

### What are the benefits?

Qualified improvement property is eligible for bonus depreciation but not for 15-year depreciation or §179 expensing. However, if the qualified improvement property also qualifies as one of the other three categories, it may qualify for 15-year depreciation and/or §179 expensing.

***Qualified improvement property all-encompassing***

Qualified improvement property is broader than qualified leasehold improvements and qualified retail improvement property. By definition, all qualified leasehold improvement property is qualified improvement property. All qualified retail improvement property is also qualified improvement property. But not all qualified improvement property is qualified leasehold improvement property or qualified retail improvement property.

For example, work done prior to three years after the building is placed in service may be qualified improvement property but cannot be qualified leasehold improvement property or qualified retail improvement property.

***Example of qualified improvement property***

A company makes improvements to the interior portion of a building that is qualified improvement property that it owns and uses for its own business. It is not qualified restaurant property and not qualified retail improvement property. The total cost of the improvements is $1 million.

If the improvements are made prior to 2016, the company would have no choice but to depreciate the improvements over 39 years. However, if the improvements are made after 2015, the company may take bonus depreciation. The balance is not eligible for 15-year depreciation because the improvements do not meet the requirements for qualified leasehold improvements, qualified retail improvement property, or qualified restaurant property. The $500,000 balance must be depreciated over 39 years.

## IRC §179 expensing

Prior to the PATH Act, a taxpayer could elect to treat certain qualified real property as §179 property. However, the aggregate amount of the cost of qualified real property that a taxpayer could elect to treat as an expense was subject to an annual limit of $250,000 of qualified real property plus an overall limit of $500,000.

The PATH Act removed the annual $250,000 limitation on the amount of qualified real property that can be expensed for tax years beginning after December 31, 2015. Thus, all §179 property is subject to a single, overall limit of $500,000 (adjusted for inflation after 2016).

Real property improvements eligible for §179 expensing are automatically also eligible for 15-year depreciation. Property that meets the definition of qualified improvement property is also eligible for bonus depreciation.

Generally, taxpayers will elect to expense those items with the longest recovery periods. Thus, taxpayers that acquire both personal property and qualified real property eligible for §179 will choose to expense the qualified real property. The personal property will generally have recovery periods of five or seven years, whereas the qualified real property will have a recovery period of 15 years.

## Bonus depreciation

For property placed in service prior to 2016, bonus depreciation was available for qualified leasehold improvements. It was not available for qualified retail improvement property or qualified restaurant property.

Beginning in 2016, bonus depreciation is available for qualified improvement property. Accordingly, as noted above, leasehold improvement property and qualified retail improvement property automatically qualify. Qualified restaurant property does not automatically qualify for bonus depreciation but may qualify if it meets the definition of qualified improvement property.

**Note:** The bonus depreciation percentage is 50% for property placed in service during 2015, 2016, and 2017, but then phases down to 40% in 2018 and 30% in 2019. After that, it expires unless further extended by Congress. (See page 4-4 for additional information.)

## 15-year depreciation

Certain qualified real property is eligible for 15-year depreciation. As previous noted, qualified improvement property is not eligible, unless it falls into one of the other three categories.

Property eligible for 15-year depreciation is automatically also eligible for §179 expensing. Property that meets the definition of qualified improvement property is also eligible for bonus depreciation.

**Caution**

Fifteen-year depreciation for qualified real property is different from 15-year depreciation for land improvements. Qualified real property uses the straight line method, whereas land improvements are depreciated using the 150% declining balance method.

## Improvements that involve multiple categories of property

Improvements made under certain circumstances may involve multiple categories of property.

***Example of improvements made by landlord***

Landlord owns and operates an office building that is leased to professional tenants. In 2016, Landlord improves and upgrades all of the bathrooms in the building including fixtures, flooring tiling, and other improvements at a cost of $700,000. Of the total $700,000 cost, $600,000 is attributable to bathrooms in space leased by tenants, and $100,000 is attributable to bathrooms in common areas. The improvements are made more than three years after the building is placed in service. Landlord has no other §179 eligible expenditures in 2016.

Landlord may elect to expense $500,000 of the $600,000 expenditures attributable to bathrooms in leased spaces because it is qualified leasehold improvement property. Landlord may take bonus depreciation of the remaining $100,000. The final $50,000 is depreciated over 15 years.

Landlord may take bonus depreciation of $50,000 on the improvements made to the common areas because it is qualified improvement property. The remaining $50,000 is depreciated over 39 years.

In 2016, Landlord gets to write off $602,308 of the total expenditure of $700,000 ($500,000 of §179 expense, $100,000 of bonus depreciation, and $2,308 of depreciation ($50,000 at 15 years and $50,000 at 39 years)).

Assume that the improvements are made before the date three years after the building was first placed in service. In that case, the improvements cannot be treated as qualified leasehold improvements and are not eligible for §179 expensing or 15-year depreciation. However, the improvements do qualify as qualified improvement property eligible for bonus depreciation. In that case, Landlord would write off $350,000 as bonus depreciation and depreciate the balance over 39 years.

## Rev. Proc. 2016-48 and §179 for real estate

Prior to extension in the PATH Act of 2015, if a §179 election was made for qualified real estate for a year beginning before 2014 and the taxpayer was not able to take the full deduction before 2015, then the undeducted amounts were converted from §179 carryover to depreciable property as if the property was newly placed in service at the beginning of the last taxable year beginning in 2014.

Rev. Proc. 2016-48 provides procedures allowing a taxpayer to do either of the following:

- Continue treating the carryover amount as converted from §179 carryover to depreciable property, as described above; or
- Amend its last tax return beginning in 2014 to treat the carryover as a §179 deduction in that year (or treat it as §179 carryover to subsequent years if the full deduction cannot be taken on the amended return).

## Other expensing provisions under the repair regulations

### Remodel-refresh costs

Rev. Proc. 2015-56 outlines a safe harbor method for restaurant and retail store remodeling projects that will allow qualified taxpayers to write off 75% of such costs. Costs of a remodel-refresh project will be allocated 75% to current expense and 25% to improvements. The capitalized portion must be depreciated under one or more general asset account (GAA) elections. Additionally, the taxpayer must include existing buildings and capitalized improvements in new GAA elections and can make late GAA elections.

A qualified taxpayer is one that:

- Sells merchandise at retail; or
- Is in the business of preparing meals, snacks, or beverages.

However, qualified retailers do not include auto dealers, manufactured home dealers, and nonstore retailers.

Unfortunately, this provision seems to be generally limited to only larger taxpayers. There are numerous limitations and complexities including:

- Taxpayers must have an applicable financial statement;
- The space on which remodel-refresh work is done cannot exceed more than 20% of the square footage of the qualified building;
- The capitalized portion of the costs cannot qualify for a partial disposition election;
- The 25% that must be capitalized must be put in a new GAA; and
- Taxpayers must apply for an accounting method change and file Form 3115.

### Safe harbor for small taxpayers with buildings

The regulations include a $10,000 annual safe harbor election for buildings owned or leased with an unadjusted basis no greater than $1 million. (Treas. Regs. §1.263(a)-3(h)) If the taxpayer qualifies and makes the election, the taxpayer is not required to capitalize, and may deduct, qualifying expenditures.

Under this provision, both residential and nonresidential properties qualify.

To qualify, the taxpayer must have average annual gross receipts of $10 million or less during the three preceding taxable years. Gross receipts include income from sales (not reduced by cost of goods sold), services, and investment income.

An eligible building property is one with an unadjusted basis no greater than $1 million. (**Note:** Unadjusted basis does not include land value.)

**Caution**

The expenditures must meet a cliff test. Under the safe harbor, a small taxpayer is not required to capitalize improvements if the total amount paid with respect to an eligible building for repairs, maintenance, improvements, and similar activities, **combined**, does not exceed the lesser of $10,000 or 2% of the building's unadjusted basis.

The election is made *annually* by attaching a statement to the taxpayer's timely filed (including extensions) original return for the tax year for which the property is placed in service.

In the case of a partnership or S corporation, the election is made by the partnership or S corporation and not by the partners or shareholders.

Once made, the annual election is irrevocable.

| **Qualified Real Property Quick Reference Chart<br>Assets Placed in Service on or After January 1, 2016** | | | | |
|---|---|---|---|---|
| **Property type** | **Qualified leasehold improvements (QLI)** | **Qualified retail improvement property (QRIP)** | **Qualified restaurant property (QRP)** | **Qualified improvement property (QIP)** |
| **Recovery period** | 15 SL | 15 SL | 15 SL | 39 SL<br>(see note) |
| **Eligible for bonus** | Yes | Yes | No<br>(see note) | Yes |
| **Three-year rule** | Yes | Yes | No | No |
| **Unrelated party rule** | Yes | No | No | No |
| **Eligible for §179** | Yes | Yes | Yes | No<br>(see note) |
| **Subject to general exclusions[1]** | Yes | Yes | No | Yes |
| **Notes** | Landlord, lessee, or sub-lessee can make improvements.<br>Must be lease between unrelated parties.<br>Does not apply to common areas. | Building can be owner-occupied. | Can be acquired building.<br>Encompasses entire building structure as well as common area.<br>Improvements that also meet the definition of QLI or QIP are eligible for bonus. | Improvements that also meet the definition of QLI, QRIP or QRP are eligible for 15 SL and §179.<br>Applies to common areas. |

[1] All property types except qualified restaurant property are subject to the general exclusions. Improvements that do not qualify under the general exclusions include:

- Enlargement of the building;
- Any escalator or elevator; and
- The internal structural framework of the building.

| Qualified Real Property Quick Definition Guide | |
|---|---|
| **Property type** | **Definition** |
| Qualified leasehold improvements | Any improvement to an interior portion of nonresidential building if (subject to general exclusions above):<br>• The improvement is IRC §1250 property;<br>• The improvement is made under or pursuant to a lease by the lessee, lessor or sub-lessee. Leases between related persons aren't treated as leases;<br>• The portion of the building is to occupied exclusively by the lessee and/or sub-lessee; and<br>• The improvement is placed in service more than three years after the building is first place in service. |
| Qualified retail improvement property | Any improvement to an interior portion of nonresidential building if (subject to general exclusions above):<br>• That portion of the building is open to the general public and is used in the retail trade or business of selling tangible personal property; and<br>• The improvement is place in service more than three years after the date the building was first placed in service. |
| Qualified restaurant property | Any building or improvement to a building if more than 50% of the building's square footage is devoted to the preparation of, and seating for on-premises consumption of, prepared meals. |
| Qualified improvement property | Any improvement to an interior portion of nonresidential building if (subject to general exclusions above):<br>• The improvement is placed in service after the date the building was first placed in service. |

# AUTOMOBILE EXPENSES

## STANDARD MILEAGE RATE

The 2016 standard mileage rate is 54 cents. (Notice 2016-01) The 2017 standard mileage rate is 53.5 cents. (Notice 2016-79)

| Federal Mileage Rates | | | |
|---|---|---|---|
| | **2015** | **2016** | **2017** |
| Business mileage | 57.5 cents | 54 cents | 53.5 cents |
| Charitable mileage | 14 cents | 14 cents | 14 cents |
| Medical and moving mileage | 23 cents | 19 cents | 17 cents |

### Luxury car caps

For vehicles placed in service after December 31, 2014, and before January 1, 2018, the PATH Act of 2015 provides that the limitations under IRC §280F for passenger cars that are qualified property are increased by $8,000. (Act §143(b)(1))

### 2016 limitations

Thus, the first-year limit for a passenger automobile placed in service in 2016 is $11,160. For a light van or truck, the limit is $11,560.

### Phase-downs after 2017

The $8,000 increase will be phased down after 2017:

- $6,400 in 2018; and
- $4,800 in 2019.

After 2019, there will be no increase for passenger cars unless Congress acts to extend bonus depreciation.

### Sport utility and certain other vehicles

Any four-wheeled vehicle designed to carry passengers over public streets, roads, or highways with a gross vehicle weight rating of more than 6,000 pounds but not more than 14,000 pounds has a §179 expensing limit of $25,000. This limit does not apply to any vehicle:

- Designed for seating capacity of more than nine passengers behind the driver's seat;
- Has a cargo area of at least six feet (interior length) in an open area (or for use as an open area but enclosed by a cap) and is not readily accessible from the passenger compartment; or
- Has an integral enclosure, fully enclosing the driver compartment and load carrying device, does not have seating behind the driver's seat, and has no body section more than 30 inches ahead of the windshield.

### Qualified property

A vehicle is "qualified property" for purposes of bonus depreciation if:

- The original use of the vehicle (the first use to which the auto is put) begins with the taxpayer after December 31, 2007;
- The vehicle generally is acquired by the taxpayer after December 31, 2007, and before January 1, 2020 (certain binding contract exceptions apply);
- The vehicle is placed in service by the taxpayer before 2020; and
- The vehicle is used more than 50% for business.

| Maximum Depreciation Amounts (Rev. Proc. 2016-23) | | | | |
|---|---|---|---|---|
| **2016** | **Federal auto without bonus and California auto** | **Federal auto with bonus** | **Federal light truck without bonus and California light truck** | **Federal light truck with bonus** |
| **1st year** | $3,160 | $11,160 | $3,560 | $11,560 |
| **2nd year** | $5,100 | $5,100 | $5,700 | $5,700 |
| **3rd year** | $3,050 | $3,050 | $3,350 | $3,350 |
| **4th year and following** | $1,875 | $1,875 | $2,075 | $2,075 |

**Caution**

The dollar limits must be reduced proportionately if business or investment use of a vehicle is less than 100%.

## Lease inclusion amounts

A taxpayer who leases a business auto may deduct the part of the lease payment representing business or investment use. (Rev. Proc. 2016-23) If business/investment use is 100%, the full lease cost is deductible. But, to ensure that auto lessees cannot avoid the effect of the luxury auto limits, taxpayers must include a certain amount in income during each year of the lease to partially offset the lease deduction. (IRC §280F) The income inclusion amount varies with the initial FMV of the leased auto and the year of the lease and is adjusted for inflation each year.

The lease inclusion applies if the lease term begins in 2016 and if the vehicle's FMV on the first day of the lease exceeds the following value:

| | |
|---|---|
| Autos | $19,000 |
| Trucks and vans | $19,500 |

To view the lease inclusion tables, go to:

**Website**
www.irs.gov/pub/irs-drop/rp-16-23.pdf

## California partial conformity

California conforms to the federal mileage rates, lease inclusion amounts, and maximum allowable auto deduction. However, there is no bonus depreciation, so you must use the federal amounts without bonus depreciation.

# BUSINESS INCOME

## CASH BASIS TAXPAYER ALLOWED TO ACCRUE CERTAIN INCOME

An S corporation was bound by the duty of consistency to recognize income in the year income was reported even though received in the prior year. (***Squeri v. Comm.***, TCM 2016-116)

The corporation was on the cash method. Inappropriately, it annually reported gross receipts in the year deposited into its bank account even when checks were actually received in the prior year.

Upon audit, the IRS moved cash receipts to the year actually received. For 2009, the IRS included checks received in 2009 but deposited in 2010 (and adjusted 2010, accordingly), but they did not exclude the checks that had been received in 2008, but deposited in 2009, because 2008 was a closed year.

The taxpayers argued that gross receipts of over $1.6 million should be excluded from their gross income in 2009 because they were actually received in 2008, and the IRS did not have authority to make adjustments because it was outside the statute of limitations.

***Comment***

The taxpayers were using the IRS's own argument against them in order to make $1.6 million of income permanently disappear.

## Duty of consistency

The Tax Court agreed with the IRS that the taxpayers had a duty of consistency to include in their 2009 returns amounts of 2008 income as they had reported. The application of the duty of consistency doctrine is based on an equitable doctrine that will generally prevent a taxpayer from benefiting from a change in facts or application of law to a specific set of facts after certain tax positions have been taken by the taxpayer. To invoke the duty of consistency, three conditions must be present:

- A representation or report by the taxpayer;
- Reliance by the IRS; and
- An attempt by the taxpayer, after the statute of limitations has expired, to change the previous representation or report in such a way as to harm the government.

In this case, the taxpayer made a clear representation, on which the IRS relied, when it filed Form 1120S claiming it received gross receipts in 2009. Clearly, the taxpayers attempted to change a previous representation after the statute of limitations, which would allow the taxpayers to avoid taxes on $1.6 million of income, a clear harm to the government.

***The 13-month year***

Common situation: Payor makes payments of $1,000 per month to taxpayer. Payor sends a check for $1,000 to taxpayer on December 30, Year 1. Taxpayer doesn't receive the check until January 2, Year 2. Payor issues a 1099 to taxpayer for $13,000 for Year 1, but taxpayer only received $12,000.

According to the instructions for Form 1099-MISC, the taxpayer should report the correct amount of the income actually received and attach an explanation of the difference.

However, many practitioners report the amount per the 1099 and include an adjustment on the miscellaneous expenses line titled "INCORRECT 1099 ADJUSTMENT." Although this method is not in accordance with IRS instructions, the IRS will not find a mismatch between the 1099 amount and the income reported. This may avoid the hassle of having to deal with a CP2000.

# BUSINESS DEDUCTIONS

# TRADE OR BUSINESS EXPENSES, GENERALLY — IRC §162

## Accounting manager could deduct cost of MBA

A controller for a major hotel was allowed a deduction for the cost of his MBA as an unreimbursed employee business expense. (***Kopaigora v. Comm.***, TCS 2016-35)

### Facts

Alex Kopaigora worked as the senior assistant controller for the Marriott hotel at LAX. He was responsible for managing a team of employees, creating budgets, analyzing financial data, producing forecasts and monitoring performance.

In July 2010, he enrolled in an MBA program at BYU. He worked at the hotel weekdays and travelled to Salt Lake City every other weekend to attend classes at BYU.

In April 2011, his employment at the Marriott was terminated. However, he continued working on his MBA and graduated in August 2012.

In September 2012, he was hired as vice president of finance by a financing company. There he was responsible for overseeing department managers, supervising employees in accounting, cash, risk, and business operations. He was also responsible for setting up accounting in accordance with GAAP and enforcing internal controls.

For the year in question, 2011, he deducted over $18,000 as unreimbursed employee expenses including tuition, airfare between California and Utah, meals, and other travel expenses.

### Arguments

The taxpayer's arguments were:

- He was established in the business of corporate finance before starting his MBA;
- He continued to be established during his period of unemployment; and
- The MBA did not qualify him for a new trade or business.

The IRS's arguments were:

- The taxpayer didn't carry on a trade or business in 2011 because he was unemployed;
- The MBA was a general degree that didn't maintain or improve skills in current trade or business; and
- The MBA qualified him for a new trade or business.

### Court's findings

The Tax Court ruled in the taxpayer's favor. The taxpayer was a well-established finance and accounting manager. Citing several taxpayer-friendly cases, the court stated that even though he was unemployed for a portion of the time he worked toward his degree, he continued taking courses to improve his managerial skills. Moreover, during his period of unemployment he actively looked for employment within the corporate finance and accounting field. Although he was hired after he graduated, nothing in the record suggested that the degree was a prerequisite for the job.

***Deductible education expenses***

Education expenses may be deducted if the education:

- Maintains or improves skills required by the individual's employment; or
- Meets the requirements of the individual's employer or the law, as a condition of employment.
  (Treas. Regs. §1.162-5(a))

Education expenses that are not deductible include education that:

- Is required to meet the "minimum educational requirements" in the taxpayer's employment or other trade or business; and
- Qualifies the taxpayer for a new trade or business, no matter if the taxpayer actually obtains employment in the new trade or business.
  (Treas. Regs. §1.162-5(b); see ***Diaz v. Comm.*** (1978) 70 TC 1067)

## Teacher gets home office deduction

The Tax Court held that a school teacher was entitled to deductions for the use of her home office because the nature of her work as an employee required her to use portions of her home as her principal place of business. (***Czekalski v. Comm.***, TCS 2016-56)

### Facts

The taxpayer was employed by the Hayward Unified School District, a part of the California public school system, as a physical education teacher for students with special needs. Her primary responsibilities included planning, developing, and implementing physical education programs for students with special needs. As the only such physical education teacher in the district, she was required to drive her personal vehicle carrying specialized equipment to several schools, working with as many as 96 students weekly. At the end of the each day, the taxpayer returned home where she prepared various required reports that she submitted to Hayward Unified School District.

She used a bedroom as an office, where she prepared reports and performed other administrative tasks for her work and devoted approximately one-half of her garage space to storing physical education equipment used in her work. She did not have an office at any of the schools.

### Home office deduction

To deduct expenses related to the business use of part of the home, the taxpayer must meet specific requirements. For home office expenses to qualify for a deduction, the portion of the home that is used for business must:

1. Be used *exclusively* (however, exceptions exist for storage of inventory and daycare facilities),
2. On a *regular* basis (cannot be occasional or intermittent),
3. In connection with a *trade or business* (cannot be a passive activity such as investment), **and** in one of the following ways:
    a. As the *principal place of business* for any of the taxpayer's trade or business; or
    b. As a place of business for *meeting or dealing with patients, clients, or customers* in the ordinary course of business; or
    c. In connection with the taxpayer's trade or business if the taxpayer is using a *separate structure* that is not attached to the dwelling.

(IRC §280A(c)(1))

**Employees:** In the case of an employee doing work for an employer, the above requirements apply, but with an additional requirement: The required exclusive use must be for the convenience of the employer. (IRC §280A(c)(1))

### Court's holding

The Tax Court held that the taxpayer used the bedroom space and a portion of the garage on a regular basis to conduct the administrative duties of her employment and for the convenience of her employer. The court found that there was no other fixed location where she could conduct such activities because the nature of her employment required her to be constantly on the road traveling among different work locations, and she was required to provide storage space for equipment owned by the school district.

| Methods for Computing Home Office Deduction | |
|---|---|
| **Optional simplified safe harbor method** | **Regular method** |
| Deduction for home office use of a portion of a residence allowed only if that portion is **exclusively** used on a **regular basis** for business purposes | Same |
| Allowable square footage of home used for business (not to exceed 300 square feet). Part-year usage is computed on a monthly basis | Percentage of home used for business |
| Standard $5 per square foot used to determine home business deduction ($1,500 max) | Actual expenses determined and records maintained |
| Home-related itemized deductions claimed in full on Schedule A | Home-related itemized deductions apportioned between Schedule A and business schedule (Schedule C or Schedule F) |
| No depreciation deduction | Depreciation deduction for portion of home used for business |
| No recapture of depreciation upon sale of home | Recapture of depreciation on gain upon sale of home |
| Deduction cannot exceed gross income from business, less business expenses | Same |
| Amount in excess of gross income limitation may **not** be carried over | Amount in excess of gross income limitation may be carried over |
| Loss carryover from use of regular method in prior year may **not** be claimed | Loss carryover from use of regular method in prior year may be claimed if gross income test is met in current year |

## California conformity

California conforms to the office-in-home deduction, including the optional simplified safe harbor method (except for the possible expense difference such as depreciation). Taxpayers may make different federal and California elections. (R&TC §§17024.5, 17201)

## Paying wages to children

Taxpayers get into trouble and lose the deduction for wages where they don't keep records and/or pay children for work that is more in the nature of personal services rather than services that contribute to the profit motive of the business. Treating children in the same manner as unrelated employees can help taxpayers successfully deduct wages paid to children.

### No records of payments

A taxpayer who operated her law office as a sole practitioner was denied deductions for wage payments made to her three young children. (***Fisher v. Comm.***, TCS 2016-10) The children worked at her law office doing tasks such as shredding waste, photocopying, and mailing documents, and the taxpayer claimed deductions in the amounts of $10,435, $10,313, and $8,022 on her Schedule C for tax years 2006–2008. However, the taxpayer didn't keep any payroll records, didn't issue W-2s to the children, and didn't withhold income tax.

Without records, the court wasn't able to determine if the amounts paid to the children were reasonable (as required under IRC §162(a)) because it was impossible to figure how many hours they worked or what the children's hourly rate was. But because it was clear the children had performed some services, the court allowed a deduction of $250 per child per tax year at issue.

### Bonus payments disallowed

Taxpayers who owned several embroidery machine repair businesses and employed their children were denied deductions for large year-end bonus payments. (***Embroidery Express, LLC v. Comm.***, TCM 2016-136)

The bonuses were tied to the performance of the business, and while the taxpayer argued that he would have paid a similar bonus to an unrelated party, the court found no evidence that he had done so. The court noted that the bonuses were more payments for familial support of the children rather than bonuses made through a bona fide employer–employee relationship.

The court allowed a deduction for the small amounts of wages paid to the children throughout the year, finding those amounts reasonable compensation considering the children's ages and the tasks they were performing.

The court allowed deductions for the full amount of wages paid to another older child who had completed school and worked full-time for the taxpayers during the years at issue as a receptionist and whose wages were in line with those paid to past secretaries.

# HOBBY LOSSES — IRC §183

## Background

Deductions in excess of income are disallowed for activities that are not engaged in for profit except for deductions that are allowable under other Code sections, such as interest and taxes. (IRC §183(a) and (b)) An activity is engaged in for profit if, based on all the facts and circumstances, the taxpayer is motivated by profit. (Treas. Regs. §1.183-2(a))

| **Nine Factors Used to Determine Profit Motive (Treas. Regs. §1.183-2(b))** | |
|---|---|
| | **Factor** |
| **1** | Business-like manner of carrying on the business |
| **2** | Taxpayer's expertise or that of his or her advisors |
| **3** | Time and effort expended |
| **4** | Expectation that assets used in the activity may appreciate in value |
| **5** | Success in similar or dissimilar activities |
| **6** | History of income or loss |
| **7** | Amount of occasional profits |
| **8** | Financial status |
| **9** | Elements of personal pleasure |

## Hair-braiding activity was a business, despite recurring losses

A taxpayer was found to have engaged in her hair-braiding activity as a business rather than a hobby, although the court noted that the taxpayer's profit motive may have been "unduly optimistic." (***Dalia v. Comm.***, TCM 2016-71) The court found her reasons for why the business failed to be credible: the economic downturn in 2008–2010, and a change in hair trends that moved away from hair braiding. The taxpayer also credibly testified that if not for a long-term lease obligation, she would have exited the business sooner.

Looking at the nine profit motive factors under the IRC §183 regulations (Treas. Regs. §1.183-2(b)), the only factor that weighed heavily against the taxpayer was the salon's persistent history of losses. The court concluded that the taxpayer operated the activity as a business and allowed substantiated expense deductions.

## Horse training activity was a business

The Seventh Circuit reversed the Tax Court's determination that a restaurant owner's horse training activities were merely a hobby. (***Roberts v. Comm.*** (April 15, 2016) U.S. Court of Appeals for the Seventh Circuit, Case No. 15-3396) The Tax Court had found that the activity was a hobby in the first two tax years that were at issue, but in later years the activity became a business. The appellate court noted that the Tax Court's reasoning amounted to saying that every business starts as a hobby and becomes a business only when it achieves a certain level of profitability.

## Building houses and breeding horses

Taxpayers unsuccessfully argued that their Saddlebred horse and real estate/construction activities were a single activity under IRC §183(d). (***Judah v. Comm.***, TCM 2015-243) If multiple activities are sufficiently interconnected, then a taxpayer may treat the activities as a single activity in order to determine whether the activity is engaged in for profit for the purposes of deducting business-related expenses. (Treas. Regs. §1.183-1(d)(1))

The taxpayers argued that the horse activity was a marketing and customer development platform for their real estate business. The horse activity allowed them exposure to wealthy horse owners who would be potential real estate customers.

In treating the horse activity and the real estate business as a single activity, the taxpayers were able to show a net profit that met the two-out-of-seven-years presumption under IRC §183(d). When the two businesses were separated, the horse activity showed 15 straight years of losses.

The court rejected the taxpayers' argument that the real estate and horse activities were sufficiently interconnected to be treated as a single activity for the purposes of IRC §183. The amount of income they realized as a result of selling real estate to connections made through horse shows was a fraction of what the real estate business brought in overall and "the benefits each activity derived from the other were merely incidental and fortuitous."

The court noted that if the taxpayers wanted to mingle with horse show attendees for networking purposes, a horse business generating $1.5 million in expenses was not necessary; the same could have been achieved for the price of a horse show admission ticket.

Overall, the taxpayers had failed to keep books and records for the horse activity, did not have a business plan, did not alter their business operations after continued losses, and derived significant pleasure from the activity, without doing any of the rigorous work that goes along with raising and training horses.

## Losses from classic car restoration side business upheld

The Tax Court recently held that a patent attorney-taxpayer's losses from his secondary business of restoring classic cars (specializing in Plymouths) were deductible because the taxpayer had a profit motive. (***Main v. Comm.***, TCM 2016-127)

In analyzing all the facts and circumstances related to the auto activity, the court found the following facts compelling in its holding that the taxpayer did have a profit motive:

- The taxpayer advertised online, in print, and at live events;
- The taxpayer traveled to acquire bargain-priced cars;
- The taxpayer maintained a large inventory, reaching 40 cars at its peak;
- The taxpayer sold cars that could not be restored along with their related parts;
- The taxpayer contracted with outsiders to manufacture unavailable parts, both for his own business and to sell to others, but then abandoned the parts manufacturing after he determined it was unprofitable;
- The taxpayer devoted considerable time to the business; and
- The taxpayer's primary patent business was undergoing a downturn during the year at issue, and the taxpayer would not have squandered his hard-earned money on an expensive hobby with no profit motive.

## Amway distributorship not engaged in for profit

The Tax Court has held that a couple could not deduct losses from their Amway distributorship due to lack of profit motive. (***Hess v. Comm.***, TCS 2016-27)

The court focused on the couple's lack of business plan, budget, and the fact that they did not change how they operated their business even after it consistently generated losses. The court also noted that the couple had not started a business venture before, did not consult with any professionals before starting their Amway distributorship, and over the course of seven years, the couple only generated $5,000 of revenue compared to $129,000 of losses. Further, the court did not find it persuasive that the couple carefully maintained receipts to substantiate all their claimed expenses because they did not even maintain records showing how much product they sold or who they sold it to, as any prudent business person would.

## Real estate agent did not have profit motive

A taxpayer was held to not have a profit motive for his real estate sales business. The taxpayer typically held two jobs at any given time because, as he testified, he "did real estate on the side." (***Pouemi v. Comm.***, TCM 2015-161) The taxpayer had Virginia and Maryland real estate licenses, and he was associated with a local realty company as an agent. The taxpayer worked his real estate business on weekends, during evenings, and during "down time" at his day job. The taxpayer earned approximately $60,000 per year at his day job.

The taxpayer maintained no formal ledgers or books for his real estate business and had no business bank account. From 2007 through 2009, the taxpayer only generated $9,457 in commissions revenue from a single sale, compared to $107,396 of claimed, and unsubstantiated, losses. A large portion of the expenses claimed were for automobile expenses. The taxpayer failed to produce a contemporaneous log and failed to meet the strict substantiation requirements of IRC §274(d). The court went on to say that many of the other unsubstantiated expenses were "completely implausible on their face."

The Tax Court held that the taxpayer did not engage in his real estate activity with the primary and genuine purpose of making a profit because he did not conduct the activity in a businesslike manner, he produced no evidence that he developed expertise in, or devoted meaningful time or effort to, his real estate activity, and he never earned a profit from his real estate activity. In the court's opinion, the fact that the taxpayer had a full time job only paying $60,000 per year, yet he reported losses of $97,939 for 2007 through 2009, indicated that he was merely using the real estate activity as an attempt to reduce his regular income tax liability for each year to zero.

## IRS may start targeting Schedule C businesses

In May, the Treasury Inspector General for Tax Administration (TIGTA) issued its audit report of the IRS's methods of addressing taxpayers who take business tax deductions for activities not engaged in for profit. The TIGTA found that the IRS does not maximize the use of all relevant and available taxpayer information to identify hobby losses, and when returns containing potential hobby losses are selected for audit, the examiners do not always address the hobby loss issues.

The TIGTA recommended that the IRS take the following steps:

- Make use of its research capabilities to identify high-income individual returns with multiyear Schedule C losses and other factors that indicate the taxpayer may not have a profit or capital gain motive for the activity; and
- Emphasize the importance of the required checks of filed tax returns in preliminary determination of whether to pursue a hobby loss issue and provide tools to assist examiners in documenting their conclusions.

In response to the report, IRS management agreed with the TIGTA's recommendations and plans to take corrective action. Practitioners with Schedule C clients with multiple years of losses, especially when the taxpayer may have another source of income, can expect an increased likelihood of audit in this area. The following case, while not a hobby loss case, is a great illustration of where the IRS should have made a hobby loss argument against the taxpayer.

## Attorney allowed deductions for farming activity

An attorney was found to be materially participating in farming activities, despite his lack of contemporaneous records, and was allowed deductions attributable to the activity. (***Leland v. Comm.***, TCM 2015-240) Generally, a taxpayer is treated as materially participating in an activity if he or she is involved in the operations of the activity on a basis which is regular, continuous, and substantial. (IRC §469(h)(1)) One of seven tests must be met to establish material participation (see below). (Treas. Regs. §1.469-5T(a))

The IRS's main argument against the taxpayer's records was that they were not contemporaneous. However, under Treas. Regs. §1.469-5T(f)(4), a taxpayer can still prove participation through any reasonable means, including using appointment books, calendars, or other narrative summaries. (Treas. Regs. §1.469-5T(f)(4))

The taxpayer was able to reasonably reconstruct the time he spent working on his farm by referring to a calendar and credit card receipts. He was able to prove that he spent more than 100 hours on farming activities, and more time than any of the other three people who occasionally worked on the farm, which satisfied one of the seven tests.

He credibly testified to the various tasks he performed on the farm, including clearing brush from interior roads, maintaining farm equipment, and a considerable amount of time spent eradicating destructive wild hogs from the farm.

The taxpayer also had considerable travel time factored in because the farm was located in Texas, and the taxpayer lived in Mississippi. The court noted that the long distance travel was integral to the operation of the farm, and did not fall under the Treas. Regs. §1.469-5T(f)(2) exception that disallows work done to avoid disallowance of any loss or credit stemming from the activity, for example, work done merely to count hours to meet the participation tests.

***Turkeys and pigs and peanuts, oh my***

The taxpayer/attorney bought the 1,276 acre farm in Turkey, Texas, and partnered with a sharecropper named Clinton Pigg. Wild hogs were a problem at the farm — they ate 250,000 pounds of the taxpayer's peanut crop one year. So, the taxpayer spent six hours a day luring hogs with Kool-Aid and corn millet to a specific area on the farm where he waited in a tripod stand to eradicate them. He also spent time clearing backroads with a piece of equipment called a "bush hogger."

### Why not §183?

The IRS may have missed out by not making an alternate hobby loss argument against the taxpayer because the taxpayer derived significant pleasure and enjoyment out of his unprofitable farm and hunting land.

## COMPENSATION PAID TO SHAREHOLDER-OFFICERS WAS REASONABLE

The Tax Court has held that $11.3 million paid as salary over two years to two shareholder-officers of a family business was reasonable and deductible under IRC §162. (***H.W. Johnson, Inc. v. Comm.***, TCM 2016-95) At stake was the possibility that the court might find a portion of the amount to be unreasonable. In that case, that portion would be reclassified as nondeductible dividends.

### Facts

The taxpayer, H.W. Johnson, Inc., was a family business engaged in concrete contracting. Incorporated in 1974 by H.W. Johnson and Margaret Johnson, its daily operations had been taken over by the founders' two sons in 1993 shortly before their father's retirement. Margaret served as president and chairman of the board, while Bruce and Donald together managed all operational aspects of the business.

Under their management, revenues grew dramatically from $4 million in 1993 to $38 million in 2004.

Bruce and Donald together managed all operational aspects of the company's business including contract bidding and negotiation, project scheduling and management, equipment purchasing and maintenance, personnel management, and customer relations. They each supervised over 100 employees in their respective divisions and worked 10 to 12 hours a day. They were at job sites regularly and were known in the industry for their hands-on management style. Largely because of their efforts, the company had an excellent reputation with developers and was often awarded contracts even when it wasn't the lowest bidder.

Facing the possibility of work disruption because of shortages of concrete, in 2002 the brothers proposed that the company invest in a concrete supplier. After Margaret disagreed, the brothers formed a separate LLC to invest in a concrete supplier. In the year under audit, the taxpayer corporation made a payment to the LLC of $500,000 for its services in obtaining concrete.

On its returns, the corporation deducted $4 million and $7.3 million in compensation to Bruce and Donald in 2003 and 2004, respectively.

## Analysis

A deduction is allowed for compensation, but the amount must be reasonable and the payment must be solely for services. (IRC §162(a); Treas. Regs. §1.162-7(a)) The Ninth Circuit (to which this case would be appealed) uses five factors to determine the reasonableness of compensation:

1. The employee's role in the company;
2. Comparison of compensation paid by similar companies for similar services;
3. The character and condition of the company;
4. Potential conflicts of interest; and
5. Internal consistency of compensation arrangements.
   (***Elliots, Inc. v. Comm.*** (1983) U.S. Court of Appeals, Ninth Circuit, Case No. 81-7173)

The IRS argued that the case hinged on the fourth factor — potential conflicts of interest. Under this factor, the potential conflict of interest is with a hypothetical investor; that is, whether the investor's interest in company profits would be harmed by an officer taking excess compensation.

## Court evaluates the five factors

The court found that the compensation paid to Bruce and Donald was reasonable. The court looked at each of the five factors, finding them either favoring the reasonableness of the compensation or neutral.

### Employee's role

The IRS conceded the significant roles that the brothers played in the company's growing success during the years at issue. **Result:** favorable.

### Comparison with other companies

The court found that there were no reliable benchmarks to make a determination. The industry average for officer compensation during the years at issue was 2.2% of gross revenues while the brothers were paid 18.4% and 20.9% in 2003 and 2004, respectively. However, the IRS conceded that the company's performance so exceeded that of the comparable companies that comparisons were not meaningful. **Result:** neutral.

### Character and condition of the company

The court noted that the company enjoyed substantial growth and profit during the years at issue. **Result:** favorable.

### Conflict of interest

The IRS argued that because the company's return on equity fell below the industry average during the years in question, the brothers were unreasonably compensated. The company had pretax returns on equity of 10.2% in 2003 and 9% in 2004. The IRS argued that the company's expected return on equity, based on a market analysis of comparable companies should have been from 13.8% to 18.3%. However, the court accepted the company's expert witness's market analysis in concluding a similar company in the same industry should have a return on equity of 10.5% and 10.9%, which was very close to the company's actual return on equity. **Result:** favorable.

### Internal consistency

The taxpayer consistently complied with an officer bonus formula since its inception in 1991. **Result:** favorable.

## Fees paid to LLC

The IRS argued that the $500,000 fee paid to the LLC for its services in obtaining concrete was a disguised payment to the brothers for services they were already obligated to provide as officers of the corporation.

However, the court rejected this argument noting that the corporation's controlling shareholder, Margaret, had expressly rejected the brothers' proposal that the corporation acquire a concrete supplier. The brothers had assumed the risks, in their individual capacities, of forming and operating the LLC. They were clearly acting in their individual capacities in forming and financing the LLC.

***The flip side: S corporations***

Both C corporations and S corporations might be tempted to pay unreasonable compensation, but they are the flip sides of each other. C corporations might be tempted to pay unreasonably high compensation to its shareholder-employees to avoid paying nondeductible dividends. On the other hand, S corporations might be tempted to use unreasonably low compensation to avoid employment taxes.

In the case of S corporations, the IRS lists the following factors in determining the amount of reasonable compensation:

- Training and experience;
- Duties and responsibilities;
- Time and effort devoted to the business;
- Dividend history;
- Compensation to nonshareholder employees;
- Timing and manner of paying bonuses to key employees;
- What comparable businesses pay for similar services;
- Compensation agreements; and
- The use of any formulas to determine compensation.
  (Fact Sheet 2008-25)

# SHAREHOLDER'S PERSONAL EXPENSES PAID BY S CORPORATION ARE LOAN REPAYMENTS

The Tax Court has held that advances from a shareholder to his wholly owned S corporation will be honored as loans as long as the corporation and shareholder intended a debtor-creditor relationship and a reasonable expectation of repayment exists; otherwise, they are capital contributions. (***Scott Singer Installations, Inc. v. Comm.***, TCM 2016-161) Moreover, the court ruled that payments made from the corporate account for Mr. Singer's personal expenses were properly treated as repayments of the shareholder loan and not as salary as the IRS claimed.

## Loans and repayments versus capital contributions and wages

Mr. Singer was the sole shareholder and president of Scott Singer Installations, Inc., an S corporation. The taxpayer made substantial advances to the corporation in two distinct stages and for opposite reasons:

- From 2006 through 2008, Mr. Singer advanced $646,443 to his corporation. During this stage, the corporation was experiencing rapid growth and additional cash was needed to fund that growth; and
- From 2009 through 2011, Mr. Singer advanced an additional $513,099 to his corporation. During this stage, the corporation was experiencing losses, and additional funds were needed to keep the business afloat.

The corporation reported all of the advances as loans from Mr. Singer on its general ledgers and tax returns. There were no promissory notes, there was no interest charged, and there were no maturity dates.

The IRS audited the corporation for 2010 and 2011. During the years at issue, the corporation paid $181,872 of Mr. Singer's personal expenses, which the corporation treated as loan repayments. The corporation did not deduct these payments as business expenses. The corporation deducted salaries and wages paid to employees during the years at issue and filed all payroll tax returns, but no payments to Mr. Singer were classified as salaries and wages.

The IRS argued that the advances made by Mr. Singer were capital contributions, and the payments of his personal expenses by the corporation were wages subject to employment taxes.

## Court's ruling

The court held that Mr. Singer intended his advances to be loans because the advances were reported consistently on the corporation's books and tax returns and because the payments of Mr. Singer's personal expenses were consistent in timing and amount, thus indicating a loan repayment rather than wages. Additionally, the court found that the most important factor was that the corporation continued to make loan repayments when the company was operating at a loss, which strongly suggested a debtor-creditor relationship.

Finally, the court turned to whether there was a reasonable expectation of repayment, without which the intention of the shareholder and corporation to create a debtor-creditor relationship is irrelevant. The court held that the advances from 2006 through 2008 were loans because the corporation was well established, was experiencing rapid growth during that time, and had operated at a profit for many years.

However, the court held that the advances in 2009 through 2011 were not loans because the corporation was operating at a loss and could not secure loans from third parties. The only source of capital during this time was Mr. Singer's family. Accordingly, the court held that Mr. Singer did not have a reasonable expectation of repayment for these amounts so they should be treated as capital contributions. The court also held that Mr. Singer's personal expenses paid by the corporation were loan repayments to the extent there were outstanding loans.

Thus, the funds advanced during the profitable period (2006 through 2008) were treated as loans. The amount of those loans exceeded the amounts of personal expenses paid by the corporation. Thus, all of the personal expenses were treated as repayments of the loans. The court never had to address whether payments made in excess of the loan balance should be classified as wages or distributions.

***Loans versus capital***

The proper characterization of transfers from a shareholder to a corporation as either loans or capital is made by reference to all the evidence. (See ***Dixie Dairies Corp. v. Comm***. (1980) 74 TC 476; see also ***Herrera v. Comm.***, TCM 2012-308.) Courts have established a nonexclusive list of factors to consider when evaluating the nature of transfers of funds to closely held corporations. Such factors include:

- The names given to the documents that would be evidence of the purported loans;
- The presence or absence of a fixed maturity date;
- The likely source of repayment;
- The right to enforce payments;
- Participation in the management as a result of the advances;
- Subordination of the purported loans to the loans of the corporation's creditors;
- The intent of the parties;
- Identity of interest between creditor and stockholder;
- The ability of the corporation to obtain financing from outside sources;
- Thinness of capital structure in relation to debt;
- Use to which the funds were put;
- The failure of the corporation to repay; and
- The risk involved in making the transfers.

# COSTS TO ACQUIRE DOMAIN NAMES FOR BUSINESS USE

The tax treatment of costs associated with domain names has long been subject to ambiguity. In a Chief Counsel Advice, the IRS has provided some clarity but only under certain situations. (CCA 201543014)

## Purchased from secondary market

The CCA concludes that costs incurred to purchase an internet domain name from a secondary market to be used in the taxpayer's trade or business must be capitalized under IRC §263 and may be amortized over 15 years under IRC §197 if certain conditions are met.

## Generic and nongeneric domain names

The CCA addresses the acquisition of both generic and nongeneric domain names both in transactions that include the acquisition of a trade or business and in transactions that do not.

## Facts and conclusion

The CCA reviews the acquisition of both generic and nongeneric domain names. Generally, a nongeneric domain name refers to the company or the name of a product sold by that company. Generic domain names, on the other hand, do not include a specific company or product name but typically describe a product or service using generic terms (e.g., desks.com).

The IRS used separate analyses for generic and nongeneric domain names in arriving at the conclusion that they must be capitalized and amortized. In both situations, however, the IRS's analysis was based on three assumptions:

- The domain name was purchased on a secondary market;
- The taxpayer purchased the domain name for use in a trade or business either to generate advertising revenue by selling space on the website or to market its own goods or services through its website; and
- The domain name is associated with a website that was already constructed at the time of purchase and will be maintained by the taxpayer.

## Software development costs

The CCA does not address the cost of developing one's own software. The IRS believes that the costs of developing computer software so closely resemble the kind of research and experimental expenditures that fall within the purview of IRC §174 as to warrant similar accounting treatment. Accordingly, taxpayers that develop their own software, have three options:

- They may treat the expenses as current deductions;
- They may treat the expenses as capital expenditures amortized for 60 months following the date the development project is completed; or
- They may treat the expenses as capital expenditures amortized over 36 months from the date the software is placed in service.
(Rev. Proc. 2000-50)

***Sale of domain names***

Domain names are actively traded in the secondary market, and domain name speculation is common. Several websites facilitate the sale of domain names, and the practice can be quite lucrative.

For example, the most expensive published sale was $35.6 million for insurance.com. That sale was not a fluke; there have been over 30 published sales for prices in excess of $3 million. Moreover, it is generally understood that the most expensive sales are those in which domain names are either sold privately or by brokerage firms, and the sale details are kept confidential.

## Questions left open

Not only may this CCA be unwelcome news to taxpayers that have been treating their domain names as depreciable over shorter useful lives, it also makes it clear that it applies only to the fact situations and assumptions noted and leaves open the question of how to treat the costs of domain names other than from the secondary market or that are not currently associated with an existing website.

The CCA states that if a purchased domain name is not an amortizable IRC §197 intangible, then the domain name is an intangible asset subject to IRC §167. The domain name is amortized under §167 only if the taxpayer can show a limited useful life of the asset (otherwise, apparently, the domain name cannot be amortized or depreciated). The CCA notes that because a business intends to use a domain name for an indeterminable period of time, the registration period of a domain name is not its useful life for purposes of §167.

## LITIGATION COSTS FOUND TO BE ORDINARY AND NECESSARY

A taxpayer was allowed to deduct legal expenditures stemming from a lawsuit brought against him by a fellow shareholder in the corporation he managed. (Letter Ruling 201548011) The shareholder sued the taxpayer for fraud, breach of fiduciary duty, and breach of contract; the taxpayer was found liable for breach of duty and fraud and was ordered to pay the shareholder compensatory and punitive damages.

The IRS found that the legal expenditures, including the compensatory and punitive damages and legal fees, were ordinary and necessary business expenses because the shareholder's claim against the taxpayer originated from the taxpayer's trade or business using the "origin of claim test" in his capacity as an officer and shareholder of an entity in which he had an ownership interest.

## LAPSED CONTRACT IS NOT WORTHLESS

Taxpayers were denied loss deductions for the remaining basis in a towing contract with the city of Los Angeles that lapsed and was not immediately renewed. (***Steinberg, et ux. v. Comm.***, TCM 2015-222) The court agreed with the IRS's arguments that the taxpayers continued to enjoy benefits of the contract even after it had lapsed, the contract was later extended for an additional five years, and the city provided an amendment to the original contract that included the interim period (between the original contract and the extension) in the original contract. These facts pointed to the contract not having become worthless at any point, and therefore no loss had occurred.

## TRANSPORTATION FRINGE BENEFITS — IRC §132

The PATH Act of 2015 made permanent the monthly exclusion amounts for transit passes and van pool benefits so that they match the exclusion for qualified parking benefits. Thus, the maximum amount for 2016 is $255. (Rev. Proc. 2016-14) For 2017, the maximum amount will remain $255. (Rev. Proc. 2016-55)

## California comparison

Here is a comparison of the federal and California 2016 transportation benefit exclusions.

| Qualified Transportation Benefit Excluded from Wages (Rev. Proc. 2016-55) | | |
|---|---|---|
| | **Federal subject and income tax wages and California subject wages** | **California income tax wages (R&TC §17149)** |
| Vanpool | Vehicle that seats six or more adults (excluding the driver) and has at least 80% of its mileage for a year used for commuters, on trips during which the number of employees commuting is at least 50% of the adult seating capacity (excluding the driver)<br>For 2016, the excludable amount was $255. For 2017, it is $255 | Vehicle that seats seven to 15 adults (including the driver) used for commuters regularly and transports seven or more commuters daily. No maximum exclusion |
| Transit passes | Any pass, token, fare card, voucher, or similar item, including items exchangeable for fares, that entitles a person to transportation on mass transit facilities (presumably including ferries) or provided by a paid transportation business in a vehicle that can carry at least six adults (excluding the driver)<br>For 2016, the excludable amount was $255. For 2017, it is $255 | Any purchase of transit rides that entitles the holder to any number of transit rides to and from work used by an employee or his or her dependents, other than dependents who use transit passes for elementary and secondary school. No maximum exclusion |
| Parking | Either on or near the employer's premises (including parking on or near a work location at which the employee provides services for the employer) or on or near a location from which the employee commutes to work by mass transit, vanpool, carpool, or any other means. Parking on or near the employer's premises generally<br>For 2016, the maximum exclusion was $255 per month. For 2017, it is $255 | Free or subsidized while participating in a ridesharing arrangement in California. No maximum exclusion |
| Bicycles | Employer-paid cost and improvements of bicycle used regularly for travel between the employee's residence and place of employment are excludable from income up to $20 per month (IRC §132(f)) | California has its own unlimited exclusion for an employee riding to and from work |

# CORPORATIONS

## SMALL BUSINESS STOCK

The PATH Act of 2015 made permanent the exclusion of 100% of the gain on small business stock under IRC §1202. Thus, qualifying stock purchased on or after September 28, 2010, will qualify for the 100% exclusion. For the gain exclusion to apply, in general, a noncorporate investor must purchase stock in a C corporation at time of original issue. However, businesses engaged in certain types of business activities (e.g., many service businesses, financial businesses, farming, natural resources, hotels, and restaurants) do not qualify to have the gain on their stock excluded. (IRC §1202)

IRC §1202 allows a taxpayer other than a corporation to exclude a portion of the gain recognized from a sale of certain qualifying small business stock held more than five years. Originally, the law allowed a 50% exclusion, but the exclusion increased over the years, and for stock purchases made after September 27, 2010, the exclusion increased to 100%. (IRC §1202(a)(4))

Almost as important as the exclusion is the fact that qualifying gain is also tax-free for AMT purposes. (IRC §1202(a)(4)(C))

*Timing*

**The exclusion percentage pertains to the acquisition date.** Once determined, the stock carries the exclusion percentage indefinitely. Therefore, the benefit of the higher exclusion amount from stock purchased during the higher-exclusion years will not be realized until future years.

| Federal Exclusion of Gain on IRC §1202 Stock | |
|---|---|
| **Exclusion percentage** | **Acquisition period** |
| 50% | Before February 18, 2009 |
| 75% | February 18, 2009–September 27, 2010 |
| 100% | After September 27, 2010 |

### Conversion to LLC did not nullify small business stock exclusion

In a private letter ruling, the IRS has stated that corporate stock that qualified as small business stock under IRC §1202 was still qualifying stock even though the corporation had converted to an LLC. (PLR 201603010) Immediately upon converting to an LLC, the LLC elected to be taxed as a corporation. Based on an analysis of the Code, the IRS concluded that the reorganization was a mere change in identity or form. Therefore, the status of the original issue stock as qualified small business stock was unaffected by the conversion.

### California nonconformity

California no longer has a small business stock exclusion.

## BUILT-IN GAINS

The PATH Act of 2015 made permanent the five-year holding period for purposes of computing built-in gain on the conversion of a corporation from a C corporation to an S corporation under IRC §1374(d).

### Partial California conformity

California generally conforms to federal BIG rules. However, California never conformed to the shortened holding period. California continues to require a 10-year holding period. (R&TC §§23051.5, 23809)

# PARTNERSHIPS

## PARTNERSHIP LOSS DISALLOWED BECAUSE TAXPAYER HAD NO BASIS

A taxpayer formed a partnership with four other individuals, and all agreed that they would not draw salary until there was sufficient cash flow. None of the five partners contributed any capital to the business. When the business folded a few years later, the taxpayer received a K-1 showing $25,000 in capital contributed from the value of the labor the taxpayer provided and a loss of $39,142, which represented a portion of the salary that he was never paid. Generally, a taxpayer-partner may claim a loss deduction from a partnership only to the extent that the amount of the loss does not reduce a partner's basis below zero. (IRC §704(d)) Basis does not include the value of services performed unless and until the value of those services has been subjected to taxation. (See ***Haff v. Comm.***, TCM 2015-138) Because the taxpayer could not show that he had any basis in the partnership, the loss deduction was disallowed.

## IRS ALLOWS LATE §754 ELECTION

The IRS has granted a partnership's request to make a late election under IRS §754 to adjust basis pursuant to IRC §743(c). (PLR 201630013) The partnership had adjusted the basis of partnership property as if the IRC §754 election were in place and had not taken any position inconsistent with that election.

### Making a late election

Treas. Regs. §1.754-1(b) provides that an election under IRC §754 shall be made in a written statement filed with the partnership or LLC return for the taxable year during which a distribution or transfer occurs. For the election to be valid, the return must be filed not later than the time prescribed for filing the return for such taxable year, including extensions thereof.

The regulations provide that the commissioner has discretion to grant a reasonable extension of time to make an IRC §754 election, provided the taxpayer demonstrates that:

- The taxpayer acted reasonably and in good faith; and
- Granting relief will not prejudice the interests of the government.

# REPAIR REGULATIONS

For tax years beginning on or after January 1, 2014, the final tangible property regulations (TPRs) became fully effective for all taxpayers. The explicit purpose of the TPRs was to reduce controversy in the determination of whether expenditures may be deducted as a current repair expense or must be capitalized. However, the regulations themselves produced a substantial amount of controversy. Final tangible property regulations (TD 9636) were issued in September 2013, and final MACRS property disposition regulations (TD 9689) were issued in August 2014.

Multiple revenue procedures and notices have been issued to provide guidance in applying the regulations:

- **Rev. Proc. 2014-16 (January 2014):** Method changes for amounts paid to acquire, produce, or improve tangible property;
- **Rev. Proc. 2014-17 (February 2014):** Method changes for depreciation;
- **Rev. Proc. 2014-54 (September 2014):** Method changes for depreciation and dispositions;
- **Rev. Proc. 2015-20 (February 2015):** Simplified change in accounting method;
- **Notice 2015-82 (November 2015):** *De minimis* amount increased to $2,500;
- **Rev. Proc. 2015-56 (December 2015):** Remodel-refresh safe harbor;
- **Rev. Proc. 2015-13 (January 2015):** Changes in accounting periods and in methods of accounting; and
- **Rev. Proc. 2016-29 (May 2016):** List of automatic changes.

## IRS ISSUES AUDIT TECHNIQUE GUIDE FOR REPAIR REGULATIONS

The IRS has issued a 202-page Audit Technique Guide (ATG) that gives its auditors detailed instructions regarding what to look for when conducting an examination of a taxpayer's capitalization policies. The ATG advises auditors to carefully assess risk and apply the law to the taxpayer's facts and circumstances and provides the interview questions auditors should ask when conducting an examination as well as the audit procedures the auditor should follow in conducting the examination.

### Recommended actions

To identify potential audit procedures, auditors are advised to take the following actions:

- Determine if the taxpayer filed Form 3115 to change its accounting method to comply with the regulations;
- Determine if the taxpayer should have, but did not, file Form 3115;
- If Form 3115 was not filed, determine if the taxpayer adopted the regulations under the simplified method;
- Read annual reports and identify new facilities or other changes affecting the acquisition or improvement of fixed assets;
- Review the Schedule M on the tax return and consider any book/tax differences pertaining to fixed assets, depreciation and materials and supplies;
- Review the taxpayer's capitalization policies;
- Determine whether any cost segregation studies or capitalization/repair studies were done;
- Determine if an IRC §481(a) adjustment was done on Form 3115;
- Determine how the taxpayer accounts for materials and supplies; and
- Determine if any elections involving capitalization or expense were made.

# *DE MINIMIS* SAFE HARBOR ELECTION — BIG BOOST FOR 2016

The IRS issued Notice 2015-82 in November 2015 increasing the amount of the *de minimis* safe harbor for taxpayers without an applicable financial statement (AFS) from $500 to $2,500 for tax years beginning in 2016. The *de minimis* safe harbor election allows a taxpayer to consider as a current expense the acquisition or production of a unit of property with a cost of $2,500 or less. The amount of the safe harbor election has changed, but the requirements remained the same. For taxpayers with an AFS, the amount of the *de minimis* safe harbor remains at $5,000 in 2016. The rules for both taxpayers with and without an AFS are the same with the exception of the dollar amount considered to be *de minimis* and whether their accounting procedure must be written. Taxpayers with an AFS must have a written accounting procedure in order to utilize the benefits of this *de minimis* safe harbor.

The notice states that the IRS will not raise the issue in examination, or elsewhere, as to whether a taxpayer may use the $2,500 maximum amount in a tax year that begins before 2016. However, the taxpayer must have an accounting policy in place in those prior years.

The safe harbor applies to the costs that are expensed for nontax purposes under the taxpayer's accounting procedures:

- Amounts paid for property costing less than a specific dollar amount; or
- Amounts paid for property with an economic useful life of 12 months or less; and
- The taxpayer treats amounts paid for the property as an expense on its AFS (or on its books if no AFS) in accordance with their accounting procedures; and
- The amount paid for the unit of property does not exceed $5,000 ($2,500 without an AFS).

While taxpayers without an AFS are not required to have a written accounting procedure, it is recommended that the procedure be documented in writing to avoid any question as to whether or not the policy existed.

**Caution**

Both taxpayers with and without an AFS must have the accounting procedure in place *at the beginning of* the tax year.

***Sample capitalization policy***

**Purpose:** This accounting policy establishes the minimum cost (capitalization amount) that shall be used to determine the capital assets to be recorded in [BUSINESS ENTITY]'s books and financial statements.

**Capital asset definition and thresholds:** A "Capital Asset" is a unit of property with a useful life exceeding one year and a per-unit acquisition cost exceeding [SPECIFY AMOUNT]. Capital assets will be capitalized and depreciated over their useful lives. [BUSINESS ENTITY] will expense the full acquisition cost of tangible personal property below these thresholds in the year purchased.

**Capitalization method and procedure:** All Capital Assets are recorded at historical cost as of the date acquired.

Tangible assets costing below the aforementioned threshold amount are recorded as an expense for [BUSINESS ENTITY]'s annual financial statements (or books). In addition, assets with an economic useful life of 12 months or less must be expensed for both book and financial reporting purposes.

**Documentation:** Invoices substantiating the acquisition cost of each unit of property are to be retained for a minimum of 10 years.

**Tax capitalization threshold:** The permissible ceiling for deducting otherwise capitalizable expenditures is $5,000 when our business has applicable financial statements. The threshold is limited to $2,500 in the absence of applicable financial statements.

## Election

A taxpayer must elect on an *annual* basis to apply the safe harbor by including a statement on the taxpayer's timely filed original return (including extensions). (Treas. Regs. §1.263(a)-1(f)(5)) If made, the election applies to **all** qualifying expenses that meet the requirements; an electing taxpayer cannot exclude particular qualifying expenses. The election automatically extends to materials and supplies.

***Example of de minimis election in 2015 versus 2016***

In 2015, Oldco does not have an applicable financial statement but has written accounting policies in place at the start of the tax year treating as expenses for financial statement purposes amounts paid for property costing $500 or less.

During the tax year, Oldco purchases 20 printers costing $300 each, 14 desks costing $250 each, and 30 chairs costing $200 each for a total cost of $15,500. They also purchase 20 laptop computers costing $1,000 each.

If Oldco makes the *de minimis* election, they may expense the $15,500 for the printers, desks, and chairs, and still have their full IRC §179 election amount available to expense the laptop computers.

At the beginning of 2016, Oldco puts new accounting policies in place treating as expenses for financial statement purposes amounts paid for property costing $2,500 or less. If Oldco makes the *de minimis* election in 2016, they may expense all of the purchases.

### California partial conformity

According to the FTB, California will follow the increase in the repair regulations *de minimis* safe harbor amount from $500 to $2,500 for taxable years beginning on or after January 1, 2016.

However, the FTB will not follow the "audit protection" expressed in IRS Notice 2015-82 for amounts included in the safe harbor in excess of $500 for pre-2016 taxable years.

**Comparison of IRC §179, Bonus Depreciation, and *De Minimis* TPR Election**

| | **IRC §179 deduction** | **Bonus depreciation** | ***De minimis*** |
|---|---|---|---|
| **Election** | Must elect | Must elect out | Must elect |
| **Used property qualifies** | Yes | No | Yes |
| **Qualifying real property** | Up to $500,000 | Yes | N/A |
| **Maximum** | $500,000 in taxable years | No limit | No limit |
| **Limitations** | Phaseout begins when total assets purchased equals $2 million ($2,010,000 for 2016) | No | No |
| **Income requirement** | Limited to the amount of trade or business income | No | No |
| **Subject to recapture if taken out of service but not disposed of** | Yes | No* | No |
| **Can create a loss** | Limited to taxable income from taxpayer's trade or business | Yes | Yes |
| **Affects financial statements?** | No | No | Yes |

* For disposition purposes, bonus depreciation is treated like any other depreciation in computing gain or loss. However, it is not straight-line depreciation, so for purposes of IRC §1245 or IRC §1250 recapture, the effect could be dramatic if disposed of early in the applicable recovery period

## CHANGE IN ACCOUNTING METHOD

Taxpayers were required to make accounting method changes to comply with the new regulations unless their accounting methods had always been in compliance (extremely unlikely).

Under IRC §446, a taxpayer cannot change accounting methods without permission from the IRS. The taxpayer must file Form 3115, Application for Change in Accounting Method. The taxpayer may also have to make an adjustment to prevent amounts of income or expense from being duplicated or omitted. This is called an IRC §481(a) adjustment.

## IRS reversal — Rev. Proc. 2015-20

The Treasury and the IRS held fast to their position that all affected taxpayers must prepare and file Form 3115 with their 2014 tax returns as the 2015 tax season began. On February 13, 2015, the IRS issued Revenue Procedure 2015-20 that provided an alternative manner to complying with the new TPRs. Under Rev. Proc. 2015-20, qualified small business taxpayers were able to use a new simplified procedure to comply with the TPRs without computing an IRC §481(a) adjustment. A qualified small business is one that meets one or both the following criteria:

- Total assets of less than $10 million as of the beginning of the tax year; or
- Average annual gross receipts of $10 million or less for the prior three taxable years.

The simplified procedure allowed a qualifying small business to implement the changes required by the TPRs on a prospective basis, taking into account only amounts paid or incurred, and dispositions occurring on or after January 1, 2014. No Form 3115 was required to be filed. No statement or election indicating acceptance, implementation or adoption of the TPRs was required. Merely filing a timely tax return (including extensions) was all that was required under Rev. Proc. 2015-20 for a taxpayer to be presumed to have utilized the simplified procedure.

**Note:** The IRS did recommend that taxpayers utilizing the simplified procedure attach a statement to their tax return indicating that they were adopting the TPRs via the simplified procedure.

| **TPR Change in Accounting Method Options for 2016** | |
|---|---|
| **If the taxpayer …** | **The taxpayer's options for 2016 …** |
| **Large taxpayers** | |
| Filed 3115 for all TPR changes | No 3115 for TPRs with automatic consent changes for 5 years |
| Filed 3115 for some TPR changes | Automatic consent changes available, scope limitations apply |
| Did not file 3115 | Automatic consent changes available, scope limitations apply |
| **Small taxpayers** | |
| Followed Rev. Proc. 2015-20 (made elections, positive statement) | No 3115 for TPRs with automatic consent changes for 5 years |
| Did NOT file 3115, no TPR elections, or positive statements | Can file 3115 for any/all TPRs, automatic consent provisions apply, scope limitations apply |
| Filed "protective" 3115 | Can file 3115 for any TPRs not included on "protective" 3115, automatic consent provisions apply, scope limitations apply |
| Filed 3115 with some TPRs | Can file 3115 for any TPRs not included on prior 3115, automatic consent provisions apply, scope limitations apply |
| Did not file 3115, statement not utilizing simplified procedure | Can file 3115 for any/all TPRs, automatic consent provisions apply, scope limitations apply |

# BUSINESS CREDITS

## CREDIT FOR INCREASING RESEARCH ACTIVITIES — IRC §41

The PATH Act of 2015 made three significant changes to the Research (R&D) Credit:

- The credit was made retroactively permanent;
- Eligible small businesses will be able to claim the credit against both regular income tax and alternative minimum tax for taxable years beginning after December 31, 2015; and
- A qualified small business will be able to claim a portion of the credit against certain employment taxes:
  - The maximum credit allowed is $250,000 per year for up to five years; and
  - A qualified small business includes a corporation or partnership with:
    - Gross receipts of less than $5 million during the taxable year; and
    - No gross receipts for any tax year before the five-tax-year period ending with the tax year.

(IRC §41(h)(3)(A))

There is no requirement that the taxpayer had to be in existence during the entire five-year testing period.

***Comment***

An employer must pay $4,032,258 in wages to generate FICA tax of $250,000.

***Example of gross receipts***

The XYZ Partnership is a calendar year partnership that had gross receipts of the following amounts in the current and prior years (2012 is XYZ's first year in business):

| | |
|---|---|
| **2012** | $1 million |
| **2013** | $3 million |
| **2014** | $9 million |
| **2015** | $6 million |
| **2016** | $4 million |

The company is eligible for the payroll tax credit because it has gross receipts of $5 million or less in the tax year and had no gross receipts for any tax year before the five-tax-year period ending with the tax year.

If the company had a single dollar of gross receipts in 2011, it would not qualify.

In 2017 (and later), the company may be eligible for a credit but may no longer claim the credit against the employment taxes because it will have had gross receipts in a year before the five-tax-year period ending with the 2017 tax year.

***Not all or nothing***

The taxpayer may elect all or any portion of the total Research Credit to be a payroll tax credit (up to the $250,000 limit). Any balance remains an income tax credit.

## Which taxes count?

The payroll tax credit portion is allowed only against the tax imposed under IRC §3111(a) — the employer's portion of Old-Age, Survivors, and Disability Insurance — 6.2% of wages subject to the tax. The credit is not allowed against the employer's portion of the 1.45% Medicare tax, income tax withheld, or the employer's FUTA.

## Making the election to reduce employment taxes

The election to claim the portion of the R&D Credit against employment taxes must be made on a timely filed (including extensions) tax return for the entity or individual. The election must include the amount of the credit which the taxpayer elects to have applied to employment taxes and may be revoked only with the consent of the Secretary. The amount of the R&D Credit that the taxpayer elects to have applied against employment taxes is termed the "payroll tax credit portion." IRC §41(h)(2)

The election is made by checking the box on line 41 in new Section D of Form 6765, Credit for Increasing Research Activities.

For partnerships and S corporations, the election is made at the entity level.

**Caution**

This is different than the credit for income tax purposes where the credit flows through the partnership or S corporation K-1 to the partner or shareholder who must determine the amount of credit based on their own limitations.

Thus, it may work both ways. The partnership or S corporation may elect to use some of the Research Credit as a payroll credit (determined at the entity level) and flow the balance through to the owners as a credit against income tax (determined at the owner level).

## Effective date

The effective date is confusing. Although the effective date is stated as for tax years beginning on or after January 1, 2016, most taxpayers won't see any benefit until at least the second quarter payroll of 2017. The payroll tax credit portion will be allowed on an employment tax return for the first calendar quarter which begins after the date on which the taxpayer files their income tax return on which the election is made. Any excess credit is carried forward and applied to the payroll tax liability in succeeding quarters until the entire credit is used up.

Thus, if a calendar-year corporation files their income tax return on March 15 which includes a claim for the payroll credit, they will get the credit beginning with the second calendar quarter. If they file on July 22, they won't be able to get any credit until the fourth calendar quarter.

## Claiming the credit on an employment tax return

Credit reporting will follow this path:

- **Form 6765, Credit for Increasing Research Activities:** There is a new Section D in which the taxpayer checks a box to make the election and elects the amount of the credit to be applied as a payroll tax credit;
- **Form 8974, Qualified Small Business Payroll Tax Credit for Increasing Research Activities:** This is the "bridge form" between Form 6765 and Form 941. It calculates the amount of the payroll credit that will be carried to Form 941. It gets attached to the 941; and
- **Form 941, Employer's Quarterly Federal Tax Return:** A new line is added that takes credit for the payroll tax credit. The amount comes from Form 8974.

Any amount of the payroll tax credit portion not used on an employment tax return will be carried forward to the succeeding quarter.

### No carrybacks or carryforwards from pre-PATH Act years

A taxpayer cannot carry back Research Credits to offset payroll taxes in taxable years beginning before January 1, 2016. Carryforward credits from taxable years beginning before January 1, 2016, cannot be used to offset payroll taxes.

Form **6765**

Department of the Treasury
Internal Revenue Service

# Credit for Increasing Research Activities

▶ Attach to your tax return.
▶ Information about Form 6765 and its separate instructions is at *www.irs.gov/form6765*.

OMB No. 1545-0619
2016
Attachment Sequence No. **81**

| Name(s) shown on return | Identifying number |
|---|---|
| | |

**Section A—Regular Credit.** Skip this section and go to Section B if you are electing or previously elected (and are not revoking) the alternative simplified credit.

| | | | | | |
|---|---|---|---|---|---|
| 1 | Certain amounts paid or incurred to energy consortia (see instructions) | | | 1 | |
| 2 | Basic research payments to qualified organizations (see instructions) | 2 | | | |
| 3 | Qualified organization base period amount | 3 | | | |
| 4 | Subtract line 3 from line 2. If zero or less, enter -0- | | | 4 | |
| 5 | Wages for qualified services (do not include wages used in figuring the work opportunity credit) | | | | |
| 6 | Cost of supplies | | | | |
| 7 | Rental or lease costs of computers (see instructions) | | | | |
| 8 | Enter the applicable percentage of contract research expenses (see instructions) | | | | |
| 9 | Total qualified research expenses. Add lines 5 through 8 | | | | |
| 10 | Enter fixed-base percentage, but not more than 16% (0.16) (see instructions) | | | | |
| 11 | Enter average annual gross receipts (see instructions) | | | | |
| 12 | Multiply line 11 by the percentage on line 10 | | | | |
| 13 | Subtract line 12 from line 9. If zero or less, enter -0- | | | | |
| 14 | Multiply line 9 by 50% (0.50) | 14 | | | |
| 15 | Enter the **smaller** of line 13 or line 14 | | | 15 | |
| 16 | Add lines 1, 4, and 15 | | | 16 | |
| 17 | Are you electing the reduced credit under section 280C? ▶ Yes ☐ No ☐ If "Yes," multiply line 16 by 13% (0.13). If "No," multiply line 16 by 20% (0.20) and see the instructions for the statement that must be attached. Members of controlled groups or businesses under common control: see instructions for the statement that must be attached | | | 17 | |

**Section B—Alternative Simplified Credit.** Skip this section if you are completing Section A.

| | | | | | |
|---|---|---|---|---|---|
| 18 | Certain amounts paid or incurred to energy consortia (see the line 1 instructions) | | | 18 | |
| 19 | Basic research payments to qualified organizations (see the line 2 instructions) | 19 | | | |
| 20 | Qualified organization base period amount (see the line 3 instructions) | 20 | | | |
| 21 | Subtract line 20 from line 19. If zero or less, enter -0- | | | 21 | |
| 22 | Add lines 18 and 21 | | | 22 | |
| 23 | Multiply line 22 by 20% (0.20) | | | 23 | |
| 24 | Wages for qualified services (do not include wages used in figuring the work opportunity credit) | 24 | | | |
| 25 | Cost of supplies | 25 | | | |
| 26 | Rental or lease costs of computers (see the line 7 instructions) | 26 | | | |
| 27 | Enter the applicable percentage of contract research expenses (see the line 8 instructions) | 27 | | | |
| 28 | Total qualified research expenses. Add lines 24 through 27 | 28 | | | |
| 29 | Enter your total qualified research expenses for the prior 3 tax years. If you had no qualified research expenses in any one of those years, skip lines 30 and 31 | 29 | | | |
| 30 | Divide line 29 by 6.0 | 30 | | | |
| 31 | Subtract line 30 from line 28. If zero or less, enter -0- | 31 | | | |
| 32 | Multiply line 31 by 14% (0.14). If you skipped lines 30 and 31, multiply line 28 by 6% (0.06) | | | 32 | |

**For Paperwork Reduction Act Notice, see separate instructions.** Cat. No. 13700H Form **6765** (2016)

**Section B—Alternative Simplified Credit** *(continued)*

| | | | |
|---|---|---|---|
| 33 | Add lines 23 and 32 | 33 | |
| 34 | Are you electing the reduced credit under section 280C? ▶ Yes ☐ No ☐<br>If "Yes," multiply line 33 by 65% (0.65). If "No," enter the amount from line 33 and see the line 17 instructions for the statement that must be attached. Members of controlled groups or businesses under common control: see instructions for the statement that must be attached | 34 | |

**Section C—Current Year Credit**

| | | | |
|---|---|---|---|
| 35 | Enter the portion of the credit from Form 8932, line 2, that is attributable to wages that were also used to figure the credit on line 17 or line 34 (whichever applies) | 35 | |
| 36 | Subtract line 35 from line 17 or line 34 (whichever applies). If zero or less, enter -0- | 36 | |
| 37 | Credit for increasing research activities from partnerships, S corporations, estates, and trusts | 37 | |
| 38 | Add lines 36 and 37<br>• Estates and trusts, go to line 39.<br>• Partnerships and S corporations not electing the payroll tax credit, stop here and report this amount on Schedule K.<br>• Partnerships and S corporations electing the payroll tax credit, complete Section D and report on Schedule K the amount on this line reduced by the amount on line 44.<br>• Eligible small businesses, stop here and report the credit on Form 3800, Part III, line 4i. See instructions for the definition of eligible small business.<br>• Filers other than eligible small businesses, stop here and report the credit on Form 3800, Part III, line 1c.<br>**Note:** Qualified small business filers, other than partnerships and S corporations, electing the payroll tax credit must complete Form 3800 before completing Section D. | | |
| 39 | Amount allocated to beneficiaries of the estate or trust (see instructions) | 39 | |
| 40 | Estates and trusts, subtract line 39 from line 38. For eligible small businesses, report the credit on Form 3800, Part III, line 4i. See instructions. For filers other than eligible small businesses, report the credit on Form 3800, Part III, line 1c | 40 | |

**Section D—Qualified Small Business Payroll Tax Election and Payroll Tax Credit.** Skip this section if the payroll tax election does not apply. See instructions.

| | | | |
|---|---|---|---|
| 41 | Check this box if you are a qualified small business electing the payroll tax credit. See instructions ☐ | | |
| 42 | Enter the portion of line 36 elected as a payroll tax credit (do not enter more than $250,000). See instructions | 42 | |
| 43 | General business credit carryforward from the current year (see instructions). Partnerships and S corporations skip this line and go to line 44 | 43 | |
| 44 | Partnerships and S corporations, enter the smaller of line 36 or line 42. All others, enter the smallest of line 36, line 42, or line 43. Enter here and on Form 8974, line 5. Members of controlled groups or businesses under common control: see instructions for the statement that must be attached | 44 | |

Form **6765** (2016)

Form **8974:** **Qualified Small Business Payroll Tax Credit for Increasing Research Activities** 950817

(January 2017) Department of the Treasury — Internal Revenue Service OMB No. 1545-XXXX

**Employer identification number** (EIN) ☐☐ – ☐☐☐☐☐☐☐

**Name** *(not your trade name)* ______________________

**The credit from Part 2, line 12, will be reported on (check only one box):**

☐ **Form 941, 941-PR, or 941-SS**

☐ **Reserved**

☐ **Reserved**

**Calendar year** ________ You must select a quarter if you file Form 941, 941-PR, or 941-SS.

**Report for this quarter . . .**

Check only one box.

☐ **1:** January, February, March

☐ **2:** April, May, June

☐ **3:** July, August, September

☐ **4:** October, November, December

## Part 1: Tell us about your income tax return.

**1** Which income tax return did you file that elected a qualified small business payroll tax credit on Form 6765, Credit for Increasing Research Activities? Check only one box. ☐ Form 1040 ☐ Form 1065 ☐ Form 1120 ☐ Form 1120-F ☐ Form 1120S

**2** What tax period was covered by your income tax return?

Calendar year ________ or tax year beginning / / ending / /

**3** When did you file your income tax return? / /

**4** If the EIN shown above isn't the same as the EIN used on Form 6765, enter the EIN used on Form 6765. ☐☐ – ☐☐☐☐☐☐☐

## Part 2: Determine the credit that you can use this period.

**5** Enter the amount from Form 6765, line 44, or, if applicable, the amount that was allocated to your EIN . . . . . . **5** ________ .

**6** Enter the amount of the credit from line 5 that was taken on a previous period(s) . . . . . . . . . . . . **6** ________ .

**7** Subtract line 6 from line 5 . . . . . . . . . . . . . . . . . . . . . . . . . **7** ________ .

**8** Enter the amount from Form 941 (941-PR or 941-SS), line 5a, Column 2 . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . **8** ________ .

**9** Enter the amount from Form 941 (941-PR or 941-SS), line 5b, Column 2 . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . **9** ________ .

**10** Add lines 8 and 9 . . . . . . . . . . . . . **10** ________ .

**11** Multiply line 10 by 50% (0.50). See the instructions if you're a third-party payer of sick pay or if you received a Section 3121(q) Notice and Demand . . . . . . . . . . . . . . . . **11** ________ .

**12** **Credit.** Enter the smaller of line 7 or line 11. Also enter this amount on Form 941 (941-PR or 941-SS), line 11 . . . . . . . . . . . . . . . . . . . . . . . . . . . . . **12** ________ .

Form **941 for 2017: Employer's QUARTERLY Federal Tax Return** 950117
(Rev. January 2017) Department of the Treasury — Internal Revenue Service OMB No. 1545-0029

**Employer identification number** (EIN) ☐☐ – ☐☐☐☐☐☐☐

**Name** *(not your trade name)*

**Trade name** *(if any)*

**Address**

Number | Street | Suite or room number

City | State | ZIP code

Foreign country name | Foreign province/county | Foreign postal code

**Report for this Quarter of 2017**
**(Check one.)**

☐ **1:** January, February, March

☐ **2:** April, May, June

☐ **3:** July, August, September

☐ **4:** October, November, December

Instructions and prior year forms are available at *www.irs.gov/form941.*

Read the separate instructions before you complete Form 941. Type or print within the boxes.

**Part 1: Answer these questions for this quarter.**

| | | | |
|---|---|---|---|
| 1 | **Number of employees who received wages, tips, or other compensation for the pay period including:** ***Mar. 12*** **(Quarter 1),** ***June 12*** **(Quarter 2),** ***Sept. 12*** **(Quarter 3), or** ***Dec. 12*** **(Quarter 4)** | 1 | |
| 2 | **Wages, tips, and other compensation** | 2 | . |
| 3 | **Federal income tax withheld from wages, tips, and other compensation** | 3 | . |
| 4 | **If no wages, tips, and other compensation are subject to social security or Medicare tax** | ☐ | **Check and go to line 6.** |

| | | Column 1 | | Column 2 |
|---|---|---|---|---|
| 5a | **Taxable social security wages** | . | × 0.124 = | . |
| 5b | **Taxable social security tips** | . | × 0.124 = | . |
| 5c | **Taxable Medicare wages & tips** | . | × 0.029 = | . |
| 5d | **Taxable wages & tips subject to Additional Medicare Tax withholding** | . | × 0.009 = | . |

| | | | |
|---|---|---|---|
| 5e | **Add Column 2 from lines 5a, 5b, 5c, and 5d** | 5e | . |
| 5f | **Section 3121(q) Notice and Demand—Tax due on unreported tips** (see instructions) | 5f | . |
| 6 | **Total taxes before adjustments.** Add lines 3, 5e, and 5f | 6 | . |
| 7 | **Current quarter's adjustment for fractions of cents** | 7 | . |
| 8 | **Current quarter's adjustment for sick pay** | 8 | . |
| 9 | **Current quarter's adjustments for tips and group-term life insurance** | 9 | . |
| 10 | **Total taxes after adjustments.** Combine lines 6 through 9 | 10 | . |
| 11 | **Qualified small business payroll tax credit for increasing research activities.** Attach Form 8974 | 11 | . |
| 12 | **Total taxes after adjustments and credits.** Subtract line 11 from line 10 | 12 | . |
| 13 | **Total deposits for this quarter, including overpayment applied from a prior quarter and overpayments applied from Form 941-X, 941-X (PR), 944-X, or 944-X (SP) filed in the current quarter** | 13 | . |
| 14 | **Balance due.** If line 12 is more than line 13, enter the difference and see instructions | 14 | . |

15 **Overpayment.** If line 13 is more than line 12, enter the difference . Check one: ☐ Apply to next return. ☐ Send a refund.

► **You MUST complete both pages of Form 941 and SIGN it.** Next ►



Cat. No. 17001Z Form **941** (Rev. 1-2017)

# CROWDFUNDING

On July 22, 2016, the IRS provided FAQs in an attempt to clarify tax treatment of crowdfunding. (www.irs.gov/uac/general-faqs-on-new-payment-card-reporting-requirements) As is often the case, the FAQs seem to provide more questions than answers.

## WHAT'S INCLUDED IN TAXABLE INCOME

According to the IRS, crowdfunding revenues generally are includible in income under IRC §61 if they are not:

- Loans that must be repaid;
- Capital contributed to an entity in exchange for an equity interest in the entity; or
- Gifts made out of detached generosity and without any quid pro quo.

However, the IRS notes that a voluntary transfer without a quid pro quo is not necessarily a gift for federal income tax purposes.

Under the IRS's guidance, it appears that most campaigns that are raising money for someone's cancer treatment or to set up a college fund for a child of a deceased parent are going to be considered nontaxable gifts.

In nongift situations, the IRS states that crowdfunding revenues must generally be included in income to the extent they are received for services rendered or are gains from the sale of property.

But what if the crowdfunding campaign is to support the development of a product/service and the contributor foregoes any type of "reward"? Is the contribution a nontaxable gift? There is no clear answer on this, and undoubtedly the IRS will apply a "facts and circumstances" analysis.

## WHEN TO INCLUDE THE INCOME

A crowdfunding campaign creator must recognize income when the creator has constructive receipt of the funds.

In those campaigns in which the campaign creator gets to keep the funding regardless of whether a campaign objective is met, the creator would have constructive receipt when the pledges are made.

In a fixed-funding campaign, the campaign creator will only receive the funds if a specified funding goal is met by a specified deadline.

If the campaign does not meet the goal by its deadline, all contributions are refunded back to the contributors. In Indiegogo's case (Indiegogo is one of the major crowdfunding hosts), refunds for unsuccessful fixed-funding campaigns are typically issued within five to seven business days of the funding deadline.

In this situation, the crowdfunding page would clearly state that the pledge would not be "final," and the credit cards would not be charged, unless the thresholds were met. So, one could argue that because the charges were not made, there was no constructive receipt.

See page 14-11 for information on sales tax issues.

# OTHER BUSINESS PROVISIONS OF PATH ACT

## EXPIRING IN 2016

### Expensing costs of film and TV production

The Act retroactively extends the expensing deduction under IRC §181 for productions beginning before January 1, 2017. In addition, the deduction is enhanced to include certain "qualified live theatrical productions." (Act §169)

### Seven-year write-off of motorsport racing track facilities

The Act retroactively extends the seven-year straight-line cost recovery period for motorsports entertainment facilities under IRC §168(i)(15)(D)). Thus, the shortened write-off applies to qualifying facilities placed in service before January 1, 2017. (Act §166)

### Three-year depreciation on racehorses

The Act retroactively extends three-year depreciation on racehorses under IRC §168 for racehorses placed in service before January 1, 2017. (Act §165)

### Accelerated depreciation for business property on Indian reservations

The Act retroactively extends accelerated depreciation of property on an Indian reservation under IRC §168(j)(8) for property placed in service before January 1, 2017. (Act §167)

## 50% EXPENSING OF MINE SAFETY EQUIPMENT

The Act retroactively extends the election to treat 50% of the costs of mine safety equipment under IRC §179E as an expense in the year the equipment is placed in service. (Act §163)

## S CORPORATION SHAREHOLDER BASIS ADJUSTMENT FOR CHARITABLE CONTRIBUTIONS

The Act retroactively makes permanent the rule first established under the Pension Protection Act of 2006 that says that a shareholder's basis in his S corporation stock is reduced by the adjusted basis of property contributed to a charity rather than the property's fair market value. (IRC §1367(a)(2); Act §115)

## ENHANCED DEDUCTION FOR FOOD INVENTORY

The enhanced deduction for food inventory under IRC §170(e)(3)(C)(iv) is retroactively made permanent. In addition, the limitation on deductible contributions of food inventory is increased from 10% to 15% of aggregate net income from the trade or business from which the contributions were made. The limit for C corporations is 15% of taxable income. The Act includes a new provision that treats the basis of donated food inventory to be 25% of the fair market value. Both the 15% limitation and the 25% of fair market value are applicable for tax years beginning after December 31, 2015.

The enhanced deduction is allowed only for "apparently wholesome food" as defined in the Bill Emerson Good Samaritan Food Donation Act. (42 USC §1791(b)(2)) "The term 'apparently wholesome food' means food that meets all quality and labeling standards imposed by federal, state, and local laws and regulations even though the food may not be readily marketable due to appearance, age, freshness, grade, size, surplus, or other conditions." (Act §113)

## DIFFERENTIAL WAGE PAYMENTS

The credit for employers that pay differential wages — payments to employees for periods that they are called to active duty with the U.S. military — is made permanent. In addition, for tax years beginning after December 31, 2015, the Act removes the 50-employee limitation; that is, an employer of any size will be eligible for the credit. (IRC §45P; Act §122)

## WORK OPPORTUNITY TAX CREDIT

The Act retroactively extends the WOTC so that it applies to qualified workers who begin work for the employer before January 1, 2019. (Act §142)

In addition, with respect to workers who begin work after December 31, 2015, the credit also applies to employers who hire qualified long-term unemployed individuals (those who have been unemployed for 27 weeks or more). The credit for long-term unemployed workers is 40% of the first $6,000 of wages. (IRC §51(d)(1)(J); Act §142(b))

## NEW MARKETS CREDIT

The Act retroactively extends the New Markets Credit under IRC §45D through 2019. In addition, it provides up to $3.5 billion in qualified equity investments for each calendar year from 2015 through 2019. The carryover period for unused credits is extended through 2024. (Act §141)

## INDIAN EMPLOYMENT CREDIT

The Act retroactively extends the credit under IRC §45A to tax years beginning before January 1, 2017. (Act §161)

## ALTERNATIVE FUEL VEHICLE REFUELING PROPERTY CREDIT

The Act retroactively extends the credit under IRC §30C to apply to property placed in service after December 31, 2014, and before January 1, 2017. (Act §182)

## CREDIT FOR TWO-WHEELED ELECTRIC PLUG-IN VEHICLES

The Act retroactively extends the credit under IRC §30D(g) to apply to property acquired after December 31, 2014, and before January 1, 2017. (Act §183)

The credit for three-wheeled vehicles was not extended.

## NEW ENERGY EFFICIENT HOME CREDIT

The Act retroactively extends the credit under IRC §45L to apply to homes acquired before January 1, 2017. (Act §188)

## CREDIT FOR FUEL CELL VEHICLES

The Act retroactively extends the credit under IRC §30B to apply to vehicles acquired before January 1, 2016. (Act §193)

# EMPLOYEE VERSUS INDEPENDENT CONTRACTOR

## COLDWELL BANKER SETTLES WITH MISCLASSIFIED EMPLOYEES

Coldwell Banker has agreed to pay $4.5 million ($1.5 million of which was paid to the attorneys) to settle a class action lawsuit involving 5,600 real estate sales associates who claimed they were misclassified as independent contractors rather than employees. (***Bararsani v. Coldwell Banker Residential Brokerage Company***, Los Angeles County Superior Court, Case No. BC495767, order approving class action settlement and entry of order and judgment, January 14, 2016)

The sales associates claimed that because they were employees and not independent contractors, Coldwell Banker was required to reimburse them for business expenses (e.g., licensing fees, motor vehicle expenses, cellphone expenses, etc.) (Labor Code §2802), pay penalties and damages for failing to keep accurate itemized wage statements (Labor Code §226), and pay other damages allowed under the Business and Professions Code. (B&PC §17200, et seq.)

***Comment***

Neither Bararsani's attorneys nor Coldwell Banker would confirm or deny the amounts, which have been reported on numerous websites. However, assuming the numbers are correct, each individual will receive approximately $600, with the law firm taking the bulk of the spoils.

The associates claimed that they were employees because Coldwell Banker controlled their activities, including:

- Prohibiting them from working for other brokerages or companies;
- Mandating how commissions would be paid;
- Specifying where the associates would work;
- Requiring associates to attend company trainings, obtain and maintain auto and liability insurance, pay for legal assistance fees, and sign and adhere to anti-sexual harassment policies; and
- Imposing conditions and requirements on computer hardware and software use.

***Comment***

This lawsuit primarily sought reimbursement of employee business expenses. It will be interesting to see if the IRS or the EDD pursues employee versus independent contractor audits and to see if IRC §3508 plays a part. IRC §3508 specifically treated certain real estate agents as nonemployees if certain requirements are met.

## JUDGE REJECTS UBER SETTLEMENT

We reported last year that drivers brought a class action case against Uber over their classification as independent contractors. (***O'Connor, et al. v. Uber Technology, Inc.*** (March 11, 2015) U.S. Dist. Ct., Northern District of California, Case No.C-13-3826 EMC, Order Denying Defendant Uber Technologies, Inc.'s Motion for Summary Judgment) This year, Uber proposed a $100 million settlement in the class action suit with drivers in California and Massachusetts. The settlement proposal was rejected by the judge because it did not compensate drivers enough. The settlement proposal, agreed upon by both sides, would require the drivers to agree to their classification as independent contractors.

The Uber case may continue to be an interesting one in this area because drivers often have other employment, use their own cars, and work when they want or not at all. If the drivers in this case are ultimately classified as employees, then employers may have a difficult time classifying all but very few workers in any industry as independent contractors.

## Transportation service or "technology platform"?

Uber has attempted to argue that it merely provides a "technology platform" to connect independent contractor drivers with people who need rides. The court has stated that Uber's argument is a bit disingenuous because Uber frequently touts itself as "Everyone's Private Driver," and the only way it makes money is if the drivers provide rides.

The court quickly rejected Uber's argument, stating: "Uber is no more a 'technology company' than Yellow Cab is a 'technology company' because it uses CB radios to dispatch taxi cabs, John Deere is a 'technology company' because it uses computers and robots to manufacture lawn mowers, or Domino Sugar is a 'technology company' because it uses modern irrigation techniques to grow its sugar cane."

## Control

The court found that there was sufficient evidence that the drivers should be classified as employees rather than independent contractors based on the following control of the manner and method in which the drivers worked:

- Uber sets the fares it charges unilaterally; the drivers have no control;
- Uber prohibits drivers from arranging rides independently of the Uber app, (e.g., riders cannot arrange a pick up time after they drop a fare off), and the solicitation of rides can result in a driver's immediate dismissal;
- Uber's employee handbook indicated that Uber maintained the right at all times and at Uber's sole discretion to bar the driver access to Uber's app;
- Uber could, and frequently did, discharge employees at will for not "accepting" leads provided via the app;
- Uber controlled the method and manner in which the drivers performed by requiring drivers to "dress professionally," send a client a text message when 1-2 minutes from the pickup location, limiting the type of radio programming that may be played, dictating which side of the street riders should be picked up on, and requiring drivers to open the door for their riders; and
- Uber's app contains a "rating" system for passengers to rate and evaluate drivers, and drivers are routinely dismissed if their rating "falls below the applicable minimum star-rating."

The court did note that the driver's ability to control when and how many hours they work is a factor to consider, but one that in and of itself does not mean that a worker is not an employee. The court noted that the more relevant inquiry is how much control Uber has over its drivers while they are on duty for Uber.

*More legal woes*

In a separate action, Uber has settled with a class of customers (riders) who sued the company over the way the company represented its background checks and the fees it charged. The customers claimed to have been misled by Uber's claim that it's "safer than a taxi" because of its "industry leading" background checks.

If the settlement is approved, the class of customers will be given the option to be reimbursed by credit card or receive a credit to their rider account. This would include anyone who took an Uber ride in the U.S. between January 1, 2013, and January 31, 2016; the exact number of customers this timeframe encompasses is unknown.

In yet another action, a class of customers is suing Uber over airport fee tolls that were allegedly charged before the tolls were required by the airport, and for letting the driver keep the fee rather than remitting it to the airport.

# COSTS OF MISCLASSIFICATION

A worker classified as an employee is subject to various payroll taxes, minimum wage, overtime, employee benefit, and worker protection programs. In contrast, the responsibilities for a business that hires an independent contractor are minimal. The business is not required to file or pay payroll taxes or workers' compensation insurance (although the independent contractor must pay self-employment taxes and should carry liability insurance).

A worker who is classified as an independent contractor can potentially save a business a lot of money — that is, if the worker is actually an independent contractor. A worker who is erroneously classified as an independent contractor can actually cost an employer a lot more money because, as illustrated in the chart below, the employer becomes responsible for the worker's share of the payroll taxes and will be subject to severe penalties as well.

In addition to the tax cost, the company/employer may also be subject to retroactive payment of:

- Workers' compensation premiums;
- Medical insurance and potential federal tax penalties for failure to provide coverage;
- Stock option and/or other pension benefits;
- Reimbursement of expenses commonly reimbursed to employees (such as automobile expenses — one of the issues in the Uber litigation discussed above); and
- Other benefit programs such as paid vacation, sick leave, and medical reimbursement plans.

## Nontax consequences of misclassification

### Worker misclassification may be costly to all parties

If the investigation results in a reclassification from independent contractor to employee, it's well known that the costs of back taxes, penalties, and interest may be high for the company. The total cost may go up if the reclassified worker is entitled to the benefits the company's employees receive, including retirement benefits, and may go up exponentially if he or she is retroactively entitled.

The results of an EDD reclassification will be forwarded to the IRS, and federal assessments will be made in addition to those made by EDD.

### Reclassified worker denied SEP contributions

We usually think of employee versus independent contractor issues as they affect the employer payroll tax liability, but incorrect treatment can also cause tax troubles for a misclassified independent contractor. The Tax Court sided with the IRS and disallowed a taxpayer's business deductions and SEP contribution after the worker was reclassified from independent contractor to employee. (***Rosenfeld v. Comm.***, TCM 2011-110)

**Caution**

In October 2011, California Senate Bill 459 (Ch. 11-706) was signed into law, effective January 1, 2012, making the "willful misclassification" of employees as independent contractors "unlawful" and providing for severe penalties on employers and any "paid person" who inappropriately advises them regarding this issue. (The law exempts only attorneys and employees of the business from being penalized.)

The broad nature of this law may expose tax professionals to penalties if they are deemed to have misadvised clients about independent contractor status. The law provides that an advisor can be jointly and severally liable with an employer if they improperly advise an employer to treat an employee as an independent contractor.

If you or your firm performs payroll services for some of your clients, or prepares the payroll tax returns, or provides any other services that may pose risks regarding independent contractor issues, you may want to consider adding engagement letter language that specifically identifies what you will NOT be doing for your clients with respect to independent contractors. Below is some suggested engagement letter language for your reference.

***Suggested engagement letter language***

*We will not be responsible for advising you with respect to independent contractor status as part of our services. If you have any questions regarding the classification of employees versus independent contractors, we strongly encourage you to consult with legal counsel experienced in employment practice matters.*

SPIDELL

Tax • Analysis • Education

Chapter 5

# Practice and Procedures

# PRACTICE AND PROCEDURES

## PTIN RENEWAL

The IRS began processing PTIN renewals for the 2017 season in mid-October. Anyone who prepares or assists in preparing federal returns for compensation must have a valid PTIN and must renew before preparing tax returns in a new calendar year.

**Website**
www.irs.gov/Tax-Professionals/PTIN-Requirements-for-Tax-Return-Preparers

## IDENTITY THEFT

### TAX PREPARATION SOFTWARE

Beginning in the 2016 tax year, an expanded set of common standards were established by the IRS Security Summit and apply to all professional tax software makers. As part of these standards, professional tax products are now required to validate each user when accessing the software. Tax preparation software may require all users to log in (with both username and password) every time they launch their software. As an additional measure, passwords may need to be changed every 90 days.

### GET TRANSCRIPT IS UP AND WORKING AGAIN

The IRS has relaunched the IRS Get Transcript online service. It now has a rigorous two-step authentication process to provide increased protection against identity theft. (IR-2016-85)

In May of 2015, the IRS promptly closed its Get Transcript service after discovering that unauthorized third parties had accessed taxpayer information via the Get Transcript service. The breach affected over 300,000 taxpayer files.

The criminals who hit the IRS didn't steal taxpayer information from the IRS; they had apparently obtained taxpayer information from other sources, likely other data breaches. They then went through the IRS's Get Transcript portal to obtain taxpayer transcripts. They were able to verify identities in roughly one-half of their attempts.

After downloading transcripts of prior-year returns, they used information on those returns to file fraudulent 2014 returns that paid out more than $50 million in refunds.

#### Convictions

Marvin Ricardo Herard, age 26, of Miami was sentenced to 48 months in prison, followed by three years of supervised release, and was ordered to pay restitution in the amount of $172,521 for his participation in an identity theft tax fraud scheme where he used stolen personal identification information to access the Get Transcript service and obtain tax records of his identity theft victims. (DOJ News Release, May 12, 2016)

Log files from Get Transcript revealed that an e-mail address controlled by Herard attempted to access 38 different taxpayers' accounts through Get Transcript, and had successfully accessed 22 accounts. For the 2014 tax year, over 100 fraudulent tax returns, seeking over $500,000 in refunds, were filed from Herard's IP address. The IRS paid out $172,521 in refunds on these fraudulent tax returns.

A Georgia husband and wife pleaded guilty to charges relating to their involvement in a stolen identity income tax refund fraud scheme using the Get Transcript service. (DOJ News Release, April 22, 2016)

The couple and another man used the personal identification of actual individuals to access Get Transcript. They obtained prepaid debit cards from stores located in multiple states, registered the cards in the names of the stolen identities, filed false income tax returns using the stolen identities and information obtained from the Get Transcript database, and directed the IRS to deposit the tax refunds onto these cards. They then used the prepaid debit cards to purchase money orders, which they deposited into bank accounts and then structured cash withdrawals in amounts less than $10,000 in order to prevent the bank from filing Currency Transaction Reports.

## IRS's GET TRANSCRIPT SERVICE

The IRS offers an online request service called Get Transcript that allows individual taxpayers to view and print a copy of their tax transcripts.

Taxpayers can also request that a transcript be mailed to their address of record by:

- Using the online tool;
- Sending in Form 4506-T, Request for Transcript of Tax Return; or
- Calling (800) 908-9946.

The online tool is available for five types of transcripts: tax account, tax return, record of account, wage and income, and verification of nonfiling. Taxpayers who choose to have transcripts sent via mail using the online tool can request tax return and tax account transcripts only.

**✐ Practice Pointer**

A taxpayer or practitioner with a power of attorney cannot use Get Transcript online to request a transcript for another taxpayer. Instead, submit Form 4506-T, Request for Transcript of Tax Return. Tax practitioners can use e-Services Transcript Delivery System if their power of attorney already exists in the IRS Centralized Authorization File.

### Registering and verification

To register to use Get Transcript, taxpayers will need to have ready the following basic information:

- Full Name;
- E-mail;
- Birthdate;
- Social Security number (SSN) or individual tax identification number (ITIN);
- Tax filing status; and
- Current address.

For identity verification purposes, taxpayers will also need to provide a number from one financial account. Get Transcript will accept any of the following:

- Credit card;
- Mortgage or home equity loan;
- Home equity line of credit; or
- Auto loan.

Taxpayers only need to provide the loan account number or a few digits from a credit card number. If using a credit card number, the credit card will not be charged.

Last, taxpayers will need their mobile phone to register. For identity protection purposes, the IRS will send a text message to the taxpayer's mobile phone. This service won't work on pay-as-you-go (prepaid) plans, landlines, Skype, Google Voice, or similar virtual phones. The phone number must be a U.S.-based number. (Yes, to use the online version, a taxpayer must have a mobile phone that accepts text messages.)

Taxpayers who have a credit freeze with Equifax will need to temporarily lift the freeze in order to use Get Transcript; otherwise, the IRS will not be able to verify the taxpayer's identity.

# SCAMS TARGETING TAX PROFESSIONALS

## Phishing scam impersonates software providers

Tax professionals should be aware of the latest phishing e-mail scam that pretends to be from tax software providers. (IR-2016-103) Recipients are instructed to download and install an "important software update" via a link that redirects to a website prompting the tax pro to download the fraudulent update. The file has a naming convention that uses the actual name of their software followed by the ".exe extension."

The download is in fact a program designed to track the tax professional's key strokes, which is a common tactic used by cyber thieves to steal login information, passwords, and other sensitive data.

Rather than clicking on links or opening e-mail attachments, preparers should go to the software provider's main webpage to download all updates or download updates from with the program itself.

Also, the IRS warns tax return preparers to be on guard against bogus e-mails seeking updated personal or professional information. (IR-2015-31)

Specifically, the bogus e-mail asks tax professionals to update their IRS e-services portal information and electronic filing identification numbers (EFINs). The links that are provided in the bogus e-mail to access IRS e-services appear to be a phishing scheme designed to capture the tax professional's username and password.

Suspected phishing attempts should be reported to the IRS at:

**Website**
www.irs.gov/uac/Report-Phishing

## Cyber attacks continue

Tax practitioners should be aware of identity thieves filing fraudulent returns by remotely taking over a tax pro's computer. (IRS News Release 2016-119 (September 2, 2016)) The attacks are typically discovered when the tax pro reconciles e-file acknowledgements. Such attacks increased in number as the filing deadline approached, and the attacks are similar to those that occurred before the April 15, 2016, deadline.

The IRS urges tax professionals to review their tax preparation software settings and immediately enact all security measures, especially those settings that require usernames and passwords to access the products.

In addition to activating security measures for tax software products, all tax preparers should take the following steps:

- Run a security full or deep scan to search for viruses and malware;
- Strengthen passwords for both computer access and software access. Make sure passwords are a minimum of eight digits (more is better) with a mix of numbers, letters, and special characters. Change passwords often;
- Be alert for phishing scams: Do not click on links or open attachments from unknown senders;
- Educate all staff members about the dangers of phishing scams in the form of e-mails, texts, and calls;
- Review any software that employees use to remotely access the network and/or that an IT support vendor uses to remotely troubleshoot technical problems and support systems. Remote access software is a potential target for bad actors to gain entry and take control of a machine; and
- Monitor PTIN activity.

## Monitor your PTIN

Tax preparers can help protect clients and their businesses from identity theft by checking their PTIN accounts to ensure the number of returns filed using their identification number matches IRS records.

Criminals are increasingly targeting tax professionals, not only to steal client data but also to steal the professionals' data such as PTINs, EFINs or e-Service passwords.

The IRS offers certain preparers the ability to monitor "Returns Filed Per PTIN." This information is available in the online PTIN system for tax return preparers who meet both of the following criteria. You must have:

- A professional credential; and
- Filed at least 50 tax returns from the Form 1040 series processed in the current year.

It is important to monitor this information even if you do not prepare returns or only prepare a small number of returns. If there is no data shown, less than 50 returns have been processed with your PTIN.

***How to monitor your PTIN***

To see how many returns were filed per PTIN:

1. Go to www.irs.gov/ptin and log in to your PTIN account;
2. From the Main Menu, select "Additional Activities";
3. Then select "View Returns Filed Per PTIN";
4. A chart labeled Returns Per PTIN should appear; and
5. A count of individual income tax returns filed and processed in the current year will be displayed.

The information in the Returns Per PTIN chart is updated weekly, and the IRS recommends that you check this information regularly. If the number of returns processed is significantly more than the number of tax returns you've prepared, and you suspect possible misuse of your PTIN, complete and submit to the IRS Form 14157, Complaint: Tax Return Preparer. The IRS requests submission on this form even though it is generally used to report a complaint against a tax preparer.

# SCAMS TARGETING TAXPAYERS

## Fraudulent CP2000s

The IRS is warning taxpayers and practitioners that a new scam uses fraudulent CP2000s to solicit money from taxpayers. The fraudulent forms look convincing and show balances due that are small enough that taxpayers just might pay rather than arguing the point.

However, upon closer inspection, these forms have telltale signs of fraud:

- The instructions direct the taxpayer to make out a check to "I.R.S." rather than to "United States Treasury"; and
- The return address is "Austin Processing Center, P.O. Box 15264, Austin, TX 78761-5264," which does not match the address listed on the IRS website for the Austin processing center.

Tax practitioners should advise clients to contact them if any unexpected balance due arrives from the IRS so that the correspondence can be verified.

For more information, go to:

**Website**
www.irs.gov/uac/irs-and-security-summit-partners-warn-of-fake-tax-bill-emails

## Pay your tax via gift card?

TIGTA has sent out an alert warning taxpayers not to fall for the latest scam perpetrated by IRS impersonators. (TIGTA "IRS Impersonation Scam Update" (June 13, 2016) Available at: www.treasury.gov/ tigta/irs_scam_updates.shtml)

The impersonators have been demanding payment from taxpayers in the form of iTunes gift cards, and the TIGTA warning reminds taxpayers that the IRS does not accept payment via gift cards or any prepaid debit card. Anyone receiving a call like this should report it to TIGTA at:

**Website**
www.treasury.gov/tigta/contact_report_scam.shtml

### Phone scams during tax season

As the 2016 tax season progressed, the tactics used by phone scammers changed. (IR-2016-40) The scams shifted focus to "verify" information reported on a recently filed return.

The scam artists claim the IRS has the taxpayer's tax return, and they just need to verify a few details to process the return. The scam tries to get the taxpayer to give up personal information such as a SSN or bank or credit card numbers. The caller may know a lot about their targets, and they usually alter the caller ID to make it look like the IRS is calling.

Commissioner Koskinen advises: "Don't be fooled. The IRS won't be calling you out of the blue asking you to verify your personal tax information or aggressively threatening you to make an immediate payment … It's a growing list of people who've encountered these. I've even gotten these calls myself."

## REPORTING THEFT TO THE IRS

Taxpayers should immediately report identity theft to one of the three major credit reporting bureaus, so they can put a fraud alert on the taxpayer's credit records (see "Identity Theft Victim Checklist" on page 5-11). The taxpayer should also contact the Federal Trade Commission at:

| |
|---|
| **Website** |
| www.ftc.gov |

The taxpayer will also need to fill out Form 14039, IRS Identity Theft Affidavit.

Taxpayers may also contact the IRS Identity Protection Specialized Unit at the number below, even if tax records have not yet been affected but identity theft is suspected (for example, due to a lost or stolen wallet).

| |
|---|
| ☎ **Telephone** |
| (800) 908-4490 |

If a taxpayer receives a notice from the IRS indicating that there may be a problem with the taxpayer's personal information, it is important to respond immediately using the name and number printed on the notice or letter. (www.irs.gov/uac/Taxpayer-Guide-to-Identity-Theft)

### Using the wrong form to report identity theft

Taxpayers must use Form 14039, Identity Theft Affidavit, if someone has filed a fraudulent return using the taxpayer's SSN. (Also see the chart "How Do You Report Suspected Tax Fraud Activity?" on page 5-13.)

With the rise of tax return identity theft, the IRS has also seen a rise in the number of complaints filed by taxpayers. Unfortunately, if the taxpayer uses the wrong IRS form to report identity theft, it is possible that the case will be delayed or the form destroyed — often without contacting the taxpayer.

Form 3949-A, Information Referral, is for reporting a variety of tax law violations — but identity theft is not one of them. However, taxpayers frequently use this form to file such a complaint. A report released by TIGTA found that using Form 3949-A to report an instance of identity theft would often result in the case being delayed for up to 60 days or the form destroyed because it is not processable under current IRS procedures, even in cases where there was enough information submitted on a Form 3949-A to classify it as an identity theft complaint. ("The Process for Individuals to Report Suspected Tax Law Violations Is Not Efficient or Effective" (September 10, 2012) TIGTA. Reference No. 2012-40-106)

# IRS AND FTB IDENTITY VERIFICATION LETTERS

Phishing attempts can affect tax practitioners, too, so it's important to know which communications from the taxing agencies are legitimate. For example, both the IRS and FTB send letters that ask for more information to verify identity, but taxpayers (and tax pros) may not immediately recognize the forms.

## IRS identity verification letters

Taxpayers who receive IRS Letter 5071C to verify their identity may proceed to idverify.irs.gov to complete the verification process. (www.irs.gov/Individuals/Employees/Understanding-Your-5071C-Letter) Letter 5071C asks taxpayers to verify their identities in order for the IRS to complete processing of the returns if the taxpayers did file the returns, or reject the returns if the taxpayers did not file them. If taxpayers cannot access the website, they can verify their identity using the toll-free number included in the letter.

## California form

The FTB uses a similar form: Form FTB 4734D, Request for Information and Documents. Some practitioners were concerned because the form requests confidential information from the taxpayer, but there was no way to verify that the form is legitimate.

After requests from Spidell to include something about the form on their website to avoid confusion about its legitimacy, the FTB has posted information about the form. Taxpayers and practitioners can now verify the contact information on the form they receive at:

**Website**
www.ftb.ca.gov/Bills_and_Notices/notices.shtml

# EFFORTS TO COMBAT IDENTITY THEFT

## No more than three refunds per account

The IRS is placing a limit of three refunds that can be electronically direct deposited into any one financial account.

The IRS understands that there are legitimate reasons why taxpayers would have multiple refunds going to a single account. Parents may have children named in their bank account. However, direct deposit is also an easy way for an identity thief to quickly divert funds to a bank account and cash out.

## Stronger protections for taxpayers using software

For the 2016 filing season, the IRS worked with tax software providers to increase security by making changes such as:

- Requiring an eight-digit password that requires use of uppercase and lowercase letters, numbers, and special characters;
- Limits on the number of unsuccessful login attempts before the user is locked out;
- Completion of three security questions; and
- Identity verification that sends a PIN to the e-mail on file for the taxpayer. The PIN is then used to verify taxpayer information before return preparation can be started.

## W-2 verification pilot program

For the 2016 filing season, the IRS tested a W-2 verification code that will verify the authenticity of the W-2 data. The IRS and its partners in the payroll and software industries will greatly expand the pilot program to add W-2 verification codes to 50 million Forms W-2 in 2017.

The IRS has partnered with certain payroll service providers (ADP, Ceridian, Intuit, and Paychex) to include a 16-digit code and a verification code field on Copies B and C of Form W-2 provided to employees. The code applies to e-filed Forms 1040 only.

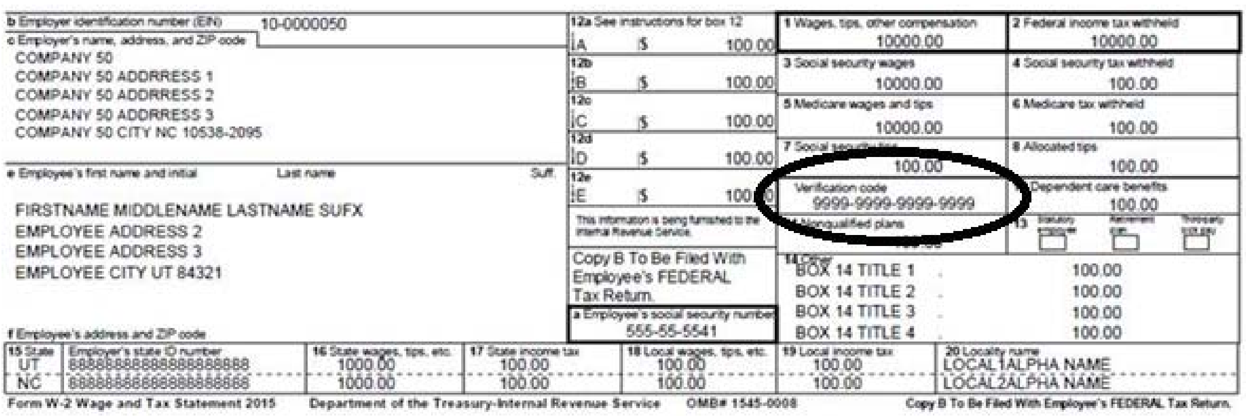
The form will include these instructions to taxpayer and tax preparers:

*Verification Code. If this field is populated, enter this code when it is requested by your tax return preparation software. It is possible your software or preparer will not request the code. The code is not entered on paper-filed returns.*

Some employees will receive a W-2 with a blank verification code box. These taxpayers do not need to enter any code data into their tax software product.

For the purposes of the pilot program, omitted and incorrect W-2 verification codes will not delay the processing of a tax return. The code will not be on the copy of the W-2 that is transmitted to the Social Security Administration. Payroll processing firms will generate the alphanumeric code based on select data elements on each Form W-2 and an algorithm provided by the IRS.

***Sample W-2 with verification code — Intuit***



b Employer identification number (EIN) 10-0000050
c Employer's name, address, and ZIP code
COMPANY 50
COMPANY 50 ADDRRESS 1
COMPANY 50 ADDRRESS 2
COMPANY 50 ADDRRESS 3
COMPANY 50 CITY NC 10538-2095
e Employee's first name and initial Last name Suff.
FIRSTNAME MIDDLENAME LASTNAME SUFX
EMPLOYEE ADDRESS 2
EMPLOYEE ADDRESS 3
EMPLOYEE CITY UT 84321
f Employee's address and ZIP code
12a See instructions for box 12 A $ 100.00
12b B $ 100.00
12c C $ 100.00
12d D $ 100.00
12e E $ 100.00
This information is being furnished to the Internal Revenue Service.
Copy B To Be Filed With Employee's FEDERAL Tax Return.
a Employee's social security number 555-55-5541
1 Wages, tips, other compensation 10000.00
2 Federal income tax withheld 10000.00
3 Social security wages 10000.00
4 Social security tax withheld 100.00
5 Medicare wages and tips 10000.00
6 Medicare tax withheld 100.00
7 Social security tips 100.00
8 Allocated tips 100.00
Verification code 9999-9999-9999-9999
Dependent care benefits 100.00
Nonqualified plans
13 Statutory employee Retirement plan Third-party sick pay
14 Other
BOX 14 TITLE 1 100.00
BOX 14 TITLE 2 100.00
BOX 14 TITLE 3 100.00
BOX 14 TITLE 4 100.00

| 15 State | Employer's state ID number | 16 State wages, tips, etc. | 17 State income tax | 18 Local wages, tips, etc. | 19 Local income tax | 20 Locality name |
|---|---|---|---|---|---|---|
| UT | 8888888888888888888 | 1000.00 | 100.00 | 100.00 | 100.00 | LOCAL1ALPHA NAME |
| NC | 8888888888888888888 | 1000.00 | 100.00 | 100.00 | 100.00 | LOCAL2ALPHA NAME |

Form W-2 Wage and Tax Statement 2015 Department of the Treasury-Internal Revenue Service OMB# 1545-0008 Copy B To Be Filed With Employee's FEDERAL Tax Return.

## IP PINs

The IRS provides a six-digit identity protection personal identification number (IP PIN) to victims of tax-related identity theft who have had their identities verified by the IRS. The IP PIN helps to prevent the misuse of a taxpayer's SSN or taxpayer identification number on income tax returns, and will avoid delays in processing the tax returns of identity theft victims.

For e-filed returns, tax software will indicate where to insert the IP PIN. For paper returns, taxpayers must enter the IP PIN in the six boxes to the right of the spouse's occupation box in the signature section. Taxpayers with an IP PIN requirement must include it on the return, or the return will be rejected. This applies to taxpayers, spouses, and dependents who have an IP PIN requirement.

**Note:** Taxpayers must not use an IP PIN as their e-file signature PIN.

The IP PIN is for federal reporting use only, and the IRS will mail a new IP PIN each December. The IP PIN is on the CP01A Notice.

## California

California utilizes a different system than the IRS. Victims of identity theft in California have their FTB account flagged, and the FTB will stop and review any returns filed under the victim's name and SSN. The FTB will confirm if the return was filed by the real taxpayer, and refunds could be delayed 60 days.

Married taxpayers will use IP PINs differently depending on if paper or electronic returns are filed:

- For paper returns, only the taxpayer listed first on the return will enter their IP PIN. If the second person listed is the one with an IP PIN, it will not be entered on the return. However, having the IP PIN guards against another return being filed under that person's name and SSN as the primary number; and
- For electronic returns:
  - Each taxpayer who receives an IP PIN must enter it on their tax return;
  - If only one taxpayer receives an IP PIN, it is entered with the taxpayer's SSN to whom it belongs; and
  - If both taxpayers receive an IP PIN, both taxpayers must enter the IP PIN that goes with their SSN.

## Eligibility for IP PIN use

Currently, only certain taxpayers are eligible for IP PINs; it is not a program to which taxpayers can "opt in." Also, once taxpayers get an IP PIN, they cannot opt out.

These taxpayers must get an IP PIN in order to file returns until they have been notified that the IP PIN is no longer required:

- Taxpayers who received a CP01A Notice (containing their IP PIN) but lost it;
- Taxpayers who had an IP PIN in a previous year but have not yet received a new one for the current filing year; or
- Taxpayers who tried to e-file a return, and the return was rejected because of a missing IP PIN.

These taxpayers may elect to get an IP PIN:

- Taxpayers who filed returns listing an address in Florida, Georgia, or the District of Columbia; or
- Taxpayers who received a letter from the IRS inviting them to join the program because they were identified as possible identity theft victims.

If a taxpayer lost or did not receive their IP PIN, go to:

**Website**
www.irs.gov/Individuals/Retrieve-Your-IP-PIN

**Website**
www.irs.gov/Individuals/Get-An-Identity-Protection-PIN

For general information on IP PINs, go to:

**Website**
www.irs.gov/Individuals/The-Identity-Protection-PIN-IP-PIN

For FAQs on IP PINs, go to:

**Website**
www.irs.gov/Individuals/Frequently-Asked-Questions-about-the-Identity-Protection-Personal-Identification-Number-(IP-PIN)

## IP PIN website tool reinstated

The IRS has reinstated the "Get an IP PIN" tool after having suspended the use of the tool in March 2016 due to security concerns. (IRS Statement on "Get an IP PIN" Tool, July 19, 2016)

Under the relaunched tool, taxpayers wanting a new IP PIN or who have lost or forgotten their IP PIN must verify their identities using a more rigorous Secure Access process that requires them to have:

- Immediate access to an e-mail address;
- Account information from a credit card or other types of loans; and
- A text-enabled mobile phone.

<table>
<tr><th colspan="2">Identity Theft Victim Checklist</th></tr>
<tr><td>☐</td><td>Report the fraud to the three major credit bureaus, and review your credit report thoroughly.<ul><li>Equifax (800) 525-6285 / www.equifax.com/CreditReportAssistance/</li><li>Experian (888) 397-3742 / www.experian.com/fraud/center.html</li><li>TransUnion (800) 680-7289 / www.transunion.com/fraud-victim-resource/place-fraud-alert</li></ul>Use the Federal Trade Commission's ID Theft Affidavit when reporting the theft to creditors and credit bureaus. The form is available on the FTC's website.</td></tr>
<tr><td>☐</td><td>California victims of identity theft are allowed free credit reports monthly for 12 months following the date of the police report. (Cal. Civ. Code §1785.15.3(b)) The method of requesting these varies depending on the credit agency.</td></tr>
<tr><td>☐</td><td>Report the fraud to the police, and save the police report to use when reporting the fraud elsewhere.</td></tr>
<tr><td>☐</td><td>For identity theft related to tax returns and employment, call the IRS Identity Protection Specialized Unit at (800) 908-4490 to have the IRS put an account marker on your Social Security number. This will allow any IRS employee who deals with the file to be aware of the ID theft. File Form 14039,IRS Identity Theft Affidavit.</td></tr>
<tr><td>☐</td><td>Contact the Franchise Tax Board Identity Theft Hotline at (916) 845-7088. File Form FTB 3552, Identity Theft Affidavit, and supporting documents.</td></tr>
<tr><td>☐</td><td>If your credit or debit card account has unauthorized charges, contact your bank or account issuer to report the transactions. Close the accounts. If checks were stolen, contact major check verification companies and ask that they not accept checks on the closed account.<ul><li>TeleCheck (800) 710-9898</li><li>Certegy (800) 437-5120</li></ul>To find out if the identity thief has passed bad checks in your name, call SCAN at (800) 262-7771.</td></tr>
<tr><td>☐</td><td>Follow up with the credit bureaus via mail, and include copies of the police report and ID Theft Affidavit.<ul><li>Equifax, P.O. Box 740241, Atlanta, GA 30374</li><li>Experian, P.O. Box 9532, Allen, TX 75013</li><li>TransUnion, P.O. Box 6790, Fullerton, CA 92834</li></ul></td></tr>
<tr><td>☐</td><td>Report the fraud to creditors if the thief opened accounts in your name. Ask for the security or fraud department. Report the fraud via telephone and regular mail.</td></tr>
<tr><td>☐</td><td>Consider a credit freeze. This means that your credit file cannot be shared with potential creditors, insurers, employers, or residential landlords without your permission.</td></tr>
<tr><td>☐</td><td>If you are contacted by debt collectors, explain that you are not responsible for the debt, and follow up in writing.</td></tr>
<tr><td>☐</td><td>If your driver's license was stolen, call your local DMV office, and report the theft and ask them to put a fraud alert on your license. Contact the DMV ID Theft Hotline at (866) 658-5758.</td></tr>
<tr><td>☐</td><td>If your mail was stolen or if someone filled out a change of address request in your name, contact the Postal Inspector to report the theft.</td></tr>
<tr><td>☐</td><td>If your Social Security number was used to claim unemployment benefits, contact the EDD's Fraud Hotline at (800) 229-6297. You can also get the EDD's Fraud Reporting Form on their website.</td></tr>
<tr><td>☐</td><td>If your Social Security number was used to claim Social Security benefits, call the Social Security Administration's Fraud Hotline at (800) 269-0271. You can also report fraud on the SSA's website.</td></tr>
<tr><td>☐</td><td>If your Social Security number was used to claim Medicare, Medi-Cal, or other social services, call the Department of Health and Human Services Office of the Inspector General at (800) 447-8477 (for Medicare fraud). Call the California Department of Health Care Services Medical Fraud Reporting Hotline at (800) 822-6222 (for Medi-Cal fraud). Call the California Department of Social Services Welfare Fraud Referral Hotline at (800) 344-8477 or by e-mail at FraudHotline@dss.ca.gov (for other social services-related fraud).</td></tr>
<tr><td colspan="2">Taken from "Identity Theft Victim Checklist" California Office of the Attorney General. Available at: www.oag.ca.gov/idtheft/facts/victim-checklist. Checklist also contains sample letters for reporting fraudulent accounts</td></tr>
</table>

| How Do You Report Suspected Tax Fraud Activity? | | |
|---|---|---|
| **If you …** | **Then** | **And** |
| Suspect or know of an individual or a business that is not complying with the tax laws on issues such as:<br>• False exemptions or deductions<br>• Kickbacks<br>• False/altered document<br>• Failure to pay tax<br>• Unreported income<br>• Organized crime<br>• Failure to withhold | Use Form 3949-A, Information Referral<br>**Caution**: Do NOT use Form 3949-A to report any of the other issues listed in this chart | Print the form and mail to:<br>Internal Revenue Service<br>Fresno, CA 93888<br>Or, order the form by mail or by calling the Tax Fraud Hotline recording at: (800) 829-0433<br>**Note:** The IRS doesn't accept alleged tax law violation referrals over the phone<br>You may also send a letter to the address above instead of using Form 3949-A. Please include as much information as possible, such as these important points:<br>• Name and address of person or business you are reporting<br>• The individual's Social Security number or the business's EIN<br>• A brief description of the alleged violation(s), including how you became aware or obtained information about the violation(s)<br>• The years involved<br>• The estimated dollar amount of any unreported income<br>• Your name, address and phone number*<br>* Although you are not required to identify yourself, it is helpful to do so. Your identity will be kept confidential |
| Suspect someone stole your identity and used your Social Security number for employment purposes or could use your Social Security number to file a tax return | Use Form 14039, Identity Theft Affidavit | Complete the form online, print it, and mail or fax to the appropriate office using the options listed on page 2 of the form. Include photocopies of at least one of the documents listed on the form to verify your identity |
| Suspect fraudulent activity or an abusive tax scheme by a tax return preparer or tax preparation company | Use Form 14157, Complaint: Tax Return Preparer (Form 14157-A, Tax Return Preparer Fraud or Misconduct Affidavit, may also be required. See below) | Complete the form online, print it, and mail it to the IRS address on the form |
| | | *(continued)* |

| How Do You Report Suspected Tax Fraud Activity? (continued) | | |
|---|---|---|
| **If you …** | **Then** | **And** |
| Suspect a tax return preparer filed a return or altered your return without your consent, and you are seeking a change to your account | Use Form 14157 **and** Form 14157-A | Send **both** forms (Form 14157 and Form 14157-A) to the address shown in the instructions for Form 14157-A |
| Suspect an abusive tax promotion or promoter | Use Form 14242, Report Suspected Abusive Tax Promotions or Preparers | The form can be mailed or faxed to the IRS address or fax number on the form |
| Suspect misconduct or wrongdoing by an exempt organization or employee plan | Use Form 13909, Tax-Exempt Organization Complaint (Referral) Form | Mail it to the address provided on the form |
| Have information and want to claim a whistleblower reward | Use Form 211, Application for Award for Original Information | Mail it to the address in the instructions for the form |
| Suspect you received or are aware of fraudulent IRS e-mails and websites | See www.irs.gov/uac/Report-Phishing for what to do if you receive a suspicious IRS-related communication | |
| Source: www.irs.gov/Individuals/How-Do-You-Report-Suspected-Tax-Fraud-Activity%3F | | |

# FILING, COLLECTION, AND PENALTY ISSUES

## IRS UPDATES PRIVATE DELIVERY SERVICE LIST

The IRS has updated the list of private delivery services (PDS) for purposes of the timely mailing treated as timely filing rule. (Notice 2016-30) The new list is effective April 11, 2016.

**Caution**

Although the IRS doesn't often update the list, this is the second update in less than a year. Be careful to use the most current list.

If in doubt, the IRS maintains its most current list online:

**Website**
www.irs.gov/uac/private-delivery-services-pds

### Background — the "mailbox rule"

IRC §7502 is descriptively entitled, "Timely mailing treated as timely filing and paying." It provides that any return, payment, or any other document pertaining to the administration of the tax law (including a Tax Court petition) that can be mailed (i.e., not including payments that must be made electronically) is treated as timely filed if it is mailed through the U.S. mail on or before the due date. If a document or payment is sent by U.S. registered mail or U.S. certified mail, and the sender's receipt is postmarked by the postal employee to whom the document or payment is presented, the date of the U.S. postmark is treated as the filing date. A "certificate of mailing" is not the same as using certified mail.

IRC §7502(f) provides that the timely mailing rule also applies to certain PDSs as approved by the IRS. Notice 2016-30 provides a list of PDSs. The list is updated only when the IRS deems it necessary to add or remove a PDS.

**Caution**

If a tax return or other tax-related document is not mailed through the U.S. mail or qualifying PDS, it must be *received* by the IRS or other tax-related agency by the deadline in order to be timely. PDSs cannot deliver to post office box addresses at IRS centers.

While three carriers are treated as qualifying PDSs, only specific services offered by each PDS qualify:

- DHL
  - Express 9:00
  - Express 10:30
  - Express 12:00
  - Express Worldwide
  - Express Envelope
  - Import Express 10:30
  - Import Express 12:00
  - Import Express Worldwide
- FedEx
  - Priority Overnight
  - Standard Overnight
  - First Overnight
  - 2 Day
  - International Priority
  - International First
  - International Economy
  - International Next Flight Out
- UPS
  - Next Day Air Early AM
  - Next Day Air
  - Next Day Air Saver
  - 2nd Day Air
  - 2nd Day Air A.M.
  - Worldwide Express Plus
  - Worldwide Express

### California conformity

California conforms to the IRS PDS list above. (R&TC §21027)

## FAILURE-TO-FILE PENALTY INCREASES

Generally, the mandatory penalty for failing to timely file an income tax return is 5% of the net amount of tax due for each full or partial month of the delinquency. The maximum penalty is 25% of the net amount of tax due.

For 2016, the minimum penalty for failure to file a return within 60 days of the return's due date increases from $135 to $205. (IRC §6651; Trade Facilitation and Trade Enforcement Act of 2015 (P.L. 114-125)) Thus, the penalty is the lesser of $205 or 100% of the amount required to be shown as tax on the return. The increased failure-to-file penalty is effective for tax returns filed after December 31, 2015. For 2017, the minimum penalty increases to $210.

### California nonconformity

California does not conform to the federal penalty increase. Under R&TC §19131(b), the penalty remains at the lesser of $135 or 100% of the amount required to be shown as tax on the return.

## INSTALLMENT AGREEMENT FEES INCREASE

The IRS has issued final regulations increasing user fees for all installment agreement types (except for low-income taxpayers) and introducing two new types of installment agreements for taxpayers who set up the installment agreement online via the IRS website. (T.D. 9798; IRB 2016-51) The new user fees are effective for installment agreements entered into, restructured, or reinstated on or after January 1, 2017.

| Installment Agreement Fees | | |
|---|---|---|
| **Type of installment agreement** | **Old fee** | **New fee** |
| Rate for over the phone or by filing Form 9465 | $120 | $225 |
| Direct debit agreement | $52 | $107 |
| Online with manual payments | N/A (new) | $149 |
| Online with direct debit | N/A (new) | $31 |
| Low income rate (except online with direct debit) | $43 | $43 |
| Restructure fee for taxpayer in default (regular) | $50 | $89 |
| Restructure fee for taxpayer in default (low income) | $43 | $43 |

## NO FRIVOLOUS-RETURN PENALTY WHERE TAXPAYER PLEADS THE FIFTH

A taxpayer who redacted some information on his Schedule B regarding certain interest and dividends was found not liable for a frivolous-return penalty. (***Youssefzadeh v. Comm.*** (November 6, 2015) USTC Order, Docket No. 14868-14 L) The taxpayer argued that the penalty should not apply because he was avoiding self-incrimination by redacting information that could have triggered a duty to file an FBAR. The court agreed, noting that the taxpayer had provided plenty of information on the return, including the total amount of interest (he had blacked out the sources of the interest). The taxpayer was able to prove that he had reasonable cause to fear that answering a question on his return could lead to criminal prosecution.

## PAY YOUR TAX AND GRAB A SLURPEE …

… all in one convenient location. The IRS announced that taxpayers who need to pay their tax in cash may now do so at over 7,000 participating 7-Eleven stores around the U.S. (IR-2016-56) Individuals wishing to take advantage of this payment option should visit the web address below, select the cash option in the “Other Ways You Can Pay” section, and follow the instructions. There is a $1,000 payment limit per day and a $3.99 fee per payment.

**Website**
www.irs.gov/Payments

## OTHER IRS ISSUES

## IRS MAY KEEP TAXPAYERS FROM TRAVELING

Starting October 1, 2020, anyone traveling by air on a domestic flight will need a form of ID that is compliant with the requirements set out in the REAL ID Act. (P.L. 109-13) However, currently not all states' driver's licenses are compliant with the act. That means that, barring changes to the licenses in those states to bring them into compliance, passengers will most likely be using passports to board domestic flights. Unless they owe the IRS money, that is.

### IRS able to cause passports to be revoked

The Fixing America's Surface Transportation Act of 2015 (FAST Act) added IRC §7345, which provides the IRS the ability to certify to the Secretary of State that an individual has a "seriously delinquent" tax debt. The State Department may revoke a passport previously issued to such an individual. A "seriously delinquent" tax debt is an unpaid, legally enforceable tax liability in excess of $50,000, including penalties and interest, for which a notice of lien or levy has been filed. (IRC §7345(b))

However, the taxpayer will no longer be considered seriously delinquent for the purpose of passport revocation if:

- The taxpayer who owes such a delinquency pays the debt in full, or enters into an installment agreement or offer in compromise;
- A spouse files for relief from joint liability; or
- The delinquency was erroneously reported.
  (http://transportation.house.gov/uploadedfiles/joint_explanatory_statement.pdf)

This could affect the travel ability of taxpayers who live in states that issue noncompliant drivers licenses; although, there are other forms of acceptable federal identification listed at:

**Website**
www.tsa.gov/travel/security-screening/identification

*Noncompliant states*

The following state/territory driver's licenses are currently not compliant with the REAL ID Act:

- Alaska
- Arizona
- Arkansas
- California
- Guam
- Idaho
- Kentucky
- Louisiana
- Maine
- Massachusetts
- Michigan
- Montana
- New Hampshire
- New Jersey
- New Mexico
- New York
- North Carolina
- North Dakota
- N. Mariana Is.
- Oklahoma
- Oregon
- Pennsylvania
- Puerto Rico
- Rhode Island
- South Carolina
- Texas
- Virgin Islands
- Virginia

Source: www.dhs.gov/current-status-states-territories

# ITINs ISSUED PRIOR TO 2013 MUST BE RENEWED

The Protecting Americans from Tax Hikes Act of 2015 (PATH Act) establishes new procedures for obtaining an individual taxpayer identification number (ITIN), effective for applications made after December 18, 2015, and requires that all ITINs issued prior to 2013 be renewed.

***What is an ITIN?***

An ITIN is a nine-digit number issued by the IRS to foreign nationals and others who have federal tax reporting or filing requirements and do not qualify for SSNs. Examples of situations in which an ITIN is required include:

- A nonresident alien individual claiming reduced withholding under an applicable income tax treaty for which an ITIN is required;
- A nonresident alien individual not eligible for an SSN who is required to file a U.S. tax return or who is filing a U.S. tax return only to claim a refund;
- A nonresident alien individual not eligible for an SSN who elects to file a joint U.S. tax return with a spouse who is a U.S. citizen or resident alien;
- A U.S. resident alien who files a U.S. tax return but who is not eligible for an SSN;
- An alien spouse claimed as an exemption on a U.S. tax return who is not eligible to get an SSN;
- An alien individual eligible to be claimed as a dependent on a U.S. tax return but who is not eligible to get an SSN;
- A nonresident alien student, professor, or researcher who is required to file a U.S. tax return but who is not eligible for an SSN, or who is claiming an exception to the tax return filing requirement; and
- A dependent/spouse of a nonresident alien U.S. visa holder, who is not eligible for an SSN. (Instructions, Form W-7, Application for IRS Individual Taxpayer Identification Number)

## Mandatory renewals

Under the PATH Act, all ITINs issued prior to 2013 are set to expire based on a multiyear schedule dependent on the date the ITIN was issued. However, the IRS was concerned that most ITIN holders would not have this information, so the IRS has developed a different schedule than that specified in the PATH Act. (IRS Notice 2016-48) Rather than setting an expiration schedule based on when the ITIN was issued, the IRS has set up an expiration schedule based upon the middle digits in the ITIN.

Effective January 1, 2017, all ITINs with middle digits of 78 or 79 (e.g., XXX-78-XXXX) will expire and must be renewed. The IRS will mail approximately 400,000 Letters 5821 to the ITIN holders' last-known address as provided to the IRS on a tax return or as provided to the U.S. Postal Service.

These ITIN holders will be able to renew their ITINs beginning October 1, 2016. ITIN holders with middle digits other than 78 or 79 should wait until they are notified by the IRS to renew their ITINs.

## Implementation issues

Under the new rules, individuals residing inside the U.S. must submit Form W-7, Application for IRS Individual Taxpayer Identification Number, as follows:

- By mail to the ITIN Operation Unit in Austin, Texas;
- In person to the IRS; or
- To a community-based certificate acceptance agent. (IRC §6109(i)(1)(A))

Persons eligible to be community-based certified acceptance agents include:

- Financial institutions;
- Tax-exempt colleges and universities;
- Federal agencies;
- State and local governments, including agencies responsible for vital records;
- Certain tax-exempt community-based organizations;
- Persons who provide tax return preparation assistance to taxpayers; and
- Other persons identified by the IRS.
  (Act §203(c) of the PATH Act of 2015)

Under the new law, individuals residing outside the U.S. must submit the proper form by mail or in person to an IRS employee or to a designated individual at a U.S. diplomatic mission or consular post. (IRC §6109(i)(1)(B))

**Website**
www.irs.gov/individuals/acceptance-agent-program

## ITINs not used for three consecutive years

In addition to the renewal requirements discussed above, any ITIN issued after 2012 will expire if not used on a federal income tax return for a period of three consecutive taxable years. Previously, ITINs expired if not used for five consecutive years. (IRS News Release IR-2014-76) These ITINs may be renewed anytime starting October 1, 2016, by submitting a Form W-7 with the "renewal box" checked and required documentation attached.

The W-7 may be attached to the return or submitted separate from the return. The applicant will receive a letter from the IRS stating that the application has been approved. Once renewed, an ITIN will remain in effect unless it is not used on a tax return for three consecutive years.

## Failure to renew

The IRS will accept returns filed by individuals who were unaware that their ITIN expired or that they were required to renew their ITIN; however, there may be a delay in processing these returns. In addition, certain credits, such as the Child Tax Credit and the American Opportunity Tax Credit, may not be allowed unless the ITIN is renewed.

## ITIN holders with, or eligible for, SSNs

An individual with an expired ITIN who has or becomes eligible for an SSN should not renew the ITIN. Instead, those individuals who already have an SSN should write a letter to the IRS or visit a local IRS office explaining that they now have an SSN and that they want all their tax records combined under their SSN.

Details about what to include with the letter and where to mail it can be found at:

**Website**
www.irs.gov/Individuals/Additional-ITIN-Information

### Use of an ITIN solely on an information return

An individual whose expired ITIN is used only on information returns filed and furnished by third parties, such as Forms 1099, is not required to renew the ITIN. The third parties who file and furnish information returns with an expired payee ITIN will not be subject to penalties for using the expired ITIN.

### Consequences of not renewing

A return filed with an expired ITIN will be processed and treated as timely filed. However, there may be a delay in processing the return. In addition, the Earned Income Tax Credit, the Child Tax Credit and the American Opportunity Credit may not be allowed unless the ITIN is renewed. For further discussion of the requirement to have a valid ITIN to claim these credits, see pages 1-37 and 1-39.

## PREPARER REQUIRED TO SEND COPY OF INJUNCTION TO CLIENTS

A tax preparer was permanently enjoined from acting as a tax return preparer after filing falsified returns for his clients showing false claims for dependents and inflated itemized deductions. (***U.S. v. Herrera*** (January 7, 2016) U.S. District Court, Dist. of Colorado, Case No. 1:15-cv-01894-JLK) As a result, the preparer was ordered to send a copy of the injunction to his clients along with a cover letter explaining how he and his employees had prepared the fraudulent returns. He was also ordered to turn over client records and surrender his PTIN and EIN.

## IRS USE OF PRIVATE DEBT COLLECTORS

P.L. 114-94, the Fixing America's Surface Transportation (FAST) Act makes the following tax-related changes:

- Mandates the use of private debt collectors to pursue "inactive tax receivables," applicable to tax receivables identified by the IRS after December 4, 2015. (IRC §6306(c) and (d)) The IRS announced that it will begin using private collection next spring;
- Repeals the three-and-one-half-month automatic extension return due date for certain employee benefit plans that was to go into effect for tax years beginning after December 31, 2015, leaving in place the current two-and-one-half-month extension period (Act §32104);
- Authorizes the Commissioner to set up an account to hire and train special compliance personnel to pursue collections (IRC §6307); and
- Extends the imposition of various transportation-related excise taxes.

## IRS TYPO LETS TAXPAYER OFF THE HOOK

Regarding a $57,698 tax liability for 1998, a taxpayer and the IRS agreed on an extension of the collection period. (***Grauer v. Comm.***, TCM 2016-52) However, the extended date in the waiver read "May 8, 20015." After another failed installment agreement and finally an intent to levy, the taxpayer argued that the typographical error renders the waiver invalid; the waiver was not agreed to in connection with an installment agreement, and the period of limitation for collection relating to 1998 had expired. The period of limitation for collection may be extended by waiver if the extension is agreed to at the same time an installment agreement is entered into. (IRC §6502(a)) The court found that an installment agreement was not agreed to in connection with the waiver, and the 10-year period of limitation for collection had expired.

## PREVIOUSLY CONCEDED ISSUE CAN'T BE CHALLENGED

Taxpayers were not allowed to rechallenge a penalty that they had conceded in an earlier proceeding, which led to the issue being dismissed. (***Thompson v. Comm.*** (May 3, 2016) U.S. Court of Appeals, Eighth Circuit, Case No. 15-2329) The taxpayers argued that they had not conceded the "individual" penalty, only the penalty determination against their partnership. However, the court noted that the taxpayers had "expressly and unconditionally conceded the penalty issue as it affected their 2001 joint tax return."

## IRS WITHDRAWS PROPOSED REGULATIONS ON NONPROFITS COLLECTING SSNs

The IRS has withdrawn a proposed regulation under IRC §170(f)(8) that would have given charitable organizations the option of reporting information to the IRS on donors who gave $250 or more during the year, including the donors' SSNs. (REG-138344-13) The proposed regulation was intended to provide an exception to the requirement for a contemporaneous written acknowledgment substantiating donations of $250 or more. (Prop. Treas. Regs. §1.170A-13(f)(18))

## CERTIFICATION FOR PROFESSIONAL EMPLOYER ORGANIZATIONS

The IRS has established a voluntary certification program for professional employer organizations (PEOs), as mandated by the Tax Increase Prevention Act of 2014 (TIPA). A PEO, sometimes referred to as an employee leasing company, enters into an agreement with a client to perform some or all of the federal employment tax withholding, reporting, and payment functions related to workers performing services for the client. (T.D. 9768)

However, under this arrangement, it is possible that the client company may believe that they are relieved from employment tax obligations. A third-party PEO is the employer only if it has exclusive control over the payment of wages. (IRC §3401(d)(1)) TIPA created new IRC §§3511 and 7705 to provide requirements for these certified PEOs.

The IRS is accepting applications for voluntary certification at:

**Website**
www.irs.gov/for-tax-pros/basic-tools/certified-professional-employer-organization

## "ONE EXAMINATION" RULE DIDN'T APPLY

A taxpayer unsuccessfully claimed that it was not required to supply the IRS its 2009 general ledger, airplane flight logs, and other business travel documents, arguing that the IRS had already examined those records in 2010, during an audit of the 2009 tax year. (***U.S. v. Titan International, Inc.*** (February 1, 2016) U.S. Court of Appeals, Seventh Circuit, Case No. 14-3789) In 2014, the IRS requested the same 2009 records for an audit of the 2010 tax year. The taxpayer refused, citing IRC §7605(b), under which only one inspection of a taxpayer's books may be made for each taxable year unless the IRS notifies the taxpayer in writing that an additional inspection is necessary. However, this rule does not apply if the IRS requests the records for an audit of a different tax year.

## TAXPAYERS ENTITLED TO DAMAGES FOR EMOTIONAL DISTRESS

Married taxpayers were entitled to damages for emotional distress caused by the IRS sending multiple levy notices while an automatic stay was in effect for the taxpayers' bankruptcy case. (***In re: Hunsaker*** (January 13, 2016) U.S. Bankruptcy Court, District of Oregon, Case No. 12-64782-fra13) Specifically, the notices caused migraine headaches and added to the tension of an already very complicated bankruptcy case. The IRS admitted that the notices were sent in violation of the stay, but that it was immune from damage claims for emotional distress under 11 U.S.C. §106. However, IRC §106 only excludes punitive damages and no other type of damages.

## TAX COURT JUDGE INDICTED FOR TAX EVASION

Diane Kroupa, who served on the U.S. Tax Court from June 2003 until she retired in June 2014, is being accused of tax evasion and obstruction of an IRS audit. (Department of Justice News Release (April 4, 2016) Available at: www.justice.gov/opa/pr/former-united-states-tax-court-judge-and-husband-indicted-conspiracy-commit-tax-evasion-and) Kroupa and her husband allegedly claimed as business expenses rent and utilities for their second home; renovation expenses of their primary residence; Pilates classes; spa and massage fees; jewelry and personal clothing; wine club fees; Chinese language tutoring; music lessons; personal computers; and expenses for vacations. Also, the couple concealed documents from their tax practitioner and caused misleading documents to be delivered to an IRS employee during an audit.

# PRACTICE ISSUES

## E-FILE IS REQUIRED

Federal e-filing became mandatory in 2011 for tax preparers who prepared 100 or more tax returns for individuals, estates, and trusts in a calendar year. (Notice 2010-85) For 2012, the threshold was reduced to 11 or more returns for those "specified tax return preparers."

The choice to file in paper format is the taxpayer's alone.

The written statement containing the taxpayer's choice to file in paper format is not attached to the taxpayer's individual income tax return, but retained by the tax return preparer.

***Opt-out statement***

The opt-out statement below was updated in Rev. Proc. 2011-25:

My tax return preparer [INSERT PREPARER'S NAME] has informed me that [INSERT (s)he] may be required to electronically file my [INSERT TAX YEAR] individual income tax return [INSERT TYPE OF RETURN: Form 1040, Form 1040A, Form 1040EZ, Form 1041, Form 990-T] if [INSERT (s)he] files it with the IRS on my behalf. I understand that electronic filing may provide a number of benefits to taxpayers, including an acknowledgment that the IRS received the return, a reduced chance of errors in processing the return, and faster refund. I do not want to file my return electronically and choose to file my return on paper forms. I will mail or otherwise submit my paper return to the IRS myself. My preparer will not file or otherwise mail or submit my paper return to the IRS.

**Caution**

If a client opts out of e-filing, the tax preparer must get a signed opt-out statement **and** file Form 8948 with the return (checking box 1, indicating that "taxpayer chose to file this return on paper"). In the instructions to Form 8948, the IRS warns:

*"Form 8948 does not meet the criteria of a taxpayer choice statement as set forth in Revenue Procedure 2011-25."*

Form 8948 is merely a form titled "Preparer Explanation for Not Filing Electronically."

**Practice Pointer**

Paper copies of Forms W-2, 1099-R, or other documents may still be required to be attached to a paper-filed return.

## California e-file requirements

A preparer is automatically enrolled in the FTB e-file program after becoming an accepted participant in the IRS e-file program. The FTB will receive confirmation from the IRS after the preparer has been accepted into their program.

Use the IRS-assigned electronic filer identification number (EFIN) to e-file with the FTB. If you transmit returns, use your IRS-assigned electronic transmitter identification number (ETIN) with the FTB.

Once you receive your IRS EFIN, you may contact the FTB's e-Programs Customer Service to verify your enrollment with California at:

**☎ Telephone**
(916) 845-0353

### California opt-out

California opt-out compliance is significantly different than federal. Form FTB 8454, e-file Opt-Out Record, is used for all California individual returns that qualify for e-file but were not e-filed. California allows a taxpayer to opt out for any reason, and there is also a reasonable cause exception, such as instructions that a particular form may not be e-filed. Although a taxpayer is not required to list a reason for not e-filing, a preparer must list a reasonable cause for not e-filing if the return was not e-filed for any reason other than taxpayer opt-out.

The preparer must keep Form FTB 8454 in his or her files. Do not send a copy to the FTB. The client must sign a new completed Form FTB 8454 each year.

Although the FTB prefers both spouses sign the opt-out form, it is acceptable for one spouse only to sign.

### Business e-file

Beginning January 1, 2015, California requires businesses that use tax preparation software to e-file those returns.

## Penalties for failure to e-file

There are no specific federal penalties for failing to e-file covered returns. In addition, we at Spidell have not heard of tax preparers receiving penalties or other sanctions.

**Caution**

Although there are no federal penalties for failure to e-file, the IRS has the power to assert sanctions. The IRS can sanction e-file providers for violations of e-file requirements, which may result in suspension or expulsion from e-file. In addition, the IRS has a limited ability through Circular 230 to sanction tax preparers who fail to e-file.

Moreover, the Government Accountability Office is recommending penalties for failures to e-file. (GAO-12-33)

## California penalty for failure to e-file

Tax preparers are subject to a penalty of $50 per individual income tax return filed on paper that should have been e-filed, unless it is shown that the failure is due to reasonable cause and not due to willful neglect. (R&TC §19170) Although the FTB has the authority to penalize tax preparers, we are unaware of any penalties assessed by the FTB.

California penalties for failure to e-file business entity returns will not begin until 2017. Beginning with the 2017 taxable year, a business that fails to electronically file its return will be subject to penalties equal to $100 for the initial failure and $500 for each subsequent failure. (R&TC §1971)

| Federal Returns that Can/Must/Cannot Be E-filed | | | | |
|---|---|---|---|---|
| **Form/return** | **Can** | **Must** | **Cannot** | **Comments** |
| 1040 series | | ✓ | | Exceptions noted below (NR, amended) |
| 1040 NR | ✓ | | | |
| Amended 1040 | | | ✓ | |
| Late 1040 | ✓ | | | Can e-file after extended deadline (i.e., October 15) |
| Individual extensions | ✓ | | | |
| 1045 (Application for Tentative Refund) | | | ✓ | |
| 1120, 1120S, 1065 | ✓ | | | "Large corporations" must e-file |
| 1041 | | ✓ | | |
| FBAR | | ✓ | | |
| 941 series | ✓ | | | |
| Estate returns (706) | | | ✓ | |
| Gift returns (709) | | | ✓ | |

# PREVENT TAX PROBLEMS FOR CLIENTS SUFFERING FROM DEMENTIA

It is sad that many of our clients, family, and friends suffer from dementia. Memory loss can come on quickly or it can be a slow process. But in the end, not anticipating this possibility can be disastrous for everyone involved. Arming yourself with authority to contact a client's family if you suspect a problem is imperative. However, simply picking up the phone and calling the client's children could be a privacy violation.

Here are some signs you, as a tax professional, might see that indicate a loss of memory:

- Client is confused about things that were not a problem in the past;
- Client fails to make estimated payments or mixes up the payments;
- Client is bouncing checks or not making regular payments such as HOA or long-term care premiums;
- Long-term client fails to schedule an appointment or make any arrangement for tax preparation;
- Client suddenly begins making small charitable contributions to multiple organizations — can be a sign that the client is becoming a victim of phone solicitations;
- Client with limited resources is making large gifts, especially to nonfamily members; and
- Client's brokerage statement is suddenly showing numerous sales — a new broker could be churning the account.

None of these actions alone is indicative of a problem, but it's a clue that there could be a problem.

## What to do?

To circumvent a future problem, you might consider, as part of your engagement letter or as a separate document, asking your client to provide an authorization to contact someone else on their behalf in case you have a problem with the return or cannot contact the client.

It is best to do this well in advance of a future problem as the client will be likely to understand the future potential problem.

Here is some suggested language to include:

***Client letter***

Dear Client,

Many of my clients would like me to contact a family member or friend if I cannot reach them, they have not filed a return, or if I have a concern about their financial decisions. If you would like to provide me with permission to release your tax information to a family member or friend, please sign below. You may revoke this permission at any time.

I, CLIENT NAME authorize TAX PROFESSIONAL NAME to contact NAME OF CONTACT at E-MAIL ADDRESS or PHONE NUMBER if TAX PROFESSIONAL NAME is unable to reach me, if I have not filed a tax return, or if TAX PROFESSIONAL NAME has a concern about my financial decisions.

I understand that I may revoke this permission in writing at any time.

Signed,

____________________________ __________________

Name Date

### Other resources

For more information, see "Financial Elder Abuse: How to Help" in the Spring 2011 issue of the California Board of Accountancy Update, available at:

**Website**
www.dca.ca.gov/cba/communications-and-outreach/update66.pdf

For more information on senior issues, go to:

**Website**
www.aplaceformom.com/senior-care-resources

## PAYROLL TAX EMBEZZLEMENT

A McDonald's franchisee in Los Angeles found out the hard way that it was liable when its third-party payroll provider embezzled its funds and did not make its employment tax deposits. (***Kimdun, Inc. v. U.S.*** (August 15, 2016) U. S. District Court, Central Dist. of California, Case Nos. 2:16-cv-01500-CAS (RAOx); 2:16-cv-01558-CAS (RAOx); 2:16-cv-01766-CAS (RAOx); 2:16-cv-02160-CAS (RAOx)) The court rejected the taxpayer's argument that once its funds left its bank account, the taxpayer had no control or ability to ensure that the payroll company made the requirement employment tax deposits. A taxpayer will still be liable if they could have stopped or discovered the embezzlement, which the court held this taxpayer could have done.

## PRACTICE MANAGEMENT — THE PROBLEM CLIENT

Clients are the reason we're in business and the sole source of profits. On the other hand, some clients can put us at risk, disrupt our business, and drive us insane.

There may come a point in dealing with any particular client when it's time to disengage. Your malpractice insurance carrier may have useful information when it comes to the problem client and the disengagement process itself.

Here are some attributes of the problem client:

- Waits until the last minute;
- Doesn't respect the value of your time;
- Complains about fees;
- Is rude to staff;
- Doesn't provide adequate documentation;
- Blames you when they miss deadlines;
- Has a bad attitude about tax compliance;
- Constantly pushes the boundaries of tax law; and
- Attempts to hide facts from you or deceive you.

### Putting us at risk

A common tax client scenario might look like this: The client waits until the last minute. After years of prodding the client to provide better documentation, the client comes into your office with the usual sloppy inadequate documentation. He's left little time to make up for the inadequate documentation, and the client is fee-sensitive and isn't willing to pay for the time you'd spend nagging him for the documentation and following up on it.

### Circular 230

Circular 230 §10.34(d) provides that a practitioner may rely in good faith without verification upon information furnished by the client. The practitioner may not, however, ignore the implications of information furnished to, or actually known by, the practitioner, and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete.

***Example of implications***

In 2014, Dan reports $5,000 of dividends from XYZ Corp. In 2015, he claims that he has no dividends from them. He did not report any sales of XYZ stock in 2014 or 2015. The practitioner must make reasonable inquiries as to why Dan didn't receive any dividends from the stock in 2015.

### Practitioner penalties

When a practitioner fails to follow the rules of tax practice, he or she may be subject to disciplinary action in the form of civil and criminal penalties. Penalties apply when a practitioner fails to ask the proper questions about a client's data when advising or preparing a substantial portion of a tax return. The most familiar penalty is the penalty under IRC §6694(a), which levies a penalty equal to the greater of $1,000 or 50% of the income derived (or to be derived) for understatement of tax due where the preparer failed to make adequate inquiries of the taxpayer when the information provided appears to be incomplete or incorrect. If the understatement is due to willful or reckless conduct, the penalty goes up to the greater of $5,000 or 75% of the income derived (or to be derived) with respect to the return.

## "The customer is always right" is wrong

The obvious problem with the tried and true wisdom is that it is singular; that is, it can only be true if you have only one customer. Customers are not created equal.

When a firm hits the point of needing additional employees but can't afford to pay the market rate to hire them, it is time to look at reducing client load to make room for more profitable clients.

Firing clients does not have to mean that you literally throw them out the door. Instead, set conditions whereby lower-priority clients self-select out and higher-priority clients self-select in. This may involve raising fees, setting standards of timeliness for chronically late clients or standards pertaining to documentation.

## Clients that are right

Each firm should understand its clients to determine whether each is worth keeping. Firms may want to rank each client on an academic scale to determine an overall grade based on several ranking criteria.

### Profitability

Each firm must determine its own acceptable level of profitability.

### Risk

Rate the potential liability a client brings to the firm. Whether it's a client that is simply in a high-risk industry or a tax client that constantly pushes the limit on deductions and income reporting, some clients pose a higher risk to the firm than other clients.

### Referral source

Clients can be a firm's best source of referrals. It is conventional wisdom that good clients will refer good clients and bad clients will refer bad ones (one more reason to dump bad clients).

### Potential for additional services

A client who is marginally profitable now may have the potential to become much more profitable in the future if that client is a go-getter.

### Job satisfaction

Does your stomach churn when a client calls you? Keep your employees in mind, too. You may be willing to deal with a profitable but unpleasant client because his dollars go straight to your bank account. But your employees get the same pay whether they deal with a pleasant client or an unpleasant one.

## Clients that are wrong

Various studies and articles have laid out certain key indicators of problem clients.

### No prior tax professional or many prior tax professionals

The client frequently changes tax professionals looking for one with the lowest fee or who may be "flexible" in terms of what gets reported on the return.

### Cynical attitude

The client is openly cynical about the tax system and questions how others "get away with" not paying their fair share.

### Lack of comprehension

Some clients deliberately don't want to understand the implications of the tax system because they believe they can't be held responsible for what they don't know (this type will throw you under the bus if something goes wrong).

### Lack of respect

This type comes in many forms, and there are many ramifications of disrespect. They waste your time, they're rude to staff, and they don't understand the value of your time (and, so, they complain about fees). And, keep in mind, this type might be pleasant to you but disrespectful of your employees.

### Ambiguity and evasiveness

This client is consistently vague or evasive when asked questions they don't want to answer.

### Don't pay their bills

Nothing more need be said about this. We are in business to make money.

## Firing a client

When it's time to terminate a client relationship, it is generally best to do so by letter. Phone and face-to-face meetings may allow things to become heated. Even if you decide to inform the client of your resignation face-to-face, a follow-up letter provides written evidence of the resignation.

The letter should be concise, factual, and cordial. It should document when services ended, any outstanding issues regarding work in process, upcoming tax due dates, fees owed to the firm, and items requiring follow up or completion by the client.

When it comes to terminating a client, care should be given to the date of such termination. Give your soon-to-be former client a reasonable opportunity to meet tax filing deadlines. In other words, it may not be in your best interest to send a termination letter to an individual tax client on April 10.

### Be tactful

There's a good chance the client knows other clients, including good ones. They may talk. Try to avoid creating bad will.

### Work in process

If the firm resigns when work is in process, the letter should address the work product that the firm will deliver to the client. From a risk management perspective, firms should not provide a partially completed product to either the terminated client or the successor firm. The firm should be prepared to write off fees for time incurred with respect to the engagement.

### Outstanding fees

The letter should state the status of outstanding fees even if the prospects of collection are dim.

### Items for client follow-up

The letter should address matters that require follow-up or completion by the client or the successor firm, clearly identifying deadlines for time-sensitive items.

# CLIENT LETTERS

## GENERAL DISENGAGEMENT/TERMINATION LETTER

[DATE]
[CLIENT NAME]
[CLIENT ADDRESS]

Dear [CLIENT NAME],

Thank you for entrusting me to act as your tax professional. [I/WE] have enjoyed having you as a client. However, due to [INSERT REASON FOR TERMINATION], [I/WE] will no longer be able to provide you with professional services.

This letter is to inform you that effective [DATE], [I/FIRM NAME] resign(s) from all engagements with [CLIENT NAME/ENTITY NAME].

[CLIENT NAME/ENTITY NAME] previously engaged [ME/FIRM NAME] to provide [LIST SERVICES].

[I/WE] recommend that you engage a new tax professional as soon as possible. Here are the services and due dates that you will need assistance with in the coming months:

- [LIST SERVICES]

[IF AN OUTSTANDING BALANCE IS OWED, REQUEST PAYMENT BY A SPECIFIED DATE]

[I/WE] will work with your new tax professional to make this transition as smooth as possible. Please contact [ME/US] with any questions you may have

Sincerely,

Your tax professional

**Website**
To download a copy of this client letter, go to:
www.caltax.com/spidellweb/public/editorial/disengagementletter.doc

## CONFLICT OF INTEREST DISENGAGEMENT LETTER

[DATE]
[CLIENT NAME]
[CLIENT ADDRESS]

Dear [CLIENT NAME],

This letter is to inform you that effective [DATE], [I/FIRM NAME] resign(s) from all engagements with [CLIENT NAME/ENTITY NAME] due to a potential conflict of interest.

[CLIENT NAME/ENTITY NAME] previously engaged [ME/FIRM NAME] to provide [LIST SERVICES].

[I/WE] have enjoyed working with you. However, because of [DESCRIBE CONFLICT OF INTEREST SITUATION] the above referenced services will no longer be provided.

[I/WE] recommend that you engage a new tax professional as soon as possible. Here are the services and due dates that you will need assistance with in the coming months:

- [LIST SERVICES]

[IF AN OUTSTANDING BALANCE IS OWED, REQUEST PAYMENT BY A SPECIFIED DATE]

[I/WE] will work with your new tax professional to make this transition as smooth as possible. Please contact [ME/US] with any questions you may have

Sincerely,

Your tax professional

**Website**
To download a copy of this client letter, go to:
www.caltax.com/spidellweb/public/editorial/conflictletter.doc

## CONSENT TO SHARING TAX RETURN INFORMATION

[DATE]
[FORMER CLIENT NAME]
[FORMER CLIENT ADDRESS]

Dear [FORMER CLIENT NAME],

You have requested that [I/WE] provide information from your tax returns to [NEW TAX PROFESSIONAL]. In order for [ME/US] to release the requested information, you must complete the written authorization below.

Federal law requires this consent form be provided to you. Unless authorized by law, we cannot disclose, without your consent, your tax return information to third parties for purposes other than the preparation and filing of your tax return. If you consent to the disclosure of your tax return information, Federal law may not protect your tax return information from further use or distribution.

You are not required to complete this form. If we obtain your signature on this form by conditioning our services on your consent, your consent will not be valid. If you agree to the disclosure of your tax return information, your consent is valid for the amount of time that you specify. If you do not specify the duration of your consent, your consent is valid for one year.

**Authorization**

I, _________________________, authorize [YOUR NAME/FIRM NAME] to disclose to _________________________ my tax return information for the following tax year(s) ________________.

Purpose for disclosing information:

______________________________________________________________________________

______________________________________________________________________________

Name and address to which the information is being disclosed:

______________________________________________________________________________

______________________________________________________________________________

______________________________________________________________________________

Duration of consent: ___________________________

Signature: ___________________________ Date: ___________________________

If you believe your tax return information has been disclosed or used improperly in a manner unauthorized by law or without your permission, you may contact the Treasury Inspector General for Tax Administration (TIGTA) by telephone at 1-800-366-4484, or by e-mail at complaints@tigta.treas.gov.

**Caution**

A consent furnished to the taxpayer on paper must be provided on one or more sheets of 8½ inch by 11 inch or larger paper. All of the text on each sheet of paper must pertain solely to the disclosure or use the consent authorizes. All of the text on each sheet of paper must also be in at least 12-point type (no more than 12 characters per inch).

**Website**

To download a copy of this client letter, go to:
www.caltax.com/spidellweb/public/editorial/consentletter.doc

## SELLING PRACTICE: TRANSFERRING CLIENTS TO NEW OWNER

[DATE]

Dear [CLIENT NAME],

After much consideration, I have decided to end my practice effective [DATE]. At this time, I have made arrangements for [NEW OWNER] to take over my practice and to provide for continued service to my clients.

You will be contacted by [NEW OWNER] in the near future to discuss your acceptance of this new relationship. At that time [NEW OWNER] will review with you the specific services you require, the applicable deadlines for these services, and other relevant items as determined by you and [NEW OWNER]. With your permission, I will then turn over your records to [NEW OWNER]. To assist them in the transition, I will be working with them during [TIME FRAME] for consultations, special projects, and other services deemed appropriate.

If you choose not to accept [NEW OWNER] as your accountants, you will need to make arrangements with another professional as soon as possible to ensure that all of your applicable filing deadlines are met timely. I will work with your subsequent accountant as appropriate.

I have enjoyed working with you in the past and wish you success in your future endeavors. If you have any questions, or would like to discuss this further please call me.

Sincerely,

Your tax professional

**Consent**

Federal law requires this consent form be provided to you. Unless authorized by law, we cannot disclose, without your consent, your tax return information to third parties for purposes other than the preparation and filing of your tax return. If you consent to the disclosure of your tax return information, Federal law may not protect your tax return information from further use or distribution.

You are not required to complete this form. If we obtain your signature on this form by conditioning our services on your consent, your consent will not be valid. If you agree to the disclosure of your tax return information, your consent is valid for the amount of time that you specify. If you do not specify the duration of your consent, your consent is valid for one year.

**Authorization**

I, ________________________, authorize [YOUR NAME/FIRM NAME] to disclose to ________________________ my tax return information for the following tax year(s) _______________.

Purpose for disclosing information:

______________________________________________________________________________

______________________________________________________________________________

Name and address to which the information is being disclosed:

______________________________________________________________________________

______________________________________________________________________________

______________________________________________________________________________

Duration of consent: ___________________________

Signature: ___________________________ Date: ___________________________

If you believe your tax return information has been disclosed or used improperly in a manner unauthorized by law or without your permission, you may contact the Treasury Inspector General for Tax Administration (TIGTA) by telephone at 1-800-366-4484, or by e-mail at complaints@tigta.treas.gov.

**Caution**

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**Website**

To download a copy of this client letter, go to:
www.caltax.com/spidellweb/public/editorial/transferletter.doc

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TAX • ANALYSIS • EDUCATION

# Chapter 6

# Retirement

# RETIREMENT

## TRADITIONAL IRAs

## CONTRIBUTION LIMITS

### IRA contribution amounts

If neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan, an individual may make deductible contributions to an IRA up to the lesser of $5,500 or the individual's compensation. This amount is unchanged from 2013 and will continue to remain the same in 2017. Married couples can make a deductible IRA contribution of up to $11,000 if the combined compensation of both spouses is at least equal to the contributed amount.

| **Maximum IRA Contribution** | |
|---|---|
| 2016 | 2017 |
| $5,500 | $5,500 |

### Catch-up contributions for age 50 and older

The IRA rules allow an individual age 50 and older to make an additional $1,000 in catch-up IRA contributions. Catch-up contribution amounts are not subject to annual inflation adjustments. The otherwise maximum contribution limit (before application of the AGI phaseout limits) for an individual who has attained age 50 before the end of the taxable year is:

| **Maximum IRA Catch-Up Contribution** | |
|---|---|
| 2002–2005 | After 2005 |
| $500 | $1,000 |

***Reminder***

The taxpayer must have enough earned income in order to maximize contributions. For example, in order for an individual to contribute the maximum IRA amount for 2016 and 2017, that individual must have at least $6,500 of earned income if the individual is at least 50 years old.

| **AGI Phaseout Limits for Taxpayers Active in Employer-Sponsored Plans** | | | |
|---|---|---|---|
| **Beginning taxable years in** | **Single, HOH, MFS (did not live with spouse)** | **MFJ** | **MFS (lived with spouse at any time during year)** |
| | **Phaseout range** | **Phaseout range** | **Phaseout range** |
| 2016 | $61,000–$71,000 | $98,000–$118,000 | $0–$10,000 |
| 2017 | $62,000–$72,000 | $99,000–$119,000 | $0–$10,000 |

**Caution**

The AGI phaseout range for married taxpayers filing separate returns is \$0–\$10,000, unless the couple lived apart at all times during the tax year. In that event, the couple is treated as if they are not married. (IRC §219(g)(4)) Thus, only each individual's AGI and status as an active participant is taken into account, and the reduction begins at the AGI threshold applicable for unmarried taxpayers.

## Individual is not an active participant, but spouse is

If the individual is not an active participant in an employer-sponsored retirement plan but the individual's spouse is, the IRA deduction limit is phased out for taxpayers with the AGIs listed here:

| AGI Phaseout Ranges for Nonactive Participant Individual with Active Spouse | | | | |
|---|---|---|---|---|
| Beginning taxable years | 2014 | 2015 | 2016 | 2017 |
| AGI phaseout range | \$181,000–\$191,000 | \$183,000–\$193,000 | \$184,000–\$194,000 | \$186,000–\$196,000 |

### California conformity

California conforms to federal rules for IRAs. (R&TC §17501) However, there may be basis differences due to prior laws. Also a taxpayer may make a separate election to treat a contribution to a traditional IRA as nondeductible.

# TRANSFER OF IRA FUNDS DIRECTLY TO CHARITY

## IRA-to-charity exclusion

The PATH Act made permanent the ability of individuals at least 70½ years old to exclude from gross income qualified charitable distributions from IRAs of up to \$100,000 per year. (IRC §408(d)(8)(F))

### California conformity

California automatically conforms to the charitable contribution of an IRA to charity. No separate election is allowed. (R&TC §17501(b))

# EARLY WITHDRAWAL PENALTY/ADDITIONAL TAX

Generally, a 10% additional tax applies to distributions made from qualified plans and IRAs if the recipient has not attained age 59½ on the date of distribution. (IRC §72(t))

Any amount distributed out of an IRA or other qualified plan to the individual for whose benefit the IRA or other qualified plan is maintained will not be included in gross income if the entire amount received is paid into an IRA or other qualified plan for the benefit of such individual within 60 days. (IRC §§402(c)(3)(A), 408(d)(3)(A) and (d)(3)(D)) There are limited exceptions from the 10% additional tax for distributions made for medical and educational purposes and for "first-time homebuyers."

 

## Exception for medical purposes

Under the exception for medical expenses, there is no penalty tax on distributions to the extent that the distribution is used to pay for medical expenses unreimbursed by insurance that exceed 10% (7.5% for those few who still qualify) of the taxpayer's AGI and that are deductible as an itemized deduction. (IRC §72(t)(2)(B)) Noteworthy, the threshold is determined without regard to whether the taxpayer itemizes deductions.

Note that to take a medical expense deduction, payment must be made on behalf of the taxpayer, his spouse, or a dependent, where a dependent is defined more liberally than it is for purposes of claiming a dependent exemption.

***Example of distributions for medical purposes***

Maggie has surgery that costs $15,000. Her AGI is $60,000. As such, 10% of her AGI is $6,000. She is under age 59½. If that is her only medical expense, she can take an IRA distribution of up to $9,000 without incurring the 10% additional tax ($15,000 expense less $6,000 AGI threshold = $9,000). The distribution is subject to income tax, however, if distributed from a traditional IRA without basis. She may take the distribution any time during the year the medical expense would otherwise be deductible for tax purposes.

### Taxpayer not exempt from 10% early withdrawal penalty for medical purposes

A taxpayer was not entitled to an exception from the 10% additional tax on an early withdrawal from her IRA even though the funds were used to pay the medical expenses of her son. (***Ireland v. Comm.***, TCS 2015-60)

In the year in question, she was 47 years old. She withdrew $5,294 from her IRA. It was reported on Form 1099-R along with withheld federal income tax of $529.

She filed as head of household for the year claiming her daughter as a dependent. She did not report the 10% additional tax, claiming that the funds were used to pay the medical expenses of her son.

The Tax Court ruled that she did not meet the requirements of the medical exception from the imposition of the 10% additional tax. The taxpayer did not claim her son as a dependent. Furthermore, she failed to demonstrate that her son met the definition of a dependent in IRC §152.

### No rollover waiver for unsubstantiated medical condition

The IRS declined to waive the 60-day rollover requirement where the taxpayer didn't provide adequate documentation that her failure to timely roll over funds was due to her medical condition. (PLR 201625022) The taxpayer had continued working and traveling during the time of her claimed medical condition. Additionally, the taxpayer used the distributed funds as a short-term loan to purchase her daughter's home, which didn't qualify under any of factors enumerated in Rev. Proc. 2003–16 as preventing her from completing a timely rollover.

## Exception for educational purposes

No penalty applies for early withdrawals if the withdrawal is used by the taxpayer to pay for the qualified higher education expenses of the taxpayer, the taxpayer's spouse, or any child or grandchild of the taxpayer. (IRC §72(t)(2)(E)) The child or grandchild does not have to be claimed as a dependent on the taxpayer's return. Qualified higher education expenses are those provided in IRC §529(f)(1), which include tuition, books, fees, supplies, and room and board at a qualified higher educational institution. (IRC §72(t)(7)) Qualified expenses must be reduced by scholarships and assistance as provided under IRC §25A(g)(2).

### Teacher not exempt from 10% early withdrawal penalty for education purposes

The Tax Court determined that a teacher's withdrawal from his IRA was subject to the 10% penalty and rejected the taxpayer's claim that the withdrawal was used for qualified higher education expenses and, therefore, qualified for the exception for educational purposes. (***Parisi v. Comm.***, TCS 2016-40) The court found that the taxpayer failed to even specify what the claimed expenses were for let alone substantiate the education-related expenses for tuition, fees, supplies or equipment.

## Wife receives 60-day rollover waiver, husband not so lucky

Married taxpayers received distributions from their SEP IRAs and directed the funds to be deposited into two new non-IRA accounts. (PLR 01612017) The husband used the funds from his account to pay for living expenses, and the amount in the wife's account was not touched. When the taxpayers realized their error, they moved the remaining funds to two new IRA accounts. The IRS allowed a waiver of the 60-day rollover rule for the amount of the wife's IRA because she had relied on her husband's knowledge of financial matters. However, the husband was not granted a waiver because he had not shown intent to roll the funds over and had instead deposited them into a checking account to use for personal expenses.

## No relief for failed IRA rollover

A taxpayer was denied relief for a rollover made outside the 60-day window, following a distribution that was intended to be used to purchase interests in a partnership. (PLR 201547010) The taxpayer directed a distribution from his IRA be sent to the partnership, intending for his IRA to hold the interests. However, the IRA custodian was not able to hold partnership interests; this was not discovered until the taxpayer filed his tax return after the 60-day window had expired. The taxpayer argued that the custodian should have prepared paperwork to transfer the shares to a financial institution that could hold the shares. The IRS disagreed, noting that the failed rollover was due to the taxpayer's choice to use his IRA to fund a business venture, and it was his obligation, not the custodian's, to see to it that the funds were deposited in a proper IRA account.

## IRS now charges $10,000 for PLR to request IRA rollover waiver

Beginning February 1, 2016, it costs your clients $10,000 to request that the IRS waive the penalty. However, if the client qualifies for automatic approval, there is no cost.

Prior to February 1, 2016, the fee to request a ruling ranged from $500 to $3,000. However, the IRS increased the user fee for requesting a ruling to $10,000, no matter the amount of the rollover and regardless of whether the IRS grants the waiver. (Rev. Proc. 2016-8)

 

### Automatic approval

The IRS will waive the penalty without a request for a letter ruling if all of the following occur (Rev. Proc. 2003-16):

- A financial institution receives funds on behalf of a taxpayer prior to the expiration of the 60-day rollover period;
- The taxpayer follows all procedures required by the financial institution for depositing the funds into an eligible retirement plan within the 60-day period (including giving instructions to deposit the funds into an eligible retirement plan); and
- Solely due to an error on the part of the financial institution, the funds are not deposited into an eligible retirement plan within the 60-day rollover period.
  (Rev. Proc. 2003-16)

Automatic approval is granted only if:

- The funds are deposited into an eligible retirement plan within one year of the beginning of the 60-day rollover period; and
- It would have been a valid rollover if the financial institution had deposited the funds as instructed.

### New "self-certification" process

In a 2016 Revenue Procedure, the IRS has provided a new self-certification procedure for taxpayers who, due to one or more specified reasons, missed the 60-day time limit to rollover distributions from a retirement plan. (Rev. Proc. 2016-47)

Under this procedure, the taxpayer may make a written certification to a plan administrator or IRA trustee by using a model letter provided in Rev. Proc. 2016-47. The plan administrator or IRA trustee may, absent actual knowledge to the contrary, rely on the certification.

The certification must state that a contribution satisfies the all of the following conditions:

- The IRS must not have previously denied a waiver request with respect to a rollover of all or part of the distribution to which the contribution relates;
- The taxpayer must have missed the deadline because of the taxpayer's inability to complete the rollover for one of the 11 reasons specified in the revenue procedure, including error by the financial institution, error by the post office, and death in the taxpayer's family; and
- The contribution must be made to the plan or IRA as soon as possible after the application reason or reasons no longer prevent the taxpayer from completing the rollover contribution. This requirement is deemed satisfied if the contribution is made within 30 days after that time.

The taxpayer's self-certification is not a true waiver of the 60-day requirement because the IRS can still deny the waiver on audit if it determines that the taxpayer did not meet the requirements.

***Comment***

Note that taxpayers now have two ways to gain a waiver without the expensive process of requesting a waiver via a private letter ruling. Notice, too, that the two methods involve different underlying reasons for allowing a waiver and different methods and time requirements.

### If you must get a ruling request

Prior to the increase in the fee, the IRS issued several dozen letter rulings each year granting waiver of the 60-day period. By far, the most often cited reason for missing the 60-day rollover requirement has been financial institution error, and most of these were situations where the funds from the IRA were deposited into a non-IRA account. The second most often cited reason is that the taxpayer's physical or mental disability impaired the taxpayer's ability to make the rollover. Incorrect advice received from a financial advisor is also grounds for a waiver.

A waiver will not be granted if the taxpayer simply believed that he or she had more than 60 days in which to make the rollover, or if the financial institution didn't inform the taxpayer about the 60-day rollover requirement.

As discussed above, the IRS will consider the use of the funds distributed. If the taxpayer has missed the 60-day rollover period, then the funds should be deposited into a separate account in order to demonstrate that they were not spent or used for nonretirement purposes.

## Applying for waiver

**Requirements for a favorable ruling:** The IRS will issue a ruling waiving the 60-day rollover requirement in cases where the failure to waive such requirement would be against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control of the taxpayer. In determining whether to grant a waiver, the IRS will consider all relevant facts and circumstances, including:

- Errors committed by a financial institution (other than as described above);
- Inability to complete a rollover due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign country, or postal error;
- The use of the amount distributed (for example, in the case of payment by check, whether the check was cashed); and
- The time elapsed since the distribution occurred.

**Requesting a letter ruling:** Revenue Procedure 2016-8 explains, in general, how to request a letter ruling from the IRS. The request must include sections that outline the facts, describe the ruling requested, state the applicable law, relate the law to the facts (analysis), and state a conclusion. In addition, the request must include numerous statements covering procedural matters, and it must be signed under the penalty of perjury.

The IRS's website includes a list of additional information that should be included with a letter ruling request for waiver of the 60-day rollover period.

Once completed, the letter ruling request must be sent to the following address:

**Address**
Internal Revenue Service
Attention: EP Letter Rulings
P.O. Box 27063
McPherson Station
Washington, DC 20038

**What to include with waiver request:** Revenue Procedure 2016-4, Appendix A, contains a sample letter ruling request format. Appendix B contains a checklist of information which should be submitted with ruling requests made under the revenue procedure.

**Website**
www.irs.gov/retirement-plans/
retirement-plans-faqs-relating-to-waivers-of-the-60-day-rollover-requirement

### Partial California conformity

California conforms to IRC §72(t) rules for the additional tax and exceptions when employees take premature distributions from pension plans, SIMPLEs, and IRAs. (R&TC §§17501, 17504)

The differences are as follows:

- The California additional tax is 2.5%, while the federal penalty is 10%;
- The California additional tax is applied against the amount taxable to California, if that amount is different from the federal amount;
- California conforms to federal rules for SIMPLE plans, except the California additional tax for withdrawing funds from a SIMPLE account within two years of first making the election to contribute is 6% (25% federal) (R&TC §17085); and
- When the FTB or the IRS levies an IRA to pay delinquent state or federal taxes, the FTB will not assess the additional tax. However, when the FTB levies the IRA to pay state taxes, we believe the distribution is still subject to the federal additional tax. (IRC §72; R&TC §17085.7) Plans levied by the FTB will not be subject to the 2.5% California additional tax only if there is a levy on the qualified retirement plan or IRA to pay taxes, not to pay delinquent child support or another agency's debt collected by the FTB.

The California additional tax (penalty) is deductible on the federal return as part of the state tax paid.

## PENALTY FOR FAILURE TO TAKE REQUIRED MINIMUM DISTRIBUTIONS

A penalty tax is imposed for failure to take a required minimum distribution (RMD). The penalty is 50% of the amount by which the amount of the RMD exceeds the actual distributions taken for the year. (IRC §4974(a)) The IRS may waive the penalty if the taxpayer shows that the failure is due to reasonable cause and that reasonable steps are being taken to remedy the shortfall. (IRC §4974(d)) Reasonable error can include mistakes (such as forgetting) caused by the infirmity of age.

Taxpayers who feel they meet the reasonable error criteria of IRC §4974(d) may exclude the 50% excise tax when they file their returns. The instructions to Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts, indicate to put "RC" on line 52, with the amount you want waived in parentheses, and attach a statement to the return explaining the reasons why you believe a reasonable cause waiver is warranted and what steps you are taking to remedy the shortfall. The penalty is due only if relief is denied. There is no provision to exclude any of the other penalties, including the 10% penalty for failing to meet the 60-day rollover requirement.

***Sample waiver explanation (attachment to return: explanation of Form 5329, line 52)***

Taxpayer is elderly and made a mistake by not taking the full amount of the 2015 required minimum distribution caused by the infirmities of age. Upon discovery of the shortfall, taxpayer took a distribution on January 5, 2016, of $5,212, the full amount of the required minimum distribution.

Taxpayer has already taken the full required minimum distribution amount for 2016 and has taken steps to ensure that the failure does not occur in the future.

# REQUIRED MINIMUM DISTRIBUTIONS — PLANNING IDEAS

At the earliest, an individual **may** generally begin taking distributions from a traditional IRA, without penalty, at age 59½.

At the latest, an individual **must** begin taking RMD by April 1 of the year following the year in which he or she turns 70½. (IRC §408(a)(9)(C)) This is the required beginning date (RBD).

Generally, RMD is calculated for each account by dividing the balance of the IRA by a life expectancy factor that the IRS publishes in table form and that the IRS changes from time to time. Although the RMD must be calculated separately for each IRA, the amounts can be totaled, and the required distribution can be taken in any amounts from any accounts so long as the distributions from all IRAs combined total the required amount.

## Considerable flexibility

With an 11-year spread between the earliest allowable distribution age and the required distribution age, there is a great deal of flexibility in planning distributions. This flexibility is further enhanced by such tools as the Roth IRA account and qualified longevity annuity accounts (QLAC).

While the usual strategy in tax planning is deferral, that usual strategy may not work for an individual who needs the cash and must take distributions. Moreover, individuals who retire early may be in lower tax brackets in early retirement and higher tax brackets in later retirement, which may be partially or wholly caused by RMD itself.

## Postponing distributions

Generally, deferral of tax liability is the most basic of tax strategies. Therefore, waiting as long as possible and allowing a retirement account to grow on a tax-deferred basis must be considered the default strategy. Moreover, the tax law gives an IRA owner a bonus deferral period even after the individual attains age 70½. (Treas. Regs. §1.401(a)(9)-5, Q&A 1(b)) An IRA owner may postpone the RMD for the first distribution calendar year until the second distribution year, taking the first RMD by April 1 of the second year.

### Advantages of delaying

Individuals may consider delaying the first distribution in the following situations:

- The taxpayer will be in a lower bracket in the second year;
- Taking two distributions in the second year won't cause a different tax rate than if the distributions were taken normally in two separate tax years;
- Taking the distribution in the second year will allow for minimized AGI limitations in the first year; or
- Income from other sources will be lower in the second year, and taking the distribution in the first year will subject the taxpayer to the 3.8% surtax by increasing modified adjusted gross income (MAGI).

### Disadvantages of delaying

Delaying RMD until the second year could have the following adverse effects:

- The first distribution may be taxed at a higher rate than it would have been if taken in the first year due to the possible higher tax bracket caused by taking two distributions in one year;
- Qualified dividends and/or capital gains tax rates may increase due to increased AGI;
- Deductions and credits may be affected by increased AGI; or
- Taking both distributions in the second year may subject the taxpayer to the surtax. For the purposes of calculating the 3.8% surtax, MAGI includes distributions from IRAs and qualified plans, which includes RMD.

### IRA and qualified plan

An individual must begin taking RMD from a qualified plan (such as a 401(k) plan) by April 1 of the year following the later of the year in which he or she:

- Turns 70½; or
- Retires.
  (IRC §401(a)(9)(C))

Under a qualified plan, there is an exception for 5% owners who follow the same rules as IRA owners.

However, the qualified plan may specify that the RBD is April 1 following the year the individual turns age 70½, regardless if they are a 5% owner. (Treas. Regs. §1.401(a)(9)-2(e)) In this case, the employee may not wait until retirement if still working.

### Rollover to qualified plan

In the case of an individual who is not a 5% owner and who has an IRA and a qualified plan through an employer, the taxpayer may roll over the IRA into the qualified plan to defer the RBD to the year following his or her retirement date (assuming the qualified plan accepts rollovers from other plans). (PLRs 2004453015, 200453026) This deferral strategy only works where a taxpayer is working past age 70½.

## Accelerating distributions

As a general rule (to avoid penalties), you **may** start taking distributions at age 59½, and you **must** start taking them at age 70½. Taking distributions early could be a planning opportunity for individuals who are in low preretirement or early retirement tax brackets, and who have accumulated IRAs with large balances. Once the time to start taking RMDs rolls around, these taxpayers may be kicked into a higher tax bracket.

Taking early distributions reduces the future tax burden by drawing down the IRA and reducing future RMDs, and the early distributions are taxed at a lower rate.

For taxpayers in a low tax bracket, consider converting portions of the traditional IRA to a Roth IRA.

*Example of accelerating distributions*

Tim retires from his job on February 3, 2017, at age 65. At the time of his retirement, he has $500,000 in cash and $1,000,000 in an IRA account. He plans to wait until he is 70 years old to begin drawing Social Security.

For four years (2017–2020), Tim lives on cash in savings, and his only taxable income is $3,000 interest on the savings accounts.

**Scenario 1 (no distributions in 2017–2020)**

In 2021, when Tim turns 70 years old, he begins taking RMD of $36,496 per year and begins receiving Social Security benefits of $36,000 per year. He still earns $3,000 in interest. He is single and does not itemize deductions.

For the years 2017–2020, Tim has no federal or California tax liability.

Beginning in 2021, however, Tim has a combined federal and California tax liability of $9,699 per year. Not only does he have $39,496 of taxable income from the interest and IRA distributions, but the two combined cause $24,472 of his Social Security benefits to become taxable — giving him AGI of $63,968. He is squarely in the 25% tax bracket.

Tim is wasting deductions and low tax brackets in years 2017–2020. If he were to take IRA distributions in those years, they could be tax-free and reduce RMD in years 2021 and later.

**Scenario 2 (distributions to top of 0% tax bracket)**

Assume Tim takes IRA distributions in 2017–2020 of $9,000 per year. His income of $12,000 ($3,000 interest income + $9,000 IRA distribution) would still be tax-free, as the total is less than his standard deduction plus exemption. He would reduce the amount on which RMD is computed by $36,000 over the four years. This will reduce Tim's tax liability by $696 per year in years 2021 and later.

**Scenario 3 (distributions to top of 10% bracket)**

Assume, instead, that Tim takes IRA distributions in 2017–2020 of about $18,000 per year, putting his taxable income at the top of the 10% bracket. He would have a tax liability of $962 per year for those four years but would reduce the amount on which RMD is computed by $72,000 when his required distribution date arrives.

**Scenario 4 (distributions to top of 15% bracket)**

Finally, assume that Tim takes IRA distributions in those four years of $47,000 per year putting his taxable income at the top of the 15% bracket. He would have a tax liability of $6,946 per year for those four years but would reduce the amount on which RMD is computed by $188,000 when RBD arrives.

*(continued)*

*Example of accelerating distributions (continued)*

| Distributions in Early Retirement (Using 2015 tax rates, standard deduction and exemption amounts, etc.) | | | | |
|---|---|---|---|---|
| | **1: No distribution** | **2: 0% bracket** | **3: 10% bracket** | **4: 15% bracket** |
| **Results (2017–2020)** | | | | |
| Annual distribution | $0 | $9,000 | $18,000 | $47,000 |
| Fed + CA tax 2017–2020 | $0 | $0 | $962 | $6,946 |
| Four-year cost | $0 | $0 | $3,848 | $27,784 |
| **Results (2021 and later)** | | | | |
| IRA balance at RBD | $1,000,000 | $964,000 | $928,000 | $812,000 |
| RMD per year | $36,496 | $35,182 | $33,869 | $29,635 |
| Taxable SS benefits | $24,472 | $23,355 | $22,239 | $18,640 |
| Fed + CA tax | $9,699 | $9,003 | $8,325 | $6,125 |
| Annual tax savings in RMD years | N/A | $696 | $1,374 | $3,574 |
| Years to exceed four-year cost | N/A | 1 | 3 | 8 |
| Savings over 15 years (after four-year cost) | N/A | $10,440 | $16,762 | $25,826 |

### Roth conversion

As an alternative to taking distributions in Scenarios 2–4, Tim can achieve the same tax results by doing a Roth conversion of the amounts designated above as distributions in 2017–2020. Remember that amounts converted from a traditional IRA to a Roth IRA must be included in gross income for the year of the conversion. Tim would enjoy tax-deferred income in the Roth account, and there is no RMD for Roths.

### The “leveraged” income item

The effect is especially strong because the amount of Social Security benefits treated as taxable goes up as other income goes up (to a maximum of 85%). This is notably relevant because individuals taking IRA distributions are also likely to be receiving Social Security benefits.

However, Social Security benefits are not the only leveraged income item. One of the most onerous is the loss of the $25,000 active participation allowance on rental real estate when AGI exceeds $100,000. This allowance is leveraged at 50%; that is, the taxpayer loses $1 of the deductible loss for each $2 increase in income until the allowance is lost completely once AGI reaches $150,000.

## Using a QLAC to further defer RMD

On July 2, 2014, the IRS released final regulations on the treatment of qualifying longevity annuity contracts (QLACs) under the RMD rules of IRC §401(a)(9). (TD 9673)

A QLAC is an annuity contract that is purchased within a traditional retirement plan (whether it's a 401(k), 403(b), or traditional IRA), under which the annuity payments are deferred until the client reaches an advanced age in order to provide retirement income security late in life. Payments must begin by the month following the month in which the client reaches age 85.

### Extending RMD requirements

The cornerstone of the initiative is the removal of RMD requirements for assets placed in a QLAC. The regulations make it easier for retirees to address the risk of outliving their assets by using a limited portion of their savings to purchase a policy in the retirement plan (including an IRA) that will provide guaranteed income for life starting at an advanced age, such as age 80 or age 85. Once that risk is addressed, a retiree's task of generating income from the remaining assets would be more manageable because it would be limited to a fixed period of time.

The regulations modify the RMD rules by excluding the value of the QLAC from the total figure used to determine required minimum distributions. The proposed regulations would apply to contracts that satisfy certain requirements, including the requirement that distributions commence not later than age 85 (though the annuity contract could specify a beginning date earlier than age 85).

The IRS has concluded that this special QLAC treatment under the RMD rules should be limited to a portion of a participant's account to avoid deferral of the participant's entire interest.

### QLAC requirements

To constitute a QLAC, the amount of the premiums paid for all QLAC contracts for the benefit of any individual cannot exceed the lesser of $125,000 or 25% of the balance of the account. An individual who exceeds these limits on premium payments may correct the excess.

> ***Example of using a QLAC and distributions in early retirement***
>
> Assume the same facts as the previous example, except that Tim contributes his maximum $125,000 to a QLAC which will begin distributions at age 85. Therefore, all IRA balances at his required beginning date are reduced by $125,000 beyond what they were already reduced with early retirement distribution in years 2017–2020.

## 401(k)s may now also contain a QLAC

In September 2014, the Treasury issued guidance that is intended to clear the way for use of annuities in 401(k) plans as well as IRAs. (U.S. Dept. of Treasury, Press Center, October 24, 2014)

In Notice 2014-66, the IRS provided a special rule that enables qualified defined contribution plans, including 401(k) plans, to provide lifetime annuities by offering a series of target date funds (TDFs) that include deferred annuities even if some of the TDFs within the series are available only to older participants.

# EXCESS IRA CONTRIBUTIONS

## Active participant could not carry forward excess IRA contributions

A taxpayer was not allowed to carry forward an IRA contribution deduction because, in the year for which the contribution was made, he was an active participant in a retirement plan at work and had income in excess of the AGI phaseout limits. (***Dunn v. Comm.***, TCM 2015-208)

### Facts

In 2008, Mr. Dunn was a participant in a retirement plan at work. He left his place of employment during 2008 and was not a participant in a retirement plan thereafter. In 2008 and 2009, he deducted IRA contributions of $6,000 each year (he was over age 50 in each of those years, and in those years the maximum contribution was $5,000 plus $1,000 if age 50 or over). In 2010, he made an $800 contribution.

On audit of the 2008 return, the IRS disallowed the $6,000 deduction because Mr. Dunn was an active participant in a retirement plan. Mr. Dunn agreed with this adjustment. The IRS allowed the deduction in 2009 because he was no longer an active participant. In 2010, the year at issue, Mr. Dunn took a $6,000 deduction, and the IRS countered that his deduction was limited to $800, the amount he contributed that year.

### Arguments

The taxpayer contended that the 2008 contribution was an "excess contribution" which became deductible in 2010.

If a taxpayer has an excess contribution for a tax year, he is deemed to have made an IRA contribution in the following year to the extent that the excess contribution plus his actual IRA contribution for the year doesn't exceed the maximum amount deductible for that following year. (IRC §219(f)(6)) An excess contribution is the amount allowable as a deduction without regard to the active participation limits. (IRC §4973(b))

The court noted that the amount Mr. Dunn deducted, $6,000, was the maximum deductible amount without regard to the active participation limits. Therefore, his excess contribution for 2008 was zero, and he accordingly had no excess contribution to carry forward.

### Conclusion

Had Mr. Dunn successfully argued that he was entitled to carry forward the excess contribution, it would have been a mixed blessing. As an excess contribution, he would have been subject to the 6% excise tax for two years resulting in a tax of $720 (6% × $6,000 × 2 years).

On the other hand, the active participation limits only prescribe a limit on the amount that may be *deducted*, not the amount that may be contributed. Therefore, Mr. Dunn was entitled to leave the 2008 contribution in the IRA and treat it as a nondeductible IRA contribution.

## No relief from excess contribution penalty for withdrawal in a later year

A couple was not relieved from the 6% per year penalty for an excess contribution to an IRA for a year in which they withdrew the excess amount by the due date of the income tax return for that year. (***Wu v. U.S.*** (August 29, 2016) U.S. Court of Appeals, Seventh Circuit, Case No. 16-1660)

Michael and Christine Wu each have an IRA to which each contributed $200,000 after selling their home in 2007. In March 2010, they realized their mistake and withdrew from their IRAs the excess contributions and related earnings. They then notified the IRS of the mistake and asked that the penalty be waived. The IRS declined to waive the penalties.

Afterward, the Wus paid the penalties and sued in district court claiming refunds only for the 2009 year. They cited IRC §4973(b), which provides that IRA contributions made but then distributed under IRC §408(d)(4) "shall be treated as an amount not contributed." IRC §408(d)(4), in turn, says that a "distribution of any contribution paid during a taxable year" is not treated as gross income if that distribution "is received on or before the day prescribed by law (including extensions of time) for filing such individual's return for such taxable year." The Wus argued that they should not be charged the penalty for 2009 because they had taken the distribution by the due date of the 2009 return.

The 7th Circuit agreed with the district court that the Wus' interpretation of IRC §408(d)(4) was incorrect. IRC §408(d)(4) only applies when an excess contribution paid into an IRA "during a taxable year" is distributed on or before the due date for that taxable year. Here, the Wus made their excess contribution in 2007 and took distributions in 2010, so no relief was available under IRC §408(d)(4).

## Excess contributions

Excess contributions from one year may be treated as IRA contributions in a later taxable year, but the 6% excise tax applies to each year the excess contribution remains in the IRA. (IRC §§219(f)(6), 4973(a)) This correction occurs automatically for any year for which a taxpayer fails to contribute the maximum allowable amount to the taxpayer's IRA. Note, however, that if the statute of limitations has expired on the year of the excess contribution and a deduction was taken for the contribution in that year, the excess contribution is instead remedied by reducing the allowable deduction for the later year. (IRC §219(f)(6)(C))

***Example of carryover of excess contribution***

Kay earned $3,000 in salary in 2015 and contributed $5,000 to an IRA. Assume that Kay does not withdraw any amount after the contribution. She has an excess contribution for 2015 of $2,000 and must pay a penalty of $120 (6% × $2,000) for 2015. In 2016, she earns $15,000 in compensation and makes a $1,000 contribution to her IRA. Kay will automatically be treated as having made an additional contribution of $2,000 for 2016 and will be allowed to deduct $3,000 as her 2016 IRA contribution.

# MAKE SURE THAT A ROBS PLAN DOESN'T ROB YOUR CLIENT'S RETIREMENT INCOME

ROBS stands for "Rollovers for Business Startups" and is a vehicle used by individuals to access their retirement funds without paying tax. A ROBS is an arrangement in which prospective owners use their retirement funds to pay for new business start-up costs by purchasing stock of the new business. The IRS made a compliance study of ROBS (the "ROBS Project"), and found that most ROBS businesses either failed or were on the road to failure with high rates of bankruptcy (business and personal), liens (business and personal), or had their corporate status dissolved by the Secretary of State (voluntary or involuntary). What follows is an overview of ROBS and the controversies surrounding them.

## ROBS transactions

The typical ROBS transaction involves a person setting up a shell corporation that sponsors a qualified retirement plan (usually a 401(k)) or an employee stock ownership plan (ESOP). The plan document allows participants to invest the entirety of their account balances in employer stock. The individual becomes the only corporate employee and then rolls over funds from a prior qualified plan (401(k)) or personal IRA into the new plan. Those funds are then used to purchase the employer stock, which is usually valued at an amount equal to the plan assets (the previously rolled-over funds). The corporation then uses the funds to finance the business start-up or to purchase a franchise.

Note that because the retirement funds were moved from one deferred tax vehicle to another, the amount "rolled over" is not included in the taxpayer's income or subject to the premature distribution penalty (for those individuals who are under age 59½).

## Oversight

Because ROBS transactions involve qualified retirement plans, they are covered by ERISA, and both the IRS and the Department of Labor exercise oversight and enforcement. The IRS focuses primarily on funding and vesting, and the DOL focuses on fiduciary duties. (Hopson, P. and Hopson J. (June 2014) "Financing a business startup or acquisition using rollover funds," *Journal of Financial Planning* 27 (6); 52-60. Available at: www.onefpa.org/journal/pages/jun14-financing-a-business-startup-or-acquisition-using-rollover-funds.aspx)

However, both the IRS and the DOL focus on whether any of the plan sponsors are engaging in prohibited transactions, which usually involve some form of self-dealing.

Although the IRS has taken the position that these transactions may not be "non-compliant per se" (Guidelines regarding rollovers as business start-ups, Memorandum from Michael Julianelle, Director, Employee Plans Rulings & Agreements (October 1, 2008)), these transactions are quite complex and fraught with traps for the unsophisticated and uninformed. Frequently, the promoter will procure a determination letter from the IRS stating that the plan meets the IRS requirements. But these determination letters do not give plan sponsors protection from incorrectly applying the plan's terms or from operating the plan in a discriminatory manner.

## Consequences of invalid transaction

Failure to comply with plan requirements will result in the plan being declared invalid. Distributions paid out from the original "rollover" will be included in the taxpayer's gross income and subject to the IRC §72 premature withdrawal penalty. If a prohibited transaction is involved, an additional 15% tax may be imposed under IRC §4975, which might increase to 100% if the violation is not cured within the taxable period.

So an invalid ROBS transaction can have severe monetary costs, which is why many practitioners advise clients that it might be better to simply withdraw their funds from their retirement plan and include the distribution in gross income from the get-go and pay the premature distribution tax (if applicable).

***Prohibited transactions***

A "prohibited transaction" means any direct or indirect:

- Sale or exchange, or leasing, of any property between a plan and a disqualified person;
- Lending of money or other extension of credit between a plan and a disqualified person;
- Furnishing of goods, services, or facilities between a plan and a disqualified person;
- Transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan;
- Act by a disqualified person who is a fiduciary whereby he deals with the income or assets of a plan in his own interest or for his own account; or
- Receipt of any consideration for his own personal account by any disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.
(IRC §4975)

## ROBS noncompliance traps

The IRS has identified several noncompliance traps involving ROBS, including:

- **Failure to file Form 5500, Annual Return/Report of Employee Benefit Plan:** Because the plan, rather than the individuals, owns the trade or business, the filing exemption available to small businesses owned by individuals does not apply. Therefore an annual Form 5500 or 5500-EZ (5500-SF for filing electronically) must be filed;
- **Discrimination:** Frequently after the initial stock is purchased by the qualified retirement plan, the plan is later amended to prevent subsequent employees from participating. According to the IRS, this may violate numerous Code qualification requirements including anti-discrimination provisions;
- **Valuation of assets:** Simply valuing the stock to equate with the amount of available funds in the plan violates the requirement that plans must have qualified appraisals done when valuing assets; and
- **Paying promoters:** Paying promoters directly or indirectly from the plan funds is a prohibited transaction.

## ROBS successes

Although there are clearly many inherent risks with ROBS, some of the largest promoters of these plans, such as Guidant, Benetrends, and SDCooper, have been promoting these transactions for the last two decades and claim that they have never had a transaction "fail" on audit. (Bennett, J. (March 2014) "Warning Shots: Tax court takes aim at retirement rollovers as funding tool" *Franchise Times*. Available at: www.franchisetimes.com/March-2014/Warning-Shots/) Many of these large promoters also state that they cover the costs of any audits that may arise. So if you have clients who are interested in pursuing a ROBS transaction, your best advice might be to make sure any promoter they use provides similar kinds of audit coverage and has similar success rates on audit.

## ROBS failures

Three cases highlight some of the inherent risks in these types of transactions.

In ***Ellis v. Comm.***, a taxpayer was found to have engaged in a prohibited transaction involving his IRA and the LLC he owned (CST Investments), resulting in the entire IRA being taxable to the taxpayer. (***Ellis v. Comm.*** (June 5, 2015) U.S. Court of Appeals, Eighth Circuit, Case No. 14-1310) The taxpayer used the funds from his self-directed IRA to start a used car business. The IRA purchased a 98% interest in the business, and the taxpayer became the general manager. Thereafter, the business compensated the taxpayer for his role as general manager, which was a prohibited transaction under IRC §4975.

In ***Peek and Fleck v. Comm.***, the Tax Court found that two taxpayers were engaged in prohibited transactions when they personally guaranteed promissory notes issued by their self-directed IRAs. The notes were issued as part of the purchase of a company by the IRAs. (***Peek and Fleck v. Comm.*** (2013) 140 TC 12) The taxpayers argued that their personal guarantees weren't prohibited transactions because the loan guarantees were between them and the company rather than the IRAs themselves.

In ***Thiessen v. Comm.***, the Tax Court again found that the taxpayers' personal guarantee made in 2003 on a loan to the corporation owned by their IRAs was a prohibited transaction and therefore invalidated the IRAs. (***Thiessen v. Comm.*** (2016) 146 TC 7) As a result, the entire IRAs were deemed distributed in 2003, and the taxpayers were liable for the unpaid tax on that income, plus the 10% early withdrawal penalty.

# SURVIVING SPOUSE WAS UNABLE TO ROLL OVER INHERITED IRA

A surviving spouse could not roll over her portion of an inherited IRA because she wasn't the beneficiary of the IRA, her son was. She received her community property share of the IRA through a settlement with her deceased spouse's estate. (PLR 201623001)

## The settlement

The taxpayer and her spouse lived in a community property state. Before her husband died, he named their son as the sole beneficiary of his IRA. After her husband's death, the taxpayer filed a claim against the estate for her one-half interest in their community property IRA asset.

The taxpayer and the estate negotiated a settlement, which was approved by a state court. The court then ordered that the IRA custodian assign the negotiated amount to the taxpayer as a spousal rollover IRA. The IRS, however, determined that the distribution could not be made as a spousal rollover. The private letter ruling states that IRC §408 must be applied without regard to community property laws. This means that for taxable distribution purposes, the son is the named beneficiary of the IRA account, and all distributions were taxable to him.

## Inherited IRAs

The rules for distributions of IRAs upon the death of the owner are complex and depend on a number of factors. Among those factors is whether the account owner had reached his or her RBD. The RBD is the date that RMDs must begin (i.e., April 1 of the calendar year following the taxable year in which the owner turns 70½). (Treas. Regs. §1.401(a)(9)-2)

Generally, if an IRA owner has begun taking required distributions, the remaining account balance must be distributed at least as rapidly as under the distribution method being used as of the date of death. However, under regulations, this requirement is satisfied if the remaining portion is distributed over the life of the beneficiary or over the remaining life expectancy of the original IRA owner if there is no beneficiary. (Treas. Regs. §1.401(a)(9)-2, Q&A 5)

Another major factor is the type of beneficiary:

- Spouse;
- Nonspouse;
- Multiple nonspouses; or
- Nonperson, including an estate.

All beneficiaries have two options:

- Take an immediate distribution; or
- Take distributions under the five-year rule.

Beneficiaries who inherit through the decedent's estate (not as named beneficiaries) must use one of the above two options. Spouses and named beneficiaries have additional options.

### Surviving spouse as beneficiary

Only the surviving spouse may roll over the account into his or her own account. The spouse has two options for postponing distributions:

- Wait to take distributions until the end of the year following the year of the owner's death or the year the deceased IRA owner would have turned 70½, whichever is later (IRC §408(a)(9)(B)(iv)); or
- Roll over the IRA into his or her own IRA and begin distributions at the surviving spouse's age 70½. (IRC §408(d)(3)(C))

### Nonspouse individual as beneficiary

If the beneficiary is not the spouse, the RMD is the designated beneficiary's life expectancy determined based on his or her age on the birthday in the year after the year in which the IRA owner died. Use this method regardless of whether the IRA owner died before, on, or after age 70½, with one exception. If the IRA owner died on or after age 70½ and his or her life expectancy is longer than the beneficiary's life expectancy, use the IRA owner's life expectancy rather than the beneficiary's life expectancy.

There are two scenarios involving a plan with multiple named beneficiaries:

- If all the beneficiaries are individuals, use the oldest beneficiary's life expectancy to calculate required distributions. (Treas. Regs. §1.401(a)(9)-4) The IRA stays in one account; and
- If the benefits under the plan are divided into separate accounts, each beneficiary may use his or her own life expectancy. (Treas. Regs. §1.401(a)(9)-8, A-2(a))

## UNIFORM LIFETIME TABLE

The Uniform Lifetime Table (reproduced below) is based on the joint life and last survivor expectancy of an individual and a beneficiary not more than 10 years younger. The table is subject to change by the IRS.

| Uniform Lifetime Table | | | |
|---|---|---|---|
| **Age** | **Distribution period** | **Age** | **Distribution period** |
| 70 | 27.4 | 93 | 9.6 |
| 71 | 26.5 | 94 | 9.1 |
| 72 | 25.6 | 95 | 8.6 |
| 73 | 24.7 | 96 | 8.1 |
| 74 | 23.8 | 97 | 7.6 |
| 75 | 22.9 | 98 | 7.1 |
| 76 | 22.0 | 99 | 6.7 |
| 77 | 21.2 | 100 | 6.3 |
| 78 | 20.3 | 101 | 5.9 |
| 79 | 19.5 | 102 | 5.5 |
| 80 | 18.7 | 103 | 5.2 |
| 81 | 17.9 | 104 | 4.9 |
| 82 | 17.1 | 105 | 4.5 |
| 83 | 16.3 | 106 | 4.2 |
| 84 | 15.5 | 107 | 3.9 |
| 85 | 14.8 | 108 | 3.7 |
| 86 | 14.1 | 109 | 3.4 |
| 87 | 13.4 | 110 | 3.1 |
| 88 | 12.7 | 111 | 2.9 |
| 89 | 12.0 | 112 | 2.6 |
| 90 | 11.4 | 113 | 2.4 |
| 91 | 10.8 | 114 | 2.1 |
| 92 | 10.2 | 115+ | 1.9 |

 

| Single Life Table for Inherited IRAs (for Nonspouse Beneficiaries Only) | | | |
|---|---|---|---|
| **Age** | **Distribution period** | **Age** | **Distribution period** |
| 40 | 43.6 | 60 | 25.2 |
| 41 | 42.7 | 61 | 24.4 |
| 42 | 41.7 | 62 | 23.5 |
| 43 | 40.7 | 63 | 22.7 |
| 44 | 39.8 | 64 | 21.8 |
| 45 | 38.8 | 65 | 21.0 |
| 46 | 37.9 | 66 | 20.2 |
| 47 | 37.0 | 67 | 19.4 |
| 48 | 36.0 | 68 | 18.6 |
| 49 | 35.1 | 69 | 17.8 |
| 50 | 34.2 | 70 | 17.0 |
| 51 | 33.3 | 71 | 16.3 |
| 52 | 32.3 | 72 | 15.5 |
| 53 | 31.4 | 73 | 14.8 |
| 54 | 30.5 | 74 | 14.1 |
| 55 | 29.6 | 75 | 13.4 |
| 56 | 28.7 | 76 | 12.7 |
| 57 | 27.9 | 77 | 12.1 |
| 58 | 27.0 | 78 | 11.4 |
| 59 | 26.1 | 79 | 10.8 |
| | | 80 | 10.2 |

| Comparison of RMDs Between Uniform Table and Single Inherited | | |
|---|---|---|
| **December 31, 2015, IRA balance** | **2016 RMD from Single Life Table — age 71 beneficiary** | **2016 RMD from Uniform Lifetime Table — age 71 owner** |
| $500,000 | $30,675 ($500,000 ÷ 16.3) | $18,868 ($500,000 ÷ 26.5) |

# ROTH IRA PROVISIONS — IRC §408A

## ROTH IRA CONTRIBUTION AMOUNTS

For taxpayers with AGI not exceeding certain amounts, nondeductible contributions to a Roth IRA are allowable up to the lesser of $5,500 or the taxpayer's annual compensation. This amount is reduced by the amount the taxpayer contributes to another IRA for the same taxable year. Consistent with general IRA rules, joint-filing couples may contribute up to $5,500 each ($6,500 each if both spouses are age 50 or older) to a Roth IRA, provided the couple's combined compensation is at least equal to the amount contributed.

The 2016 (and 2017) catch-up contribution limit for individuals age 50 and older is $1,000 (the IRA rules allow an individual age 50 and older to make additional catch-up IRA contributions).

Catch-up contribution amounts are not subject to annual inflation adjustments. The otherwise maximum contribution limit (before application of the AGI phaseout limits) for an individual who has attained age 50 before the end of the taxable year is increased as follows:

| Catch-Up Contribution | |
|---|---|
| **2002–2005** | **After 2005** |
| $500 | $1,000 |

## ANNUAL CONTRIBUTION LIMITATIONS DUE TO INCOME

The maximum contribution that can be made to a Roth IRA is phased out on an adjusted-for-inflation basis in accordance with the table below.

| Roth IRA AGI Limits | | | |
|---|---|---|---|
| **Filing status** | **2015** | **2016** | **2017** |
| Single, HOH, or MFS and did not live with spouse at any time during the year | $116,000–131,000 | $117,000–132,000 | $118,000–133,000 |
| MFJ | $183,000–$193,000 | $184,000–$194,000 | $186,000–$196,000 |
| MFS and lived with spouse at any time during the year | $0–$10,000 | $0–$10,000 | $0–$10,000 |

**Practice Pointer**

Unlike a traditional IRA, there is no limitation on the ability to contribute to a Roth based on whether the individual or spouse is a participant in a retirement plan.

### California conformity

California conforms to IRC §408A and automatically conforms to any federal changes. (R&TC §§17501–17509, 23701)

## NEW FUNDING OPTIONS AVAILABLE FOR myRA ACCOUNTS

The Treasury Department has expanded the ways taxpayers can fund their myRA accounts. Previously, taxpayers could only fund a myRA via direct deposit through an employer. Now, those accounts can be funded by the following methods:

- Through one-time or recurring electronic transfer contributions from personal checking or savings accounts; or
- By directing all or a portion of a federal tax refund to the myRA account. Taxpayers can elect this method by completing Form 8888, Allocation of Refund (Including Savings Bond Purchases), and making the corresponding entry on line 76 on their 1040 (or relevant line on the 1040-A or 1040-EZ).

**Note:** Contributions may not be made by sending a personal check directly to the myRA administrator.

 

## The basics of myRA accounts

A myRA ("My Retirement Account") is a retirement savings account for individuals, but employers may facilitate the myRA contributions. Savers may contribute $2 or more every payday, up to $5,500 per year ($6,500 if age 50 or over). A myRA balance will never go down, and there are no account maintenance fees.

Technically, myRAs are Roth IRAs subject to all of the rules of Roths, including contribution limits based on income and filing status.

A myRA earns interest at the same variable rate as the Government Securities Investment Fund ("G Fund") in the Thrift Savings Plan for federal employees. Savers may voluntarily roll over myRAs to private-sector retirement accounts at any time. Once a saver's myRA reaches $15,000, or after 30 years, the balance will be rolled over to a regular Roth IRA.

## Employer role

An employer may — at their own discretion — offer employees the ability to fund a myRA through payroll deductions.

There is no cost to employers, and they are not required to administer, contribute to, or match the contributions. Employers are encouraged, but not required, to make myRA available for employees. In essence, the contribution is treated like the employee allocating a portion of their paycheck to a separate account.

For information on California legislation that will establish the California Secure Choice Retirement Savings Program, a similar account in California that will be available in the future, see page 10-7.

For more information or to open a myRA account, visit myRA online at:

**Website**
http://myra.gov

For a client letter about these accounts and the ease of setting them up, go to:

**Website**
www.caltax.com/spidellweb/public/editorial/myRAletter.doc

# OTHER RETIREMENT PLAN ISSUES

## PATH ACT ALLOWS ROLLOVERS INTO SIMPLE IRAs

Under the old rules prior to the PATH Act of 2015, SIMPLE IRAs did not accept rollovers from any other type of retirement plan — the only allowed contributions were from a qualified salary reduction arrangement or a transfer from another SIMPLE IRA. (IRC §408(p)(1)) Also, before funds could be rolled from a SIMPLE IRA into another type of retirement plan, a two-year waiting period had to be met. (IRC §72(t)(6)) The two-year waiting period begins on the date that the employee first participated in a qualified salary reduction arrangement maintained by the employer.

However, the PATH Act provides that these plans may now accept rollovers from other types of retirement plans once the two-year waiting period is met:

- A traditional IRA (IRC §408(d)(3));
- A qualified trust (IRC §402(c));
- A qualified annuity (IRC §403(a)(4));
- A §403(b) tax-sheltered annuity (IRC §403(b)(8)); and
- A governmental §457 plan. (IRC §457(e)(16))

This provision applies to rollover contributions made after December 18, 2015. (IRC §408(p)(1)(B) as amended by PATH Act §306) The requirement that the two-year waiting period be met before rolling SIMPLE funds to another type of plan is still in effect.

# ALLOWABLE ROLLOVERS

**Comparison Chart of Allowable Rollovers**

| Rollover From | Rollover To: IRA | SEP-IRA | SIMPLE IRA | Roth IRA | 457(b) | 403(b) | Qualified Plan | Designated Roth Account |
|---|---|---|---|---|---|---|---|---|
| **IRA** | Yes | Yes | Yes | Yes, must include in income | Yes, must have separate accounts | Yes | Yes | No |
| **SEP-IRA** | Yes | Yes | Yes | Yes, must include in income | Yes, must have separate accounts | Yes | Yes | No |
| **SIMPLE IRA** | Yes, after two years | Yes, after two years | Yes | Yes, after two years. Must include in income | Yes, after two years. Must have separate accounts | Yes, after two years | Yes, after two years | No |
| **Roth IRA** | No | No | No | Yes | No | No | No | No |
| **457(b)** | Yes | Yes | Yes | Yes, after December 31, 1997. Must include in income | Yes | Yes | Yes | Yes |
| **403(b)** | Yes | Yes | Yes | Yes, after December 31, 1997. Must include in income | Yes, must have separate accounts | Yes | Yes | Yes |
| **Qualified Plan** | Yes | Yes | Yes | Yes, after December 31, 1997. Must include in income | Yes, must have separate accounts | Yes | Yes | Yes (401(k) plans) |
| **Designated Roth Account** | No | No | No | Yes | No | No | No | Yes, if a direct trustee-to-trustee transfer |

**Warning:** The comparison chart shows general information that may not be applicable to all plans. Now all accounts allow rollover contributions. (Treas. Regs. §1.402(a)(31)-1, Q&A 13) Check with your pension administrator for additional requirements. A trustee-to-trustee transfer is required in some instances. A 60-day rollover rule may apply. (www.irs.gov/ep)

# MORE AGGRESSIVE RETIREMENT PLANS

## AGGRESSIVE — SOLO 401(k) PLANS

Sometimes called a self-employed 401(k), solo 401(k), or a variety of other proprietary names, the individual 401(k) is for sole proprietors or corporations where the only employee is the owner (or owner and spouse). Individual 401(k) plans have two parts:

- Profit sharing, with a maximum of 20% of compensation for sole proprietors or 25% for corporations; and
- Elective deferrals of 100% of compensation up to $18,000 for 2016, plus $6,000 for taxpayers age 50 and older.

The overall maximum contribution for each individual for 2016 is $59,000, including the catch-up for individuals age 50 and older.

Most available plans are fully integrated; that is, they pair the profit-sharing and deferral parts and provide for investment within a single account.

### 401(k) plans especially powerful for smaller incomes

The sheer size of potential 401(k) contributions and the deductions that go with them — especially in relation to a relatively small amount of income — make the individual 401(k) so powerful. It may seem like the power of a 401(k) at lower incomes can't be of much interest. After all, how can a taxpayer who only makes $10,000 per year possibly make a large plan contribution and still afford to eat? Here are a few situations that fit:

- A spouse with a small business can shelter all or most of the income from income tax;
- A full-time employee with a side business; and
- A semi-retired person who doesn't need the income to live on.

Moreover, experts advise that we will see more people retiring through phases in which they will work part time, start new small businesses, or serve as consultants. The number of people who can benefit from the individual 401(k) is very likely to explode in the coming years.

Here is a comparison of the 2015 maximum contribution amounts for 401(k)/profit-sharing plan combination and SEPs based on net income from self-employment for individuals age 50 and older.

| **Comparison of Contribution Amounts** | | |
|---|---|---|
| **Net income** | **Solo 401(k)** | **SEP** |
| $10,000 | $9,294 | $1,859 |
| $30,000 | $27,880 | $5,576 |
| $80,000 | $38,870 | $14,870 |
| $184,820 | $59,000 | $35,000 |
| $276,080 | $59,000 | $53,000 |

Consider the advantages of the solo 401(k):

- Maximum contributions are greater ($59,000 versus $53,000);
- Contributions at low levels of income are much greater; and
- The maximum contribution for solo 401(k) is achieved at much lower income levels than for the SEP ($184,820 versus $276,080).

In years gone by, the SEP was a favorite because it was "simple." But that has changed. The only advantage the SEP has over the solo 401(k) is that the SEP may be established prior to the due date of the return, while the 401(k) must be established prior to the end of the taxable year.

## MORE AGGRESSIVE — DEFINED BENEFIT PLANS FOR SOLO PRACTITIONERS

When a solo practitioner is looking at retirement plans for a way to defer taxes, their choices are not limited to a Simplified Employee Pension (SEP) plan or other defined contribution plan. Often, an advisor will recommend adopting a defined benefit (DB) plan. Depending on the taxpayer's age, the annual tax-deductible contribution they may make can be much larger than the $53,000 maximum allowed under the typical profit sharing plan. This can result in significant tax savings to the individual while accumulating significant savings for retirement.

There is no maximum contribution that can be made to a DB plan, per se. Rather, the DB plan defines the benefit that can be paid from the plan. The maximum annual benefit payable from a DB plan is the lesser of $210,000 payable at age 62 or the high three-consecutive-year average compensation. If the compensation average supports it, an individual with 10 years of participation in a DB plan can receive a $210,000 annual benefit, or an equivalent lump sum of approximately $2.6 million. Since the limit is determined when benefits are paid, the $210,000 benefit limit is actuarially adjusted for ages earlier than 62 and later than age 65; and further reduced *pro rata* for years of participation in the DB plan less than 10 years. The high three-consecutive-year average limit is reduced *pro rata* for years of service less than 10 years.

| Maximum Annual Benefit | |
|---|---|
| **Age** | **Maximum benefit limit** |
| 55 | $130,997 |
| 60 | $182,724 |
| 62 | $210,000 |
| 65 | $210,000 |
| 67 | $243,517 |

The compensation that can be recognized for plan purposes will depend on the entity type for the business. An entity that is taxed as a sole proprietor uses their net earned income (line 31 from the Schedule C) minus the pension contributions (excluding 401(k) deferrals). An entity that is taxed as a corporation (including an S corporation) uses W-2 compensation for plan purposes. Passthrough income on a Schedule K-1 for an S corporation is not recognized as compensation for plan purposes.

With a DB plan, the sole proprietor will need to work with their consultant, accountant, and advisor to determine the annual contribution level. Once the contribution level is decided, the actuary will determine the benefit available at normal retirement. The calculations are based on their age, compensation, years to retirement, and expected return on assets. The older you are, the larger the possible contribution is to a DB plan.

***Example of retirement at age 52***

A 52-year-old sole proprietor, with net Schedule C compensation (after the DB contribution) well over the compensation limit ($265,000 for 2015) could count on depositing approximately $175,000 annually (depending on asset performance). This assumes normal retirement at age 62.

***Example of retirement at age 55***

A 60-year-old sole proprietor, with net Schedule C compensation (after the DB contribution) well over the compensation limit ($265,000 for 2015) could count on depositing approximately $200,000 annually (depending on asset performance). This assumes normal retirement at age 65.

## Set up a defined benefit plan at time of sale of business

When a client sells their business for a large profit, even the most knowledgeable client will gasp at the tax bite. But, if planned properly, the owner (and spouse if he or she works in the business) can establish a retirement plan that will quickly build a retirement nest egg and offset income from the sale of the business.

By using a defined benefit plan, the seller can take a big deduction by funding the plan in the year of the sale. Sometimes the owner can make two years' contributions in one year and expand the deduction.

For this discussion, we will use the simplest fact pattern: a business that is operated by the owner/employee, and there are no other employees.

***Example of defined benefit plan just before sale***

John, age 65, operated a small but lucrative consulting business. He had no employees and had a salary of $250,000 for each of the last 10 years. In 2016, he will sell the business for $2 million. The agreement states that John will receive $1.5 million in 2016 and $500,000 plus $100,000 in consulting fees in 2017.

John establishes a defined benefit plan in 2016, which will pay him $210,000 at retirement. He may contribute $240,000 in 2016 and another $240,000 in 2017. He does not need to take a salary in 2017. Since a defined benefit plan allows the funding to be based on the highest-paid three consecutive years of service, the plan could fund the maximum retirement benefit without regard to current wages. As long as the historical wages (highest three consecutive years) are high enough, the funding can ignore current (now lower) wages.

In 2017, he dissolves his corporation and stops funding the pension plan. A defined benefit plan must accrue benefits over time (generally 10 years) to avoid "front loading" contributions. In this example, John would have accrued two-tenths (0.2) of the maximum benefit allowed, or a $42,000 annual benefit ($210,000 × 0.2).

It is also possible to deduct two years' contributions in one year. To do this, the owner must know of the impending sale in advance to do proper planning and execution.

### What about the spouse?

You can increase and potentially double up on the contributions if the spouse has been an employee of the business. The spouse's contributions are based on his or her salary and years of service.

### Permanency rule

Under Treas. Regs. §1.401-1(b)(2), a defined benefit plan must be in place for at least 10 years unless there is an independent business reason to terminate the plan. Reasons include substitution of another plan or business restructuring, such as a merger, change in stock ownership, or restructure in bankruptcy. The IRS is stricter for this rule with a defined benefit plan than a profit-sharing plan. However, even with a business reason, the plan must be in place for at least two years.

***Recipe for defined benefit plan***

For a defined benefit plan that will work properly, combine these ingredients:

- Owner/employee with at least 10 years of service;
- More than 50 years old;
- No other (or few) employees;
- Has and is willing to use the cash to fund the plan; and
- Follows directions and makes payments on time.

### Other employees

If the company employs other employees, they must also be covered under the plan. However, the effect can be minimized if:

- The employees are young. The amount required will be substantially reduced if they are 20 or more years away from retirement;
- The owner wishes to provide the employees with compensation for past service. The plan contribution can replace or supplement a bonus that the employer would have paid anyway; and
- The sale can be arranged so that the employees are terminated prior to the end of the plan year. This necessitates good timing and planning. Use of a qualified pension advisory service is recommended.

### Cost

The cost to establish, operate, and then terminate a defined benefit plan is high. Fees can be in the $2,500 to $5,000 range to establish the plan, and more than $3,000 annually (depending on the number of participants) to maintain it. So the client should make sure that the tax benefit is well worth the cost.

### Complex rules

The reason the plan is more expensive than a profit sharing plan is that there are complex rules, and the plans must be approved by the IRS. Both the IRS and the Department of Labor can potentially audit the plans.

***More information on retirement plans***

For more information on using these plans, register for Spidell's on-demand webinar, "Retirement Plans: Maximizing Tax Benefits and Wealth Accumulation." See the sales booth or go to www.caltax.com and click on Webinars to register.

*Audit rate*

For fiscal year 2014, the national audit rate was 7,135 out of 876,881 Forms 5500 filed, or 0.81367939321299%. Of those 7,135, there were 93 one-life defined benefit plans pulled for audit.

## 2016 AND 2017 PLAN LIMITATION AMOUNTS

| Maximum Contributions to Retirement Plans | | | | | |
|---|---|---|---|---|---|
| | **2013** | **2014** | **2015** | **2016** | **2017** |
| **IRAs (regular and Roth)** | | | | | |
| Up to Age 50 | $5,500 | $5,500 | $5,500 | $5,500 | $5,500 |
| Age 50+ | $6,500 | $6,500 | $6,500 | $6,500 | $6,500 |
| **401(k); 403(b); 457 plans** | | | | | |
| Up to Age 50 | $17,500 | $17,500 | $18,000 | $18,000 | $18,000 |
| Age 50+ | $23,000 | $23,000 | $24,000 | $24,000 | $24,000 |
| **SIMPLE IRAs** | | | | | |
| Up to Age 50 | $12,000 | $12,000 | $12,500 | $12,500 | $12,500 |
| Age 50+ | $14,500 | $14,500 | $15,500 | $15,500 | $15,500 |
| **Defined contribution plans** | | | | | |
| Profit sharing/ money purchase | $51,000 | $52,000 | $53,000 | $53,000 | $54,000 |
| SEP IRA | $51,000 | $52,000 | $53,000 | $53,000 | $54,000 |

**Solo 401(k):** In 2016, the maximum contribution for a solo 401(k) is $53,000 or $59,000 for taxpayers age 50+.

| Annual Compensation Limits of Defined Benefit Plans (IRC §§401(a)(17), 404(j), 408(k)(3)(C)(7)) | |
|---|---|
| 2012 | $250,000 |
| 2013 | $255,000 |
| 2014 | $260,000 |
| 2015 | $265,000 |
| 2016 | $265,000 |
| 2017 | $270,000 |

 

## California conformity

California conforms to these amounts. (R&TC §17501)

# IRC §§529 AND 529A

## QUALIFIED TUITION PROGRAMS — IRC §529

### PATH Act enhancements

Under the PATH Act, §529 rules are enhanced in the following ways:

- Computer technology and equipment are permanently allowed as qualified higher education expenses for purposes of §529; and
- Individuals are allowed a 60-day "rollover" period for nonqualified distributions; that is, the law will give individuals up to 60 days to redeposit the distribution into a qualifying account for that individual without the distribution being taxable.
(Act §302)

## QUALIFIED ABLE PROGRAMS — IRC §529A

Effective beginning in 2015, the Achieving a Better Life Experience (ABLE) Act provides a new type of tax-advantaged savings plan for disabled individuals. (IRC §529A) They are closely modeled on IRC §529 qualified tuition plans (QTPs).

An ABLE account is a tax-favored savings account that can accept contributions for an eligible blind or disabled individual who is the designated beneficiary and owner of the account. A designated beneficiary doesn't include distributions for qualified disability expenses in their income. The account is used to provide for qualified disability expenses. Earnings in an ABLE account aren't taxed unless a distribution exceeds a designated beneficiary's qualified disability expenses. Contributions to an ABLE account are not tax deductible and must be in cash or cash equivalents.

### IRS issues simplifying rules

In a notice, the IRS issued rules that will be included in final regulations when issued. The IRS states that "these changes will make it easier for states to offer and administer ABLE programs. (Notice 2015-81)

The changes include:

- Categorization of distributions are not required of ABLE programs. It will be up to the beneficiaries to properly determine whether distributions are for qualified disability expenses, not the ABLE program;
- Contributors' TINs will not be required. ABLE programs will not be required to request the TINs of contributors to ABLE accounts at the time when the contributions are made, if the program has a system in place to reject contributions that exceed the annual limits; and
- Disability diagnosis certification will be allowed. Designated beneficiaries can open an ABLE account by certifying that they meet the qualification standards including that they have received a signed physician's diagnosis. ABLE programs will not need to receive, retain, or evaluate detailed medical records.

## California conformity

California conforms to federal law for ABLE accounts and also creates an ABLE program in California. (R&TC §§17140.4, 23711.4)

# SOCIAL SECURITY

## SOCIAL SECURITY (FICA)

### FICA wage base — $127,200 in 2017

The Social Security Administration (SSA) announced the 2017 FICA wage base to be $127,200. For 2016, the wage base is $118,500.

FICA is made up of two components:

- Old Age, Survivor, and Disability Insurance (OASDI); and
- Medicare.

Both the employer and employee are subject to a 6.2% rate for OASDI and 1.45% for Medicare. In addition, an employer is required to collect from each of its employees the 0.9% Additional Medicare Tax only to the extent the employer pays wages to the employee in excess of $200,000 in a calendar year. This rule applies regardless of the employee's filing status or other income. (Prop. Treas. Regs. §31.3102-4) There is no requirement that the employer match the 0.9% tax or notify its employees if it withholds additional Medicare tax.

The 2016 cost of living adjustment is zero.

| **FICA and Self-Employment Tax Update** | | | |
|---|---|---|---|
| | **2015** | **2016** | **2017** |
| Maximum FICA (OASDI) wage base | $118,500 | $118,500 | $127,200 |
| FICA tax rate (employer/employee) | 7.65%/7.65% | 7.65%/7.65% | 7.65%/7.65% |
| Self-employment tax rate | 15.3% | 15.3% | 15.3% |
| Maximum FICA tax (employer/employee) | $9,065/$9,065 | $9,065/$9,065 | $9,731/$9,731 |
| Maximum self-employment tax (to OASDI limit) | $18,131 | $18,131 | $19,462 |
| Maximum Medicare health insurance wage base | Unlimited | Unlimited | Unlimited |
| Medicare health insurance rate | $1.45% + 0.9% above $200,000 | $1.45% + 0.9% above $200,000 | $1.45% + 0.9% above $200,000 |
| Earned income ceilings for Social Security benefits: early retirement age | $15,720 | $15,720 | $16,920 |
| Earned income ceilings for Social Security benefits: full retirement age and over | Unlimited | Unlimited | Unlimited |
| Basic Medicare B premium | $104.90/month $1,258.80 to $4,028.40/year | $121.80/month $1,461.60 to $4,677.60/year | $134.00/month $1,608.00 to $5,143.20/year |

 

# IS YOUR SOCIAL SECURITY STATEMENT REPORTING CORRECT INFORMATION?

Suppose you (or your client) is approaching age 62 and wondering when to apply for SSA retirement benefits — early (62), full retirement (currently age 66), delayed (up to age 70), or some date in between these key points. After locating your most recent SSA earnings and benefits statement, you peruse projected benefits at the three key points. Your eyes then wander to your record of earnings all the way back to your first job as a teenager, and you notice that some earlier years are void of data, and some years show understated earnings. What should you do?

## Making corrections to an incorrect earnings statement

Immediately contact the SSA and begin working with them to make the proper corrections. They will have you prepare SSA Form 7008, Request for Correction of Earnings Record, which is the document initiating corrective action.

There is a statute of limitations for corrections (Social Security Act, §205(c)) — three years, three months, and fifteen days after the earnings year in question. During this period, once notified, the SSA will work to correct the misstatement. There are exceptions allowing corrections after the statute has expired. (Social Security Handbook, §§1424, 1425) An individual generally can work with the SSA to make corrections after expiration of the statute, provided a timely income tax return was filed for the year in question, but the burden is on the individual to prove the correct amounts. Be ready to dig up everything possible, such as W-2s, tax return copies, wage stubs, any other relevant records, as well as names, addresses, and phone numbers of former employers.

## Situations in which an earnings statement might be incorrect

Earnings could be incorrect for several reasons, including:

- An employer reported earnings incorrectly, or used a wrong name or Social Security number;
- The individual got married or divorced and changed his or her name but never reported the change to the SSA;
- The individual worked using a Social Security number that didn't belong to him or her; or
- Identity fraud — the presence of zeros and/or unusually large earnings can be a red flag.

If you're in your 60s and trying to correct misstated earnings from 35–40 years ago, you may experience difficulties. However, even if you have no documents for those earlier years, you should still contact the SSA and see if anything can be done. For example, if you had W-2 wages from a certain employer for several years, but there are two years of wages missing within that span, the SSA may be able to provide some help.

## Background on SSA statements and calculation of benefits

In 1995, the SSA began mailing earnings statements to selected age groups. The purpose was to inform workers of their benefits, help them plan financially, and most importantly, ensure that earnings records were accurate. The SSA's actuarial group foresaw a veritable tsunami of 50-somethings (baby boomers) biding their time until retirement, and hoped earnings records could be verified and corrected, if needed, long before the big wave hit.

In 2000, the SSA began mailing statements annually to workers age 25 and older — described as the largest customized mailing ever undertaken by a federal agency. ("*The Social Security Statement*: Background, Implementation, and Recent Developments," *Social Security Bulletin*, Vol. 74, No. 2, 2014) Mailing was suspended in 2011 due to budget constraints, with online access implemented in 2012. Starting in September 2014, they're once again being mailed to age groups at five-year increments, such as 25, 30, 35, etc., and annually to workers age 60 and over.

Monthly benefits are calculated from a worker's rolling average of his or her highest 35 years of earned income after each of those years (up to age 60) is indexed for inflation. Earnings at age 60 and over, while still a part of the calculation, are not indexed. While the calculation is mind-boggling, the good news is the SSA calculates benefits for you, providing it has correct and complete information with which to work.

***Comment***

The annual earnings statement shows actual earnings. The inflation adjustment is done at the time the individual applies for benefits and when showing projected benefits on the statement.

## Who's responsible for a correct earnings statement?

The SSA, with a very sophisticated and user-friendly website, now provides for individual accounts to be created, with one of the resulting opportunities being the ability to download one's current earnings statement at any time. From the homepage (www.socialsecurity.gov or www.ssa.gov), one can select "my Social Security" and easily create an account. Yet, those that receive their earnings statements in the mail may bring them to their tax appointment, often still sealed (similar to their tax organizer), and hand them to their accountant, saying, "Do you need this? I don't know what it is."

Since the SSA can only work with the information it's given and provides everyone the utmost opportunity to verify earnings and see that they're correct, the onus is on each worker to maintain a correct record. Regarding years with no documentation to support missing earnings, the individual should be prepared for possibly losing those years in the calculation. If there's any consolation, there are two silver linings:

- A worker's 35 highest earnings years (after indexing) are used for calculating benefits; therefore, if a person has 40–45 years of earnings, losing a single year may not even impact the calculation; and
- The formula for calculating benefits is skewed favorably to lower earners. Indexed earnings are factored into one's Primary Insurance Amount (PIA) calculation, with the PIA formula heavily weighted at the lower end of the earnings strata. Therefore, missing a couple of years of earnings, even within the highest 35 years, could very well have a minimal impact on benefits.

## How to read your earnings statement

Below is a portion of a sample earnings statement provided by the SSA:

| Sample Earnings Statement | | |
|---|---|---|
| **Years You Worked** | **Your Taxed Social Security Earnings** | **Your Taxed Medicare Earnings** |
| 1991 | $1,592 | $1,592 |
| 1992 | $2,854 | $2,854 |
| 1993 | $4,678 | $4,678 |
| 1994 | $6,367 | $6,367 |
| 1995 | $7,923 | $7,923 |
| 1996 | $9,985 | $9,985 |
| 1997 | $13,095 | $13,095 |
| 1998 | $16,232 | $16,232 |
| 1999 | $19,252 | $19,252 |
| 2000 | $22,240 | $22,240 |
| 2001 | $0 | $0 |
| 2002 | $26,341 | $26,341 |
| 2003 | $28,412 | $28,412 |
| 2004 | $30,970 | $30,970 |
| 2005 | $33,253 | $33,253 |
| 2006 | $35,799 | $35,799 |
| 2007 | $38,342 | $38,342 |
| 2008 | $40,065 | $40,065 |
| 2009 | $40,191 | $40,191 |
| 2010 | $41,790 | $41,790 |

For retirement benefits, the relevant column is Your Taxed Social Security Earnings. These amounts will often differ from taxable earnings. For W-2 recipients, it's the amount shown in box 3 of the W-2, Social Security wages, which will never be greater than the maximum amount of earnings subject to Social Security withholding in a given year. For self-employed workers, the relevant earnings amount is from line 4 of Schedule SE.

**✎ Practice Pointer**

When meeting with new clients, perhaps those over age 40, you might ask them to bring their latest earnings statement to the initial interview. This is always an opportunity for existing clients as well. You can then help them look it over and perhaps assist them with some long-range benefits planning, especially married couples looking to coordinate their combined benefits.

# SOCIAL SECURITY RETIREMENT BENEFITS INVOLVING DIVORCED SPOUSES

Although the underlying rules for SSA retirement benefits are fairly straightforward and materially consistent since the 1930s, they can be very confusing for the general public; sometimes even for specialists in the field. The issue of divorced spousal benefits is often rife with misunderstanding and misinformation; therefore, we'll revisit and examine various issues in this area.

## Basic rules

Spousal benefits are available to married and divorced spouses. This discussion focuses on the latter, but in both situations there are two parties — the claimant and the owner of the earnings record on which the benefits are claimed. In the case of divorce, either ex-spouse can claim benefits on the other's earnings record if:

- The marriage lasted 10 years or more;
- The claimant is unmarried and is age 62 or older (the earnings record holder does not have to remain unmarried);
- The benefit the claimant is entitled to on his or her own earnings record is less than the benefit he or she would receive on the ex-spouse's record; and
- The spouse on whose record benefits are claimed:
  - Must have applied for benefits of his or her own; or
  - Qualifies for benefits, in which case the claimant can receive benefits after two years have elapsed since the divorce (see example below).

***Example of divorced claimant***

Assume John and Jane meet the requirements listed above. Jane, who is age 62, wants to apply for spousal benefits on John's earnings record. John is age 67 and plans to wait until age 70 to apply for his own benefits. They were divorced in 2010. Jane can claim spousal benefits because it has been at least two years since the divorce, and John qualifies for benefits even though he hasn't yet applied for them. In this situation, the SSA uses the term that Jane is "independently entitled" to benefits on John's record.

## Benefit amounts

If one claims benefits on his or her own record prior to reaching full retirement age (currently age 66), the benefit is reduced as much as 25% (to 75%) at age 62 relative to the amount of benefits that would be received at full retirement age.

If one claims spousal benefits at full retirement age or more, the full benefit is 50% of the earnings record holder's primary insurance amount (PIA), the amount he or she would receive at full retirement. If one claims divorced spousal benefits at age 62, the reduction is up to 30% of this benefit. This translates to 35% of the former spouse's PIA.

Therefore, the actual benefit if applying at age 62 is the greater of 75% of one's own FRA benefit, or 35% (70% × 50%) of the former spouse's PIA.

 

***Example of claiming at age 62***

Jerry is age 62 and is ready to claim benefits. If he were to wait until FRA, age 66, to draw benefits, he would receive $800 per month based on his own earnings record. Because he's drawing benefits at age 62, his benefits are reduced to 75% of the FRA amount, or $600 per month.

Jerry, however, is a qualifying divorcee. His ex-spouse's benefits would be $2,100 per month at her FRA. Therefore, if Jerry waited until his own FRA to collect on his ex-spouse's earnings, his monthly benefit would be $1,050. By applying at age 62, that amount is reduced to $735 (70% × $1,050).

At age 62, Jerry may claim benefits of $735, the greater of the amount based on his own earnings or his ex-spouse's earnings.

## Phase out of restricted applications

The option to execute a restricted application is being eliminated for anyone born after 1953 (this is not the same as "file and suspend" which is no longer available after April 30, 2016). Restricted applications are used by claimants to specify the receipt of spousal benefits only (divorced or current), while deferring one's own benefits until a later date, thereby realizing deferred retirement credits in the interim. For those born through 1953, a restricted application can still be filed upon reaching full retirement age, but for those born after 1953, the "deemed filing" rule will apply at any time, in that one will be deemed to be filing for the greater of one's own benefits, or spousal benefits.

***Example of restricted earnings***

Tom is age 66 in 2016, born in 1950 (before 1954). He is a qualifying divorcee. If Tom were to start drawing benefits now, he would receive $2,000 per month. Tom plans to wait until age 70 to start drawing benefits at which time he will receive $2,640:

$2,000 × 8% per year × 4 years

He may apply now for restricted benefits based on his ex-spouse's earnings. His ex-spouse is entitled to benefits of $1,800 based on her FRA. Tom may claim benefits of $900 per month (50% × $1,800) for four years between the ages of 66 and 70. He will then switch to benefits based on his own earnings and receive $2,640.

If Tom were born after 1953, he may not use this strategy.

## Divorce and remarriage

Using the earlier example of John and Jane, assume Jane is receiving benefits as a divorced spouse. She then marries Bill and becomes ineligible for spousal benefits on John's record (see note below). Five years later, she and Bill divorce; she is now eligible for benefits on John's record once again, but not on Bill's record, because the 10-year requirement isn't met.

*Comment*

In the case of divorce, the general rule is that one loses spousal benefits upon remarrying. There is an exception, in that if the new spouse is entitled to receive certain benefits of his/her own, including those of a divorced spouse or a widow(er), then the previously divorced spouse's entitlement does not end with remarriage. ("Remarriage of a Divorced Spouse–Policy," Social Security Administration, POMS RS 00202.045)

Regarding the example of Jane and her new husband Bill, assume they were married for 10+ years and then got divorced. Is Jane eligible for divorced spousal benefits from either John or Bill, and if so, which one? Yes, Jane is eligible for benefits from whichever former spouse's earnings record provides the higher benefits, assuming these benefits are greater than those under her own record.

### Multiple ex-spouses

Jane has two ex-spouses in the above example: John and Bill. Turning it around, assume Jane has a substantial career earnings record, while John's and Bill's leave much to be desired. Which ex-spouse can claim divorced spousal benefits on Jane's record, assuming all prerequisites have been met? Both. If she had three marriages, each lasting ten years or more, all three exes could receive benefits on her record.

### Claiming benefits

To collect benefits based on an ex-spouse's earnings, go online to the SSA's website or call:

☎ **Telephone**
(800) 772-1213

Be prepared to provide documents that establish your right to the benefit. You'll likely be asked for your birth certificate, marriage license, and divorce decree. In addition, you'll need your ex-spouse's Social Security number. If you don't know it, you'll be asked for his/her date and place of birth and the names of his/her parents — information which will allow Social Security to look the number up.

## MEDICARE

For 2016, most taxpayers saw no increase in their Part B Medicare premiums. It remained at $104.90 per month. However, two groups of taxpayers saw their premiums go up in 2016:

- Lower income participants who were not eligible for the "hold harmless" rule; and
- High income participants.

For those taxpayers who are (1) not high income individuals subject to the Medicare premium surcharge, and are also (2) not entitled to the hold harmless provision, basic premiums rose to $121.80 per month in 2016.

## HIGH-INCOME INDIVIDUALS

Individuals with incomes above certain thresholds pay a higher Medicare premium surcharge and do not receive the benefit of the hold-harmless rule. The surcharge is based on "modified AGI" using a two-year look-back. A two-year look-back means, for example, that the 2017 surcharge is based on 2015 modified AGI.

Modified AGI is the taxpayer's adjusted gross income plus:

- Tax-exempt interest;
- Excluded savings bond interest used to pay for educational expenses;
- Excluded foreign-earned income;
- Income derived from sources within Guam, American Samoa, and the Northern Mariana Islands; and
- Income from sources in Puerto Rico.

Taxpayers who file as head of household, or qualifying widow or widower, are treated as single for purposes of the Medicare premium surcharge.

## Part D subject to surcharge

Beginning in 2011, the same high income beneficiaries who pay the Part B premium surcharge are paying a graduated surcharge on Part D premiums if they are enrolled in Part D. The income levels are the same for Part D surcharges as Part B.

| **2016 Medicare Parts B and D Premium Surcharge** | | | |
|---|---|---|---|
| **If 2014 Modified AGI Is ...** | | **2016 Part B monthly premium** | **2016 Part D monthly premium** |
| **Single** | **Married** | | |
| $85,000 or less (w/ 2015 withholding) | $170,000 or less | $104.90 | Plan premium |
| $85,000 or less (w/o 2015 withholding) | $170,000 or less | $121.80 | Plan premium |
| $85,001–$107,000 | $170,001–$214,000 | $170.50 | Plan premium + $12.70 |
| $107,001–$160,000 | $214,001–$320,000 | $243.60 | Plan premium + $32.80 |
| $160,001–$214,000 | $320,001–$428,000 | $316.70 | Plan premium + $52.80 |
| Above $214,000 | Above $428,000 | $389.80 | Plan premium + $72.90 |

| **2017 Medicare Parts B and D Premium Surcharge** | | | |
|---|---|---|---|
| **If 2015 Modified AGI Is ...** | | **2017 Part B monthly premium** | **2017 Part D monthly premium** |
| **Single** | **Married** | | |
| $85,000 or less (w/ 2015 withholding) | $170,000 or less | $109.00 | Plan premium |
| $85,000 or less (w/o 2015 withholding) | $170,000 or less | $134.00 | Plan premium |
| $85,001–$107,000 | $170,001–$214,000 | $187.50 | Plan premium + $13.30 |
| $107,001–$160,000 | $214,001–$320,000 | $267.90 | Plan premium + $34.20 |
| $160,001–$214,000 | $320,001–$428,000 | $348.30 | Plan premium + $55.20 |
| Above $214,000 | Above $428,000 | $428.60 | Plan premium + $76.20 |

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SPIDELL
Tax • Analysis • Education

Chapter 7

# Estates and Gifts

# ESTATES AND GIFTS

## UNIFIED EXCLUSION AMOUNT

For 2016, the unified estate and gift tax exclusion amount is $5,450,000. (Rev. Proc. 2015-53) For 2017, it rises to $5,490,000. (Rev. Proc. 2016-55)

## ANNUAL GIFT TAX EXCLUSION

For 2016, the annual gift tax exclusion is $14,000. (Rev. Proc. 2015-53) For 2017, it remains at $14,000. (Rev. Proc. 2016-55)

## LONGER EXTENSION PERIOD FOR TRUST RETURNS

H.R. 3236, the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, changed the extended due date for Form 1041.

There has been no change to the filing deadline for trust returns, which are still due on April 15 (three and one-half months after the end of the tax year). However, the extended due date changes from September 15 to September 30 (five and one-half months from the original due date).

## NEW BASIS REPORTING AND REQUIREMENTS

The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (the Act) requires estates that are required to file estate tax returns to file information returns with the IRS and the estate's beneficiaries. (H.R. 9236) These statements report the basis of the assets. The new law also adds a new basis rule requiring beneficiaries to use the basis as reported by the estate if the estate is a taxable estate.

Although the Act became effective immediately, the IRS quickly delayed the reporting requirements twice until March 31, 2016. These extensions did not delay the requirements of the law change, just delayed the filing of a report under the new provisions.

The IRS stated that they will not penalize you for late filing if the basis reporting forms were not filed before June 30, 2016, but all estates and beneficiaries subject to the new provisions must follow them if the estate tax return was due after July 31, 2015. (Notice 2016-27)

***Comment***

The beneficiary reporting requirement addresses a longstanding problem. Beneficiaries are often not aware of the values that are reported on an estate tax return because, prior to the Act, the estate was not required to communicate the values of the assets to the beneficiaries. This has meant that taxpayers have often had to resign themselves to estimating, long after the fact, the basis of assets acquired from decedents.

# BASIS REPORTING REQUIREMENTS

An executor of an estate that is required to file an estate tax return — generally those with a gross estate greater than the basic exclusion amount ($5,450,000 in 2016) — must report values of each interest and other information to the IRS and to each beneficiary acquiring an interest in the property. (IRC §6035(a)(1) and (2))

The requirement applies only to estates required to file an estate tax return, not including those who file simply to elect portability. The IRS has created Form 8971, Information Regarding Beneficiaries Acquiring Property From a Decedent, to furnish the information required.

## Form 8971

The form itself includes information about the estate and beneficiaries, including the beneficiaries' names, TINs, addresses, and the date information was provided to the beneficiary. Schedule A reports information concerning the property to each beneficiary.

Form 8971 and all Schedule As must be provided to the IRS. Each beneficiary receives their own Schedule A, without Form 8971.

Form 8971 is due no later than the earlier of:

- 30 days after the due date of the estate tax return (generally within nine months of the date of the decedent's death plus extensions); or
- 30 days after the return is filed.
(IRC §6035(a)(3)(A))

In the event of an adjustment in value by the IRS or a court determination, a supplemental report must be filed within 30 days of the determination and provided to the IRS and beneficiaries.

The Act requires that the reports of basis be furnished within the above deadline for all applicable estates which file an estate tax return subsequent to July 31, 2015. However, the IRS delayed the filing of the statements to June 30, 2016, in Notice 2016-27.

The delay in implementing the filing requirement does not mean that estates which filed returns required under IRC §6018 (Estate Tax Returns) after July 31, 2015, and before June 30, 2016, are off the hook for filing the 8971. It just meant that such estates did not need to file Form 8971 for such estates until June 30, 2016. In other words, Form 8971 must be filed for all required estate tax returns that were due to be filed after July 31, 2015.

### Property to be reported on Form 8971

Under Prop. Treas. Regs. §1.6035-1(b) all property included in the gross estate of an applicable estate must be reported on Form 8971, with four exceptions:

- Cash (other than coins or bills with numismatic value);
- Income in respect of a decedent;
- Tangible personal property not requiring an appraisal under Treas. Regs. §20.2031-6(b); and
- Property sold by the estate in a transaction to which capital gain or loss would apply.

### Beneficiaries who must receive Form 8971

Form 8791 must be furnished to all persons who receive a legal or beneficial interest in the property subject to reporting. This includes the executor if the executor is a beneficiary. Since this technically includes contingent beneficiaries who might be unlikely to actually receive property, commentators had hoped for better clarification from the IRS. Unfortunately, the proposed regulations fail to clarify this issue.

With the reporting required so soon after the filing of the estate tax return, it will frequently be impossible to determine which assets are going to which beneficiary. The proposed regulations provide that in this event, all assets which might go to a beneficiary must be included in the report to them. This will occur in spite of the possibility of creating turmoil among competing beneficiaries, who might examine the property ultimately going to other parties and dispute the tax results they receive in relation to those other parties.

When a beneficiary has not been located by the deadline of the reporting requirement, the information which is available should be reported to the IRS, along with an explanation of the efforts to determine the whereabouts of the beneficiary. If the beneficiary is later located, supplemental statements might need to be prepared.

### Supplemental reports

The due date of the Form 8971 will sometimes require estates to file the statement prior to knowing which assets are going where, and the IRS response to this problem is that the filer must just "over-report" the assets on multiple forms.

Prop. Treas. Regs. §1.6035-1(e)(3) allows, but does not require, a supplemental filing when an inconsequential omission or error occurred or to specify the actual distribution of assets when the original filing was based on estimated distributions. The proposed regulation makes the due date of a supplemental filing to correct estimated distributions 30 days after the distribution.

### Subsequent transfers

The IRS determined that some taxpayers might try to circumvent the Act by transferring subject property to other members of their family who would then use a different basis amount.

As a result of this concern, the proposed regulations require that the original recipient of a Form 8971 must file a supplemental Form 8971 with the IRS, and with any transferee who receives the property from the original recipient in a transaction where the transferee's basis is determined in reference to the recipient's basis (such as a gift). The supplemental statement must be filed within 30 days of the transfer.

For purposes of this requirement, a related transferee means:

- Any member of the transferor's family as defined in IRC §2704(c)(2), which includes descendants, ancestors, siblings, and associated spouses, but not uncles and aunts, nephews and nieces, etc.;
- Any controlled entity within the meaning of IRC §2701(b)(2)(A); or
- Any trust in which the transferor is a deemed owner.

Since this would appear to include revocable living trusts, even though such trusts rarely file their own return, it seems any time an individual creates a revocable living trust as part of their estate plan and there was a previous Form 8971 provided to them, a new Form 8971 should be filed with a copy to the trustee.

***Comment***

Because of the subsequent transfer rule, care must be exercised particularly when working with new clients who may have been a recipient of Form 8971 in the past and have now made a subsequent transfer. It may be prudent to make a question about past Forms 8971 and current transfers a routine part of income tax interviews and questionnaires.

## Penalties for failing to file Form 8971

### Failure to file correct Forms 8971 by the due date

IRC §6721 imposes a penalty if Form 8971 and related Schedules A (a required component of Form 8971) are not furnished to the IRS by the due date, and reasonable cause cannot be shown. It applies if the return is not filed timely or it is filed without correct information. Only one penalty applies for each Form 8971 required to be filed with the IRS.

The amount of the penalty depends on when the correct Form 8971 with Schedules A is filed:

- If filed within 30 days of the due date, the penalty is $50 per Form 8971;
- If the form is not filed within 30 days, the penalty rises to $260 per Form 8971; and
- If the failure to file Form 8971 and Schedules A is due to intentional disregard, the minimum penalty is $530 per incident.

All penalty amounts will be adjusted for inflation.

### Failure to furnish correct Schedules A to beneficiaries by the due date

IRC §6721 also imposes a penalty when a filer fails to furnish a copy of Schedule A to each beneficiary, a Schedule A fails to include correct information, or a Schedule A fails to include complete information by the required due date. The penalty is per Schedule A, and reasonable cause is a valid defense.

- If the correct and complete Schedule A is furnished within 30 days of the due date, the penalty amount is $50 per each Schedule A that did not meet the deadline. The maximum penalty is $532,000 unless the taxpayer qualifies for a lower maximum of $186,000 based on having average gross receipts of $5 million or less. (**Note:** Gross receipts is not a typo. The general failure to file an information return penalties apply here, so the lower penalties are based on gross receipts.);
- If the correct and complete Schedule A is furnished later than 30 days after the due date, the penalty is $260 per each Schedule A. The maximum penalty is $3,193,000 per year, unless the taxpayer qualifies for the lower maximum discussed above, in which case the maximum per year drops to $1,064,000; and
- If any failure is due to intentional disregard, the minimum penalty is $530 per incident, In this case, no maximum amount will apply.

All penalty amounts will be adjusted for inflation.

### Inconsequential errors

An error that does not prevent the IRS from processing Form 8971 and Schedules A and does not hinder the beneficiary from timely receiving and using information will not be subject to penalty. However, errors related to beneficiary surname, address, TIN, and asset value are **never** considered inconsequential.

Form **8971**
(January 2016)
Department of the Treasury
Internal Revenue Service

# Information Regarding Beneficiaries Acquiring Property From a Decedent

▶ **Information about Form 8971 and its separate instructions is at *www.irs.gov/form8971*.**

OMB No. 1545-2264

Check box if this is a supplemental filing ☐

## Part I Decedent and Executor Information

| 1 Decedent's name | 2 Decedent's date of death | 3 Decedent's SSN |
|---|---|---|
| 4 Executor's name (see instructions) | 5 Executor's phone no. | 6 Executor's TIN |

7 Executor's address (number and street including apartment or suite no.; city, town, or post office; state or province; country; and ZIP or foreign postal code)

8 If there are multiple executors, check here ☐ and attach a statement showing the names, addresses, telephone numbers, and TINs of the additional executors.

9 If the estate elected alternate valuation, indicate the alternate valuation date: ____________

## Part II Beneficiary Information

How many beneficiaries received (or are expected to receive) property from the estate? ________ For each beneficiary, provide the information requested below. If more space is needed, attach a statement showing the requested information for the additional beneficiaries.

| A<br>Name of Beneficiary | B<br>TIN | C<br>Address, City, State, ZIP | D<br>Date Provided |
|---|---|---|---|
| | | | |
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| | | | |

## Notice to Executors:

Submit Form 8971 with a copy of each completed Schedule A to the IRS. To protect privacy, Form 8971 should not be provided to any beneficiary. Only Schedule A of Form 8971 should be provided to the beneficiary. Retain copies of all forms for the estate's records.

**Sign Here**

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, all information reported herein is true, correct, and complete.

▶ Signature of executor | Date

May the IRS discuss this return with the preparer shown below? See instructions . . . . . . . . . . . . . . ☐ Yes ☐ No

**Paid Preparer Use Only**

| Print/Type preparer's name | Preparer's signature | Date | Check ☐ if self-employed | PTIN |
|---|---|---|---|---|
| Firm's name ▶ | | | Firm's EIN ▶ | |
| Firm's address ▶ | | | Phone no. | |

**For Privacy Act and Paperwork Reduction Act Notice, see the separate instructions.** Cat. No. 37794V Form **8971** (1-2016)

# SCHEDULE A—Information Regarding Beneficiaries Acquiring Property From a Decedent

▶ **Information about Form 8971 (including Schedule A) and its separate instructions is at *www.irs.gov/form8971*.**

Check box if this is a supplemental filing ☐

## Part 1. General Information

| **1** Decedent's name | **2** Decedent's SSN | **3** Beneficiary's name | **4** Beneficiary's TIN |
|---|---|---|---|
| | | | |

| **5** Executor's name | **6** Executor's phone no. |
|---|---|
| | |

**7** Executor's address

## Part 2. Information on Property Acquired

| **A**<br>Item No. | **B**<br>Description of property acquired from the decedent and the Schedule and item number where reported on the decedent's Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return. If the beneficiary acquired a partial interest in the property, indicate the interest acquired here. | **C**<br>Did this asset increase estate tax liability? *(Y/N)* | **D**<br>Valuation Date | **E**<br>Estate Tax Value *(in U.S. dollars)* |
|---|---|---|---|---|
| 1 | Form 706, Schedule ____________ , Item ________<br>Description — | | | |
| | | | | |
| | | | | |
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### Notice to Beneficiaries:

You have received this schedule to inform you of the value of property you received from the estate of the decedent named above. **Retain this schedule for tax reporting purposes.** If the property increased the estate tax liability, Internal Revenue Code section 1014(f) applies, requiring the consistent reporting of basis information. For more information on determining basis, see IRC section 1014 and/or consult a tax professional.

Form 8971 (1-2016)

## SCHEDULE A—Continuation Sheet

*Use only if you need additional space to report property acquired (or expected to be acquired) by the beneficiary.*

Check box if this is a supplemental filing ☐

## Part 1. General Information

| **1** Decedent's name | **2** Decedent's SSN | **3** Beneficiary's name | **4** Beneficiary's TIN |
|---|---|---|---|
| | | | |

| **5** Executor's name | **6** Executor's phone no. |
|---|---|
| | |

**7** Executor's address

## Part 2. Information on Property Acquired

| **A**<br>Item No. *(continue from previous page)* | **B**<br>Description of property acquired from the decedent and the Schedule and item number where reported on the decedent's Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return. If the beneficiary acquired a partial interest in the property, indicate the interest acquired here. | **C**<br>Did this asset increase estate tax liability? *(Y/N)* | **D**<br>Valuation Date | **E**<br>Estate Tax Value *(in U.S. dollars)* |
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### Notice to Beneficiaries:

You have received this schedule to inform you of the value of property you received from the estate of the decedent named above. **Retain this schedule for tax reporting purposes.** If the property increased the estate tax liability, Internal Revenue Code section 1014(f) applies, requiring the consistent reporting of basis information. For more information on determining basis, see IRC section 1014 and/or consult a tax professional.

# BASIS CONSISTENCY REQUIREMENT

The rules for basis of inherited assets are now more complicated. The traditional rule under IRC §1014 provides that the basis of property acquired from a decedent is the fair market value at date of death (unless it is income in respect of a decedent). That is still the case for your clients who inherit property from estates that are not subject to estate tax. However, the rules have changed for assets inherited from larger estates.

If there is a taxable estate, the Act requires the beneficiary to use the basis reported on Form 706, even if that basis is lower than the fair market value. These new rules only apply if the property's inclusion in the decedent's estate increased the estate tax liability. Therefore, if there is no estate tax due, these new rules don't apply because the inherited assets didn't "increase the liability for the (estate) tax." (IRC §1014(f)(2))

Newly enacted IRC §1014(f)(1) states that for estates that are subject to estate tax, the basis of inherited property shall not exceed:

(A) The final value for purposes of the decedent's estate tax; and
(B) If the final value has not been determined for purposes of the decedent's estate tax, then the value reported to the IRS on a statement (Form 8971) required by IRC §6035(a).

For the above purpose, the "basis of property has been determined" if:

- The value of the property is shown on an estate tax return, and the value is not contested by the IRS before the expiration of the statute of limitations;
- In a case not described in (A), if the value is specified by the IRS and such value is not timely contested by the executor of the estate; or
- The value is determined by a court or pursuant to a settlement agreement with the IRS.

When applicable, the basis that will apply is initially the amount reported on the Form 706 until it is amended. If the statute of limitations expires and the IRS does not contest the values, those values will continue to be the basis if there is a taxable estate. If the estate is audited, a new basis will apply to any asset whose basis was changed.

***Comment***

Note that returns filed only for purposes of making a portability election do not impose a consistency requirement under IRC §1014(f).

## Penalty provisions

Taxpayers who use an incorrect basis amount for property that is subject to these new basis consistency requirements will be subject to penalties.

If a tax return subject to these rules reports "any inconsistent estate basis," then under IRC §6662(b)(8), any portion of the underpayment is subject to a 20% accuracy penalty on top of any underpayment penalty. An inconsistent estate basis exists if the basis of property claimed on the tax return exceeds the basis as determined under IRC §1014(f).

## Exclusions

Although the general rule of IRC §1014(f)(2) requires that any property included in an estate tax return, which increases tax, must follow the consistency rule, there are specific exclusions from the rule.

 

The proposed regulations specifically exclude property:

- That qualifies for a marital or charitable deduction because such property does not increase an estate tax; and
- Any personal property which does not require an appraisal under Treas. Regs. §20.2031-6(b). That regulation provides that household and personal effects do not necessitate individual appraisals unless they have intrinsic or artistic value exceeding $3,000.

***Comment***

How far one should push this exclusion for personal property depends on the risk aversion of the client and tax preparer. Treas. Regs. §20.2031-6(b) addresses "household and personal effects," and so would not likely include other items of personal property such as automobiles. In addition, given the potential penalty faced for inconsistent basis, it may be wise to err on the side of including assets rather than attempting to exclude them.

## Omitted property

If a Form 706 was filed but omitted certain assets, the omitted assets will have a zero basis unless the statute of limitations is still open and a supplemental return is filed. Where that cure is available, the traditional manner of finally determining the tax basis discussed earlier will apply. (Treas. Regs. §1.1014-10(c)(3)(i)(A))

If no Form 706 was filed and the estate includes property which would have increased tax, the basis will be considered zero unless a Form 706 is filed. In that event, the final determination of basis will be made as discussed earlier.

***Example of omitted property rule and no Form 706***

John has an estate which does not appear to require a 706 because it is below the amount of his exclusion, and John does not have a surviving spouse, so no filing occurs for portability.

Because no estate tax return was filed, the statute of limitations has never run on Form 706.

Some years after John's death, the family discovers an asset which, had it been known at the time of John's death, would have caused the estate to exceed applicable credits and caused an estate liability.

Under the omitted property rule, the basis of all John's assets is zero, unless the personal representative files a Form 706 in which case the rules for final determination discussed above would apply.

***Comment***

Because the omitted property rule contemplates that "later discovered" property could cause an estate to be subject to the consistency rules years following death, the question naturally arises as to what happens if property of the estate has already been sold. While the proposed regulations do not specifically address this problem, they do make it clear that a beneficiary might be subject to deficiency and tax liability where the statute on the beneficiary's income tax return is still open and the basis of sold assets is deemed to be zero.

## Other basis rules of Code still applicable

There were some early concerns that the way new IRC §1014(f) was written, it would override other rules (such as depreciation) which allow adjustments to basis post-death. The proposed regulations clarify that the consistency rule of IRC §1014(f) must be followed when applicable to determine the basis of assets received from a decedent, but any adjustments for depreciation, like-kind exchanges, etc., occurring subsequent to death would still apply.

## Practical application

The new provision says that the basis of inherited property "shall not exceed" the basis as finally determined. If the estate tax return overvalued the property, this implies that the beneficiary should reduce their basis to the lower actual fair market value. It would have been more instructive if the statute had said, "the amount reported on the estate tax return or the fair market value at date of death, whichever is lower."

***Example of reported value more than actual value***

A taxable estate reported 100 shares of IBM stock at $54 per share, which was a typo. The actual value was $45 per share on the date of death. The taxpayer should report the actual $4,500 fair market value as basis. If not, is the taxpayer subject to an overvaluation penalty if they use the reported $5,400? As a practical matter, why would a beneficiary verify the accuracy of the reported date of death value when they receive a basis statement on an IRS form telling them they must use the reported value?

***Example of actual value more than reported value***

Same facts as above, but reversed. A taxable estate reported the value of 100 shares of IBM stock as $4,500 rather than the actual $5,400. In that case, the beneficiary must use the reported amount as their basis, as the basis cannot exceed the amount reported. In this situation, if the estate was not a taxable estate, even if it was required to file an estate tax return and an information return, it appears the beneficiary can use the fair market value of $5,400 as would have occurred under the pre-Act law, as the Act's basis provisions would not apply.

| How New Rules Apply | | | |
|---|---|---|---|
| | **Must report estate tax value to the IRS and to beneficiaries** | **Beneficiaries must use value used on Form 706 or Form 8971** | **Beneficiaries must use FMV if lower than Form 706 or Form 8971** |
| Estate with no filing requirement | No | N/A (no Form 706 filed) | N/A (no Form 706 filed) |
| Estate with filing requirement but no tax due | Yes | No | Must use FMV |
| Estate with tax liability | Yes | Yes | Yes, if the FMV is lower than the amount on Form 706 |

 

# PORTABILITY

The American Taxpayer Relief Act of 2012 (ATRA '12) made permanent the portability of the deceased spouse's unused exclusion amount (DSUE) for deaths after December 31, 2010. (IRC §2010(c)) This provision allows a surviving spouse to use the unused estate tax exclusion of his or her predeceased spouse by electing to carry it forward for the surviving spouse's benefit.

The surviving spouse can now inherit the deceased spouse's exemption along with the deceased spouse's assets. Accordingly, a bypass trust is no longer required to shelter assets from estate taxes. The only thing necessary at the first death, for estates that will be worth more than $5,000,000 (indexed for inflation) at the second death, is the filing of an estate tax return when the first spouse dies.

While the question of whether it is better to use a bypass trust or take advantage of a portability election is not entirely settled, it is important for tax practitioners to understand the portability election. Failure to make the election in a timely manner when appropriate can lead to expensive consequences, because not making the election on the death of the first spouse will preclude taking advantage of the deceased spouse's unused exemption when the surviving spouse passes.

## DECEASED SPOUSE'S UNUSED EXCLUSION (DSUE)

The portability election is made for the DSUE of the first spouse to die. It may not be made if the decedent was a nonresident alien. It is in general terms the amount of the decedent's exclusion that was not needed to protect the first spouse's estate from the estate tax.

The DSUE is the lesser of:

- The basic exclusion amount effective in the year of death; or
- The excess of the decedent's applicable exclusion amount, over the sum of the amount of the taxable estate and the amount of the adjusted taxable gifts of the decedent.

***Example of DSUE calculation***

In 2009, Mason made a taxable gift valued at $1 million and reported the gift on a timely filed gift tax return. Mason used $1 million of his applicable gift tax exclusion amount, reducing his gift tax liability to zero.

Mason dies in 2016 and is survived by his wife, Deborah. Mason's taxable estate is $2 million. The executor of Mason's estate computes his DSUE amount to be $2,450,000.

The DSUE amount is the lesser of:

| | |
|---|---|
| The 2016 basic exclusion amount | $5,450,000 |

Or:

| | |
|---|---|
| Mason's applicable exclusion amount | $5,450,000 |
| Minus taxable estate | (2,000,000) |
| Minus exclusion applied to taxable gifts | (1,000,000) |
| Total | $2,450,000 |

### The applicable exclusion amount (AEA)

The applicable exclusion amount is the total of the decedent's basic exclusion amount plus any DSUE amount from a predeceased spouse. Thus, if a decedent was predeceased by a spouse for which a portability election was made, the applicable exclusion amount of the decedent is likely to be greater than whatever the basic exclusion amount is at the time of the decedent's death.

> ***Example of AEA upon Deborah's death***
>
> When Deborah passes away, the basic exclusion amount has been inflation adjusted to $6,000,000. She has not used any of Mason's ($2,450,000) DSUE. Her applicable exclusion amount will be $8,450,000 ($6,000,000 + $2,450,000).

Portability is designed so that it will not carry forward benefits to unlimited future spouses. It limits the amount carried forward by comparing the surviving spouse's basic exclusion amount to the DSUE the surviving spouse is carrying forward from a prior spouse and allowing the lesser of the two amounts to be carried forward by election in the surviving spouse's estate.

> ***Example of DSUE in Deborah's estate***
>
> Deborah remarries, and when she dies she leaves her entire estate to her new husband. Because the DSUE cannot exceed the lesser of the basic exclusion amount or the amount of her AEA after subtracting the amount of her taxable estate and taxable gifts, her DSUE which can be carried forward to a new husband will be $6,000,000.
>
> If instead, she set aside the $5,000,000 in a bypass trust for the benefit of her children from her marriage to Mason, her DSUE going forward to her new husband would be $3,450,000 (her AEA of $8,450,000 less $5,000,000).

## Last spouse to die

IRC §2010(c)(4)(B)(i) states that a decedent may use the unused exclusion amount of his or her "last spouse to die." This prevents surviving spouses from using the DSUE of multiple predeceased spouses.

The regulations clarify that a surviving spouse will not lose the DSUE by simply remarrying. (Treas. Regs. §20.2010-3(a)(3)) However, if a surviving spouse remarries, he or she loses any unused exclusion amount from the first deceased spouse if he or she also outlives the second spouse.

This is the case even if there is no DSUE from the new spouse.

> ***Example of remarriage***
>
> Henry died in 2011 with a taxable estate of $1 million. The executor of Henry's estate made an election on his estate tax return to permit his wife, Wanda, to use his DSUE of $4 million.
>
> Wanda married Joe in 2013. If Joe predeceases Wanda in 2016 and leaves his entire $5,450,000 estate to his children from a prior marriage, Wanda will have no DSUE from Joe and loses her DSUE from Henry.

The regulations also clarify that if the surviving spouse marries again and that marriage ends in divorce or an annulment, the subsequent death of the divorced spouse does not end the status of the prior deceased spouse as the last deceased spouse of the surviving spouse. They must be married at the time of death for a subsequent spouse to become a "last deceased spouse." (Treas. Regs. §§20.2010-1(d)(5), 20.2010-3(a)(3))

***Example of divorce***

Assume from the previous example that Wanda and Joe divorce shortly before Wanda's death. Their marriage has no effect on Wanda's DSUE; she keeps Henry's DSUE.

# MAKING THE ELECTION

The election must be made on a timely filed estate tax return. (Treas. Regs. §20.2010-2(a)) This means the executor must file a return making the election within nine months of the decedent's date of death, unless an extension is requested, which would give the executor an additional six months. (IRC §§2010(c)(5), 6018(a), 6075(a))

Use Form 706 to elect portability of a DSUE.

The current version of the form is designed to allow estimated values of the gross estate rather than the detailed valuations that are typically involved when filing Form 706. Using the Table of Estimated Values included in the Form 706 instructions, the executor is permitted to estimate the value of the decedent's estate using $250,000 increments.

## Timeliness of filing

Generally, the law provides that the election is to be made on or before the due date for filing Form 706 for the estate. However, this creates a bit of controversy because no return is actually due if the estate is not over the threshold amounts; that is, the taxpayer is not required to make the portability election and, as such, no return is necessary.

Although the final regulations make no exception for late elections, the regulations indicate that the Treasury is considering making the safe harbor in Rev. Proc. 2014-18 permanent. That safe harbor allowed late portability elections for estates created after 2011 and before 2014 but only if the estate was not otherwise required to file Form 706.

Without regard to the possible extension of Rev. Proc. 2014-18, the final regulations make clear that whether an estate can obtain relief for making a late portability election will depend on whether or not it was required to file an estate tax return. (Treas. Regs. §20.2010-2(a)(1))

- If the estate is otherwise required to file a Form 706, the IRS will not grant an extension of time to make the election via a request for a private ruling; and
- If the estate is not required otherwise to file a Form 706, then the IRS can (but does not have to) grant relief via a private letter ruling request under the late election relief provisions of Treas. Regs. §301.9100-3.

**Practice Pointer**

Obtaining relief requires a private letter ruling. The taxpayer will need to pay the applicable user fee (currently $9,800) and also deal with the cost of professional representation to make the request.

The preamble to the regulations mentions the situation in which an estate filed a Form 706 that showed a tax due (and thus there was no DSUE on the original Form 706) but for which the resolution of a contingent liability caused the estate to file a claim for refund. In such a case, a DSUE is created. The regulations clarify that so long as the estate did not explicitly elect out of portability on the original return, the estate will be held to have provided a proper computation of the DSUE. (Treas. Regs. §20.2010-2(b))

### Foreign spouses

The final regulations provide a new rule allowing the decedent's unused exclusion amount to be used by a surviving spouse who becomes a U.S. citizen after the decedent's death. In such a case, so long as the executor makes the DSUE election, the surviving spouse, after becoming a U.S. citizen subject to U.S. taxes, will be able to utilize the DSUE amounts. (Treas. Regs. §§20.2010-3, 25.2505-2)

### Opting out

If an estate would be required to file a Form 706, but the personal representative does not wish to make a portability election, there is a checkbox in Section A of Part 6, Form 706, which will allow the personal representative to opt out of the automatic application of portability.

## APPLYING THE DSUE TO GIFTS

If the executor of the predeceased spouse's estate elects portability of the DSUE amount, the surviving spouse can apply the DSUE against any tax liability arising from subsequent lifetime gifts in addition to transfers at death. (IRC §§2010, 2501, 2502) The Form 706 on which the deceased spouse's estate made the election must be attached to the Form 709 reporting the gift.

Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, Line 19, on Part I of the form, asks the donor whether he or she has applied a DSUE amount received from a predeceased spouse to a gift or gifts reported on the present or a previous Form 709.

Donors who answer in the affirmative must complete Schedule C, Deceased Spousal Unused Exclusion (DSUE) Amount, to determine the DSUE amount and applicable credit received from prior spouses. This will determine the amount of DSUE that may be used to reduce the donor's gift tax.

Any DSUE carried to a surviving spouse is used first before using the surviving spouse's own basic exclusion amount.

***Example of a lifetime gift***

Henry died in 2011 with a taxable estate of $1 million. The executor of Henry's estate made an election on his estate tax return to permit his wife, Wanda, to use his DSUE of $4 million.

In 2016, as part of her estate plan, Wanda makes a $6 million lifetime gift to their children. Wanda can make that gift without being subject to gift tax because she can use her $4 million DSUE from Henry and $2 million of her own exclusion amount.

Note that although a surviving spouse may only carry forward the DSUE from the last deceased spouse, there may be cases where prior gifts used in completing a Form 709 came from more than one predeceased spouse.

## NEW GUIDANCE ON QTIP ELECTIONS

Rev. Proc. 2016-49 clarifies that otherwise nontaxable estates have the flexibility to elect portability and make a qualified terminable interest property trust (QTIP) election.

A QTIP election can have the benefit of reducing a decedent's taxable estate and increasing the DSUE available to the surviving spouse. For this reason, the executor of a decedent's estate may want to make a QTIP election regardless of whether the election is necessary to reduce the estate tax to zero.

 

### Concern about Rev. Proc 2001-38

Since the enactment of the portability provisions, some practitioners have been concerned about the effect Rev. Proc. 2001-38 may have on nontaxable estates wishing to make QTIP elections.

Rev. Proc. 2001-38 allowed the IRS to treat QTIP elections as null and void for estate and transfer tax purposes if the election was not necessary to reduce estate tax liability. Would the IRS recognize the election for what would otherwise be an unnecessary QTIP election to maximize the DSUE?

Rev. Proc. 2016-49 clarifies that the executor can use the QTIP election to maximize the unused exclusion amount. It also provides procedures to continue to disregard unnecessary QTIP elections, which was the original purpose of Rev. Proc. 2001-38.

### Why use the QTIP?

QTIP trusts provide all the income to the surviving spouse but allow the decedent to designate who inherits the property after the death of the surviving spouse. Assets in a QTIP trust qualify for the estate tax marital deduction and get a step-up in basis at the death of the surviving spouse.

Prior to the portability provisions, many estates used QTIP trusts to provide for a surviving spouse, while maximizing the estate tax exclusion at the death of the first spouse.

Portability eliminates the need for the QTIP to avoid estate tax in many situations, but passing the assets outright to the surviving spouse allows the survivor to designate the beneficiaries when the surviving spouse dies. This removes protection for the children of a prior marriage and is contrary to the wishes of most first spouses, as the first spouse usually wants to control the disposition.

The QTIP continues to be beneficial for controlling assets after the death of the second spouse and allows the added benefit of maintaining the DSUE.

# VALUATION DISCOUNTS

## NEW PROPOSED REGULATIONS

Proposed regulations under IRC §§2701 and 2704 could limit valuation discounts for family-controlled entities for estate, gift, and generation-skipping tax purposes. (REG–163113-02)

Family-controlled entities are valuable tools in estate planning because they provide the ability to reduce tax on transfers to family members through valuation discounts. In many estate plans, these discounts are enhanced through the use of restrictions on the recipient's ability to manage, force distributions, liquidate, and/or sell interests in the entity.

If the proposed regulations are adopted in their current form, they would reduce the availability of creating valuation discounts through lapsed rights and restrictions on liquidation. The proposed regulations would make the following changes for transfers of interests in family-controlled entities:

- Create a new lookback period that treats lapses of voting and liquidation rights made within three years of death as additional transfers (this eliminates the ability to make deathbed transfers to create valuation discounts);
- Disregard the ability of nonfamily members to block the removal of restrictions unless the nonfamily member has (1) held their interest for more than 3 years, (2) owns a substantial interest in the entity, and (3) has the right to be redeemed or bought out for cash or property;

- Disregard restrictions on liquidation that are not mandated by federal or state law when determining the value of transferred interests;
- Eliminate discounts where the transferee is an assignee and not a full owner in the entity; and
- Clarify that the entities covered by the regulations cover interests in LLCs and other entities and business arrangements, even if they are disregarded entities for other federal taxation purposes.

## EFFECTIVE DATE

The proposed regulations would be effective on and after the date they are published as final regulations. This means they are not yet effective, but practitioners should be advised that changes may be coming.

***Comment***

The future of these proposed regulations is unclear. Republicans in both the House and Senate have introduced bills to nullify them and to prevent future regulations, and a public hearing is scheduled for December 1.

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Chapter 8

# Real Estate

# REAL ESTATE

## THE PRINCIPAL RESIDENCE COD EXCLUSION

The PATH Act retroactively extended the exclusion for cancellation of debt on a qualified principal residence so that it applies to debts discharged before January 1, 2017. In addition, the act modifies the exclusion to apply to discharges that occur in 2017 if the discharge is pursuant to a written agreement entered into in 2016. (IRC §108(a)(1)(E))

Under IRC §108(a)(1)(E) and (h), a taxpayer may exclude from income up to $2 million of COD income ($1 million if married filing separately) from the discharge of qualified principal residence acquisition indebtedness on or after January 1, 2007, and before January 1, 2017.

### No California conformity

Citing fiscal concerns, Governor Brown vetoed SB 907, which would have retroactively reinstated California's partial conformity to the qualified principal residence COD exclusion. California's partial conformity to the principal residence exclusion expired December 31, 2013. Taxpayers who claim the principal residence exclusion on their federal return may use insolvency to exclude that income on the California return. See page 10-10 for details.

## PASSIVE LOSSES

### RENTAL INCOME NONPASSIVE UNDER SELF-RENTAL RULE

The Fifth Circuit has affirmed the Tax Court's decision in ***Williams v. Comm.*** (TCM 2015-76) that net rental income taxpayers claimed as passive income should be recharacterized as nonpassive under Treas. Regs. §1.469-2(f)(6). (***Williams v. Comm.*** (February 2, 2016) U.S. Court of Appeals, Fifth Circuit, Case No. 15-60341) The court agreed that even though passive loss rules under IRC §469 do not specifically refer to S corporations, the passive loss rules and the self-rental rules, in particular, still apply to S corporations.

#### Self-charged rents

Generally, self-charged rents exist when a taxpayer rents property for use in an activity in which the taxpayer materially participates. The rental income is recharacterized as nonpassive so the taxpayer may not reduce ordinary income from the activity (such as Schedule K-1, line 1 income from an interest in an S corporation or partnership) while simultaneously generating passive income on the personal side. (Treas. Regs. §1.469-2(f)(6))

***Example of self-rental rule***

Jordan is the sole owner of an S corporation from which he earns $200,000 combined W-2 and K-1 income. He owns the office building personally, which serves as the corporate offices, and the corporation pays him rent for its use. On his personal return, the net rental income from the building is exactly $0 after deducting interest, depreciation, property taxes, and other expenses.

He also owns two residential rental properties which generate $30,000 of net losses. He cannot take a deduction for the two rental properties because he's over the AGI limit for the $25,000 active participation allowance.

Jordan comes up with a great idea and can't wait to tell his tax professional. He will increase the rent he charges his corporation by $30,000, thereby reducing his income from the corporation from $200,000 to $170,000. On the personal side, the increased rent will make his net rental income from the office building $30,000, which will exactly absorb the $30,000 losses from the residential rentals. Jordan thinks that the net result will be a decrease in taxable income of $30,000.

Unfortunately for Jordan, the self-rental rule will treat the income from the office building as nonpassive income. As such, he will increase his rental income on his Form 1040 to $30,000, and the losses from the residential rentals will still be suspended.

## TAXPAYERS NOT REQUIRED TO REGROUP ACTIVITIES

The IRS did not have the authority to "regroup" taxpayer's business interests for purposes of the passive loss rules. (TAM 201634022) The taxpayer's groupings of their business interests were not "clearly inappropriate" under the standards of Treas. Regs. §1.469-4(e).

### Background

One or more trade or business activities or rental activities may be grouped as one activity if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of IRC §469. (Treas. Regs. §1.469-4(c)(1)) Whether activities constitute an appropriate economic unit depends upon all the relevant facts and circumstances, with the greatest weight given to the following factors:

- Similarities and differences in types of businesses;
- The extent of common control;
- The extent of common ownership;
- Geographical location; and
- Interdependencies between or among the activities.
  (Treas. Regs. §1.469-4(c)(2))

The IRS may regroup a taxpayer's activities if any of the activities resulting from the taxpayer's group is (1) an inappropriate economic unit, and (2) a principal purposes of the taxpayer's grouping is to circumvent the purposes of IRC §469. (Treas. Regs. §1.469-4(e))

The regulations provide an example which illustrates the IRS's authority to regroup. The example involved doctors who formed a partnership that they controlled but in which they did not materially participate. The doctors transferred medical equipment to the partnership in exchange for partnership interests. The partnership's services were provided almost entirely to patients of the doctor/partners. The doctors treated the partnership as a separate activity from their medical practices, thereby making the partnership's income passive income that could be offset by unrelated passive losses. The example concludes that the practice of each doctor and each doctor's interest in the partnership were an appropriate economic unit that should be grouped as a single activity.

### Facts

The taxpayer is a doctor and surgeon who was an employee of two S corporations that were medical practices and a partner in a small partnership that owned an outpatient surgery center. All three entities generated taxable income to the taxpayer. The taxpayer also owned a residential rental property that generated losses.

The taxpayer materially participated in the two S corporations but was passive with respect to the partnership. The taxpayer treated the partnership as a separate activity on his tax return.

**Result:** Had the taxpayer grouped the partnership with the S corporations, the grouped entity would have (1) been nonpassive because the doctor would have materially participated in the single grouped activity, and (2) the grouped activity would have had net income. Therefore, the taxpayer would have had a net passive loss from the rental which would have been suspended.

By grouping the partnership as a separate activity, the passive income from the partnership can be offset by the passive losses from the rental.

### Conclusion

The TAM noted that a key distinction between the example in the regulations and the facts of the case was that the outpatient surgery center (the partnership) had one majority owner (unrelated) that had control of day-to-day operations. There was also no clear indication that the doctor acquired his interest in the partnership with a principal purpose of circumventing the purposes of IRC §469.

In looking at the five-factor test, the TAM found that there was more than one reasonable method by which the doctor's activities could be grouped. Although the activities of the medical practices (S corporations) and the outpatient surgery center (partnership) were all within the medical industry, they provide different types of medical services. Additionally, the doctor had different ownership interests and exercised different levels of control among the entities, all three were in different locations, and they did not share employees or recordkeeping.

# REAL ESTATE PROFESSIONALS

The IRS continues to audit and deny real estate professional status to taxpayers.

**We have winners!** Unlike prior years, 2016 saw more taxpayers prevail.

## QUALIFYING REAL ESTATE PROFESSIONAL

Rental real estate is per se, passive and, therefore, losses generated from rental real estate are nondeductible (with the limited exception of a maximum $25,000 deduction for active participation). However, "real estate professionals" may deduct rental real estate losses under IRC §469(c)(7).

A taxpayer qualifies as a real estate professional for a tax year if they meet **both** of the following tests:

- More than one half of the personal services the taxpayer performs during the tax year are performed in real property trades or businesses in which the taxpayer materially participates; and
- The taxpayer performs more than 750 hours of service during the tax year in real property trades or businesses in which the taxpayer materially participates.
  (IRC §469(c)(7)(B))

## Material participation

If the taxpayer meets the more than half-time and the 750-hour requirements, the taxpayer is a real estate professional, but may only report losses with respect to rental real estate activities in which the real estate professional materially participates.

A taxpayer materially participates in an activity for a given tax year if the taxpayer meets *at least one* of the following seven tests:

- The taxpayer participates in the activity for more than 500 hours;
- The taxpayer's participation constitutes substantially all of the participation in such activity of all individuals (including nonowners);
- The taxpayer participates more than 100 hours, and such participation is not less than the participation of any other individual;
- The activity is a significant participation activity under Treas. Regs. §1.469-5T(c), and the taxpayer's aggregate participation in all significant participation activities exceeds 500 hours;
- The taxpayer materially participated in the activity in any five of the last ten taxable years;
- The activity is a personal service activity under Treas. Regs. §1.469-5T(d), and the taxpayer materially participated in the activity for any three taxable years preceding the current tax year; or
- Based on all of the facts and circumstances, the taxpayer participates in the activity on a regular, continuous, and substantial basis during such year.
  (Treas. Regs. §1.469-5T; also see §1.469-5T(e) and (h)(2) for special rules applicable to limited partners and retired farmers)

A taxpayer who satisfies both the real estate professional and material participation tests above may deduct the full amount of their losses. (Treas. Regs. §1.469-9(e)(1)) However, the taxpayer must meet the material participation tests for each rental activity, and that may be difficult for any given activity if that activity is a small one.

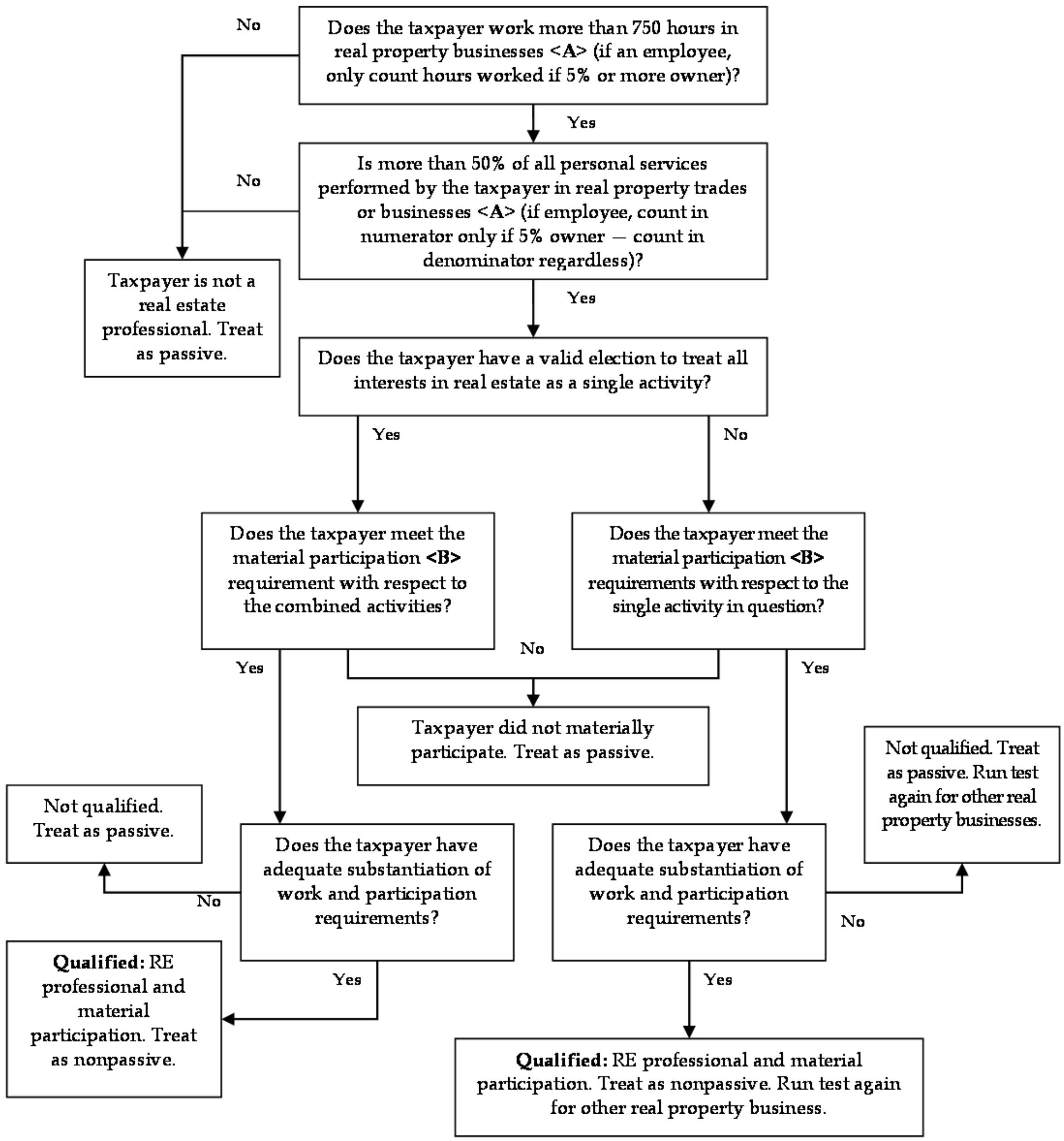
The single-activity election permits a taxpayer to treat all interests in rental real estate as one activity, thereby creating a single, bigger activity, and one for which it will be easier to meet the material participation test. The election is binding for the tax year in which it is made and for all future years in which the taxpayer is a qualifying taxpayer. The election is made by filing a statement with the taxpayer's original income tax return. (IRC §469(c)(7); Treas. Regs. §1.469-9(g)(3)) Simply aggregating losses from various rental activities and reporting them on the tax return is not a sufficient election.

***Example of single-activity election***

Sheila owns 10 single family residences that she rents and works on each one 80 hours per year for a total of 800 hours. She does no other work. She meets both tests to be a real estate professional because she works 750 hours or more in real estate trades or businesses, and more than one-half of the work she does during the year is in real estate trades or businesses. However, she does not materially participate in any one of the rental activities and cannot take losses on any of them.

If she makes the single-activity election, all 10 of the properties will be treated as one, and she will easily meet the material participation test with respect to that one activity.

## Real Estate Professional Flowchart




<A> Real property businesses include:

| | |
|---|---|
| Development | Rental |
| Redevelopment | Operation |
| Construction | Management |
| Reconstruction | Brokerage |
| Acquisition | |
| Conversion | |

<B> To materially participate you must meet one of the following tests:

1. Spend more than 500 hours in the activity
2. Perform substantially all the work in the activity
3. Spend more than 100 hours in the activity, and no one else does more
4. Spend more than 100 hours and aggregate more than 500 hours in significant participation activities
5. Materially participate in the activity any 5 of the last 10 years
6. The activity is a personal service activity
7. Facts and circumstances support regular, continuous, and substantial participation

* **Note:** Limited partners may only use tests 1, 5 and 6

# REAL ESTATE PROFESSIONAL CASES

## Real estate professional must prove material participation

In ***Gragg***, the taxpayer argued that as a real estate professional, her material participation in rental properties she owned was irrelevant and that her status as a real estate professional made all her rental activities per se nonpassive. (***Gragg v. U.S.*** (August 4, 2016) U.S. Court of Appeals, Ninth Circuit, Case No. 4:12-cv-03813-YGR) The court ruled the taxpayer demonstrated that she qualified as a real estate professional but failed to demonstrate that she materially participated in her rental activities.

Rental activities are, by default, passive activities regardless of the taxpayer's participation in the activity. (IRC §469(c)(2)) However, real estate professionals are not subject to the default rule. (IRC §469(c)(7)) Taxpayers and their professional advisors often end their analysis of the issue here, as ***Gragg*** did. They then deduct the full amount of their rental activity losses against ordinary income without testing material participation.

## Facts and circumstances can save bad records

A taxpayer's material participation was determined based on all the facts and circumstances. In ***Hailstock***, the taxpayer filed income tax returns for multiple years at one time. (***Hailstock v. Comm.***, TCM 2016-146) The IRS audited the taxpayer, and due to her scarce records, determined deficiencies based on a bank deposits analysis. The IRS also denied her determination that she was a real estate professional that materially participated in her real estate activities.

Thankfully for Ms. Hailstock, a taxpayer must only meet one of seven material participation tests. One of those tests treats a taxpayer as materially participating in an activity for a tax year if, based on all the facts and circumstances, the taxpayer participates in the activity on a regular, continuous, and substantial basis. (Treas. Regs. §1.469-5T(a)(7)) Despite Ms. Hailstock's poor records, the Tax Court found her testimony regarding her activities credible and held that she was a real estate professional that materially participated in her rental activities. The court found persuasive the fact that she owned many properties and did not have other employment.

**✐ Practice Pointer**

Most taxpayers maintain better records than Ms. Hailstock, but most are also likely missing time records or logs to determine material participation. Using the facts and circumstances test, practitioners can help document their client's time spent well before an audit. Factors that may help determine material participation are multiple properties, lack of other employment, activities are located close enough to the taxpayer to enable their reasonable management (not 200 miles away), and absence of a management company.

## *Stanley* case encompasses multiple issues

A recent case analyzed the rules related to real estate professionals much more comprehensively than any other in recent memory. (***Stanley v. U.S.*** (November 12, 2015) U.S. District Court, Western Dist. of Arkansas, Case No. 5:14-CV-05236)

### Facts

The taxpayer, an attorney, joined a property management company (LMC) as its president and general counsel. Stanley also served as president of a related company that provided telecommunication services (LCI) to properties managed by LMC. From the time Stanley joined LMC, he was granted 10% of the company's stock but was required to relinquish his stock upon full retirement from LMC.

During the course of his employment with LMC, Stanley acquired minority ownership interests in business entities that owned or operated the rental properties and adjoining golf courses managed by LMC. Eventually, Stanley had an ownership interest in more than 100 entities. Stanley also directly owned multiple other rental properties. During the years at issue, Stanley grouped his rental activities and business activities together as one activity for income tax reporting.

### Services performed as employee

Generally, services performed as an employee are not counted in determining whether a taxpayer qualifies as a real estate professional unless the taxpayer is a 5% owner, as defined in IRC §416(i)(1)(B). (IRC §469(c)(7)(D)(ii))

The IRS made multiple arguments that Stanley did not actually own at least 5% of the company's stock, and therefore could not qualify as a real estate professional. Mainly, the IRS argued that Stanley did not contribute any capital in exchange for his shares and that because Stanley was required to relinquish his shares upon retirement, he didn't really own them pursuant to IRC §83 because the shares were subject to a substantial risk of forfeiture. The court rejected both arguments.

First, the court recognized that the fact that Stanley did not make a capital contribution for his shares is not determinative of whether he nevertheless owned them because a capital contribution is merely one avenue of acquiring ownership of stock or other property. Second, the court found the IRS's IRC §83 argument without merit because IRC §83 merely provides guidance for when a taxpayer should report gross income for property received in connection with the performance of services.

### Tracking time within real property trade or business

The IRS argued that because not all of the services Stanley performed for LMC were real property activities, such as his role as LMC's general counsel, he needed to keep track of time spent within LMC using at least two categories: activities in real property trades or businesses and activities not in real property trades or businesses, and that he needed to qualify as a real estate professional based only on his time working in real property activities within LMC.

The court rejected the IRS's argument because IRC §469 does not require that services performed in real property trades or businesses be of any specific character or that all such services must be directly related to real estate. Rather, the services must simply be performed "in real property trades or businesses in which the taxpayer materially participates." (IRC §469(c)(7)(B)(i) and (ii))

### Grouping rental and nonrental activities together

Taxpayers that meet the two-part real estate professional test are barred from grouping rental and nonrental activities only for purposes of determining material participation for a given activity (or activities if the single-activity election has been made). However, real estate professionals may group rental and nonrental activities for other purposes, including for purposes of determining passive activity income, losses, and credits. (Treas. Regs. §1.469-9(e)(3)(i))

One or more trade or business activities or rental activities may be grouped as one activity if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of IRC §469. (Treas. Regs. §1.469-4(c)(1)) Whether activities constitute an appropriate economic unit depends upon all the relevant facts and circumstances, with the greatest weight given to the following factors:

- The extent of common control;
- The extent of common ownership;
- Geographical location; and
- Interdependencies between or among the activities.
  (Treas. Regs. §1.469-4(c)(2))

Note, however, a rental activity may not be grouped with a trade or business activity unless the activities being grouped together constitute an appropriate economic unit, and:

- The rental activity is insubstantial in relation to the trade or business activity;
- The trade or business activity is insubstantial in relation to the rental activity; or
- Each owner of the trade or business activity has the same proportional ownership interest in the rental activity.
  (Treas. Regs. §1.469-4(d)(1))

In ruling in favor of Stanley, the court noted the significant differences in the types of activities Stanley grouped together: LMC provided property management, LCI provided telecommunications, there were golf courses in addition to the rental properties, and all four types of activities worked in concert with the rental real estate activities. While golf and apartment rentals are not inherently related, the court noted that LMC created a successful business model that linked the two. Much as fast food restaurants might attract customers with a playground area, or a warehouse store (such as Costco or Sam's Club) might have an adjoining gas station or restaurant, LMC's business model sought to attract tenants through golf. The court also found that LMC, LCI, and the golf activities were insubstantial in relation to the rental activities.

The court ruled in favor of Stanley on the major issues discussed here, but specifically avoided creating a bright-line rule regarding what constitutes "insubstantial." It did note, however, that Stanley testified that the LMC, LCI, and the golf courses accounted for less than 20% of the total revenue for all activities.

***Example of grouping activities***

John owns a 20% interest in two 100-unit apartment properties, and owns three sole proprietor businesses: a real estate management business, a washer/dryer rental business, and a restaurant, all located within the same city. John has no employees for either the real estate management or washer/dryer rental businesses. John's real estate management and washer/dryer rental businesses primarily serve the apartment properties. Even though the washer/dryer rental business primarily serves John's rental properties, it is not inherently a real property trade or business. The following is a summary of John's activities:

| Business | Active participation hours | Real property trade or business |
|---|---|---|
| Apartment #1 | 300 | Yes |
| Apartment #2 | 400 | Yes |
| Real estate management | 400 | Yes |
| Washer/dryer rental | 95 | No |
| Restaurant | 600 | No |

John makes the single-activity election for the two apartment properties, so they are treated as a single activity. John can qualify as a real estate professional because more than half of the personal services John provides during the year are performed in real property trades or businesses, and he spends more than 750 hours in real property trades or businesses in which he materially participates (Apt. 1 (300 hours) + Apt. 2 (400 hours) + RE management (400 hours) = 1,100 hours).

*(continued)*

***Example of grouping activities (continued)***

Without the real estate management business, John would only have 700 hours of active participation in real property trades or businesses and would not qualify as a real estate professional.

John must test each of his activities separately to determine material participation. In other words, he cannot group the apartments, which are treated as a single activity, with the real estate management activity for purposes of testing material participation in those activities, even though he was able to use the hours spent on all three to determine whether he was a real estate professional. The following is a material participation summary of John's activities:

| Activity | Materially participates? | Reason |
|---|---|---|
| Apartments | Yes | > 500 hours participation |
| Real estate management | Yes | > 100 hours participation and sole participant (may meet other tests as well) |
| Washer/dryer rental | No | Does not meet any of the seven tests |
| Restaurant | Yes | > 500 hours participation |

Even though John could not group the apartments with his other activities for purposes of testing material participation, in light of ***Stanley***, he should be able to group the apartments, his real estate management business, and his washer/dryer rental business together as one activity for income tax reporting because they represent an appropriate economic unit due to the fact that the real estate management and washer/dryer businesses primarily service John's rental activities.

The grouping will be advantageous to John because he can treat losses from the otherwise passive appliance repair business as part of a larger nonpassive economic unit.

## Diligent records substantiate 750-hour test for real estate professional

A taxpayer was able to pass the 750-hour real estate professional test even though the only real estate trade or business engaged in by the taxpayer was a three-unit apartment building in which two units were rented while the taxpayer lived in the third. (***Simmon-Brown v. Comm.***, TCS 2015-62) The taxpayer kept close records of the work he did on the two units and carefully separated time spent on those two units from time spent on the unit in which he and his family lived. He also segregated time spent working on the common areas and counted two-thirds of that time.

# TRAVEL TIME AND INVESTOR TIME GENERALLY DON'T COUNT

## Travel time

The Tax Court has generally refused to count travel time because it represents commuting that "is an inherently personal activity and as such does not constitute 'work' in connection with a trade or business." (***Truskowski v. Comm.***, TCS 2003-13)

However, in ***Leyh v. Comm.***, TCS 2015-27, a taxpayer successfully used travel time to count toward the 750-hour material participation requirement. In this particular case, the focus of the court was on the adequacy of the contemporaneous records kept by the taxpayer rather than on the inherently personal nature of the travel time itself.

**Caution**

Neither ***Truskowsky***, which disallowed driving time in counting hours on the grounds that it is commuting, nor ***Leyh***, which allowed travel time in counting hours, may be cited as precedent as they are Tax Court Summary decisions. Therefore, a real estate professional may not rely on the ***Leyh*** decision in deducting expenses incurred in driving from the taxpayer's home to his or her rental properties. However, the IRS may not rely on ***Truskowsky***.

### Commuting and the principal place of business

A taxpayer's commuting costs generally are nondeductible personal expenses. (Treas. Regs. §§1.162-2(e), 1.262-1(b)(5)) However, the costs of going between one business location and another are generally deductible. (IRC §162(a); Rev. Rul. 55-109) Thus, for a real estate professional, the drive from home to the first stop at a rental property is nondeductible commuting, while the drive from the first rental property to the second would be deductible business mileage. The drive from the final stop and a rental property back home would, again, be commuting.

There is one big exception. If an office in the taxpayer's residence satisfies the principal place of business requirements under IRC §280A(c)(1)(A), then the residence is considered a business location. Accordingly, travel expenses from the residence to other work locations in the same trade or business are deductible. (Rev. Rul. 99-7) Thus, if the real estate professional establishes that his or her residence satisfies the principal place of business requirement, the drive from home to the first stop and the drive from the last stop back home are deductible business drives.

### Establishing principal place of business

It is not sufficient to establish an office-in-home deduction in order to avoid the commuting limitations; it must be an office in home under the principal place of business test.

Generally, a home office will qualify as a taxpayer's principal place of business if the taxpayer meets the following requirements:

- The taxpayer uses the home office exclusively and regularly for administrative or management activities of the taxpayer's trade or business; and
- The taxpayer has no other fixed location where he or she conducts substantial administrative or management activities of his or her trade or business.
  (IRC §280A(c)(1))

**Caution**

Note, however, that individuals who establish their real estate professional status (their hours requirements) primarily through work other than their rental properties (such as working as a real estate broker) can probably not meet the principal place of business test if they have a work location in that other business. A taxpayer may have only one principal place of business regardless of the number of business activities in which the taxpayer may be engaged. (Treas. Regs. §1.280A-2(b)(2))

## Investor time

In general, work done by an individual in his or her capacity as an investor in an activity is not treated as participation in the activity for purposes of testing material participation unless the individual is directly involved in the day-to-day management or operations of the activity. (Treas. Regs. §1.469-5T(f)(2)(ii)(A)) Work done by an individual in his or her capacity as an investor in an activity includes:

- Studying and reviewing financial statements or reports on operations of the activity;
- Preparing or compiling summaries or analyses of the finances or operations of the activity for the individual's own use; and
- Monitoring the finances or operations of the activity in a nonmanagerial capacity. (Treas. Regs. §1.469-5T(f)(2)(ii)(B))

Cases and rulings dealing with time spent as an investor do not discuss the definition of time spent as an investor in much more detail than simply spitting out the immediately aforementioned regulations.

In ***Moon***, husband and wife taxpayers owned three single-family residential rental properties. (***Moon v. Comm.***, TCS 2016-23) Mrs. Moon was a part-time ski instructor and managed the couple's properties. Mrs. Moon oversaw the rentals, performed repairs and renovation work, and maintained contemporaneous logs of her time. Mrs. Moon's logs claimed the following hours spent on the properties: 1,002.5 hours in 2008, 1,227.5 hours in 2009, 834.5 hours in 2010, and 863.5 hours in 2011.

The IRS argued that Mrs. Moon overstated the time spent on her logs and that the time Mrs. Moon spent on business and tax issues should be excluded as investor activities. The Tax Court found Mrs. Moon's testimony and her time logs credible and rejected the IRS's argument.

### California nonconformity

California has never conformed to IRC §469(c)(7) pertaining to real estate professionals. Real estate professionals with losses from rental real estate must treat those losses as passive losses for California purposes. (R&TC §17561)

# TWO NEW FORMS REPLACE HUD-1

## BACKGROUND

The Consumer Financial Protection Bureau, as mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act, has created two new forms for consumers applying for a mortgage. The new forms, Loan Estimate and Closing Disclosure, replace forms developed separately under the Truth in Lending Act and the Real Estate Settlement Procedures Act of 1974. ("TILA-RESPA Integrated Disclosure: Guide to the Loan Estimate and Closing Disclosure Forms," Consumer Financial Protection Bureau (January 2015))

Proposed forms were made available on July 9, 2012, and the final forms have been in use since October 3, 2015.

## FORM DETAILS

The HUD-1 Settlement Statement became obsolete. Information previously contained on the HUD-1 now appears on two new forms, the Loan Estimate and the Closing Disclosure.

### Loan Estimate

The first new form, Loan Estimate, must be provided within three business days of the date a consumer submits a loan application, and it is designed to help consumers understand the key features, costs, and risks of the mortgage loan.

Page 1 of the Loan Estimate includes general information and sections for loan terms and projected payments. Page 2 details the closing costs, and Page 3 contains loan estimate information.

### Closing Disclosure

The second new form, Closing Disclosure, must be provided at least three business days before the closing date of the loan, and it is designed to help consumers understand all transaction costs of the loan.

Page 1 of the Closing Disclosure is similar to the Loan Estimate and includes sections for general information, loan terms, and projected payments. The remaining pages of the five-page form cover loan costs, details of payoffs and payments, escrow information, and loan calculations.

## REQUIREMENTS

While the two new forms must be used for most closed-end consumer mortgages, the older disclosure forms are still required for:

- Home equity lines of credit;
- Reverse mortgages; and
- Mortgages secured by a mobile home or dwelling that is not attached to land.

**Note:** The requirement to use the older forms does not apply to people who make five or fewer mortgages per year because they are not considered "creditors" under the law.

FICUS BANK

4321 Random Boulevard • Somecity, ST 12340

*Save this Loan Estimate to compare with your Closing Disclosure.*

# Loan Estimate

**DATE ISSUED** 2/15/2016
**APPLICANTS** Michael Jones and Mary Stone
123 Anywhere Street
Anytown, ST 12345
**PROPERTY** 456 Somewhere Avenue
Anytown, ST 12345
**SALE PRICE** $180,000

**LOAN TERM** 30 years
**PURPOSE** Purchase
**PRODUCT** Fixed Rate
**LOAN TYPE** ☒ Conventional ☐ FHA ☐ VA ☐ ___________
**LOAN ID #** 123456789
**RATE LOCK** ☐ NO ☒ YES, until 4/16/2016 at 5:00 p.m. EDT
*Before closing, your interest rate, points, and lender credits can change unless you lock the interest rate. All other estimated closing costs expire on* ***3/4/2016*** *at 5:00 p.m. EDT*

## Loan Terms

| Loan Terms | | Can this amount increase after closing? |
|---|---|---|
| **Loan Amount** | $162,000 | **NO** |
| **Interest Rate** | 3.875% | **NO** |
| **Monthly Principal & Interest**<br>*See Projected Payments below for your Estimated Total Monthly Payment* | $761.78 | **NO** |
| | | **Does the loan have these features?** |
| **Prepayment Penalty** | | **YES** • **As high as $3,240** if you pay off the loan during the first 2 years |
| **Balloon Payment** | | **NO** |

## Projected Payments

| **Payment Calculation** | **Years 1-7** | **Years 8-30** |
|---|---|---|
| Principal & Interest | $761.78 | $761.78 |
| Mortgage Insurance | + 82 | + — |
| Estimated Escrow<br>*Amount can increase over time* | + 206 | + 206 |
| **Estimated Total Monthly Payment** | $1,050 | $968 |

| | | | |
|---|---|---|---|
| **Estimated Taxes, Insurance & Assessments**<br>*Amount can increase over time* | $206<br>a month | **This estimate includes**<br>☒ Property Taxes<br>☒ Homeowner's Insurance<br>☐ Other:<br>*See Section G on page 2 for escrowed property costs. You must pay for other property costs separately.* | **In escrow?**<br>**YES**<br>**YES** |

## Costs at Closing

| | | |
|---|---|---|
| **Estimated Closing Costs** | $8,054 | Includes $5,672 in Loan Costs + $2,382 in Other Costs – $0 in Lender Credits. *See page 2 for details.* |
| **Estimated Cash to Close** | $16,054 | Includes Closing Costs. *See Calculating Cash to Close on page 2 for details.* |

# Closing Cost Details

## Loan Costs

| A. Origination Charges | $1,802 |
|---|---|
| .25 % of Loan Amount (Points) | $405 |
| Application Fee | $300 |
| Underwriting Fee | $1,097 |

| B. Services You Cannot Shop For | $672 |
|---|---|
| Appraisal Fee | $405 |
| Credit Report Fee | $30 |
| Flood Determination Fee | $20 |
| Flood Monitoring Fee | $32 |
| Tax Monitoring Fee | $75 |
| Tax Status Research Fee | $110 |

| C. Services You Can Shop For | $3,198 |
|---|---|
| Pest Inspection Fee | $135 |
| Survey Fee | $65 |
| Title – Insurance Binder | $700 |
| Title – Lender's Title Policy | $535 |
| Title – Settlement Agent Fee | $502 |
| Title – Title Search | $1,261 |

| D. TOTAL LOAN COSTS (A + B + C) | $5,672 |
|---|---|

## Other Costs

| E. Taxes and Other Government Fees | $85 |
|---|---|
| Recording Fees and Other Taxes | $85 |
| Transfer Taxes | |

| F. Prepaids | $867 |
|---|---|
| Homeowner's Insurance Premium ( 6 months) | $605 |
| Mortgage Insurance Premium ( months) | |
| Prepaid Interest ( $17.44 per day for 15 days @ 3.875%) | $262 |
| Property Taxes ( months) | |

| G. Initial Escrow Payment at Closing | | | | $413 |
|---|---|---|---|---|
| Homeowner's Insurance | $100.83 | per month for | 2 mo. | $202 |
| Mortgage Insurance | | per month for | mo. | |
| Property Taxes | $105.30 | per month for | 2 mo. | $211 |

| H. Other | $1,017 |
|---|---|
| Title – Owner's Title Policy (optional) | $1,017 |

| I. TOTAL OTHER COSTS (E + F + G + H) | $2,382 |
|---|---|

| J. TOTAL CLOSING COSTS | $8,054 |
|---|---|
| D + I | $8,054 |
| Lender Credits | |

## Calculating Cash to Close

| | |
|---|---|
| Total Closing Costs (J) | $8,054 |
| Closing Costs Financed (Paid from your Loan Amount) | $0 |
| Down Payment/Funds from Borrower | $18,000 |
| Deposit | – $10,000 |
| Funds for Borrower | $0 |
| Seller Credits | $0 |
| Adjustments and Other Credits | $0 |
| **Estimated Cash to Close** | $16,054 |

## Additional Information About This Loan

| | | | |
|---|---|---|---|
| **LENDER** | Ficus Bank | **MORTGAGE BROKER** | |
| **NMLS/__ LICENSE ID** | | **NMLS/__ LICENSE ID** | |
| **LOAN OFFICER** | Joe Smith | **LOAN OFFICER** | |
| **NMLS/__ LICENSE ID** | 12345 | **NMLS/__ LICENSE ID** | |
| **EMAIL** | joesmith@ficusbank.com | **EMAIL** | |
| **PHONE** | 123-456-7890 | **PHONE** | |

| **Comparisons** | **Use these measures to compare this loan with other loans.** |
|---|---|
| **In 5 Years** | $56,582 Total you will have paid in principal, interest, mortgage insurance, and loan costs.<br>$15,773 Principal you will have paid off. |
| **Annual Percentage Rate (APR)** | 4.274% Your costs over the loan term expressed as a rate. This is not your interest rate. |
| **Total Interest Percentage (TIP)** | 69.45% The total amount of interest that you will pay over the loan term as a percentage of your loan amount. |

### Other Considerations

**Appraisal** We may order an appraisal to determine the property's value and charge you for this appraisal. We will promptly give you a copy of any appraisal, even if your loan does not close. You can pay for an additional appraisal for your own use at your own cost.

**Assumption** If you sell or transfer this property to another person, we
- ☐ will allow, under certain conditions, this person to assume this loan on the original terms.
- ☒ will not allow assumption of this loan on the original terms.

**Homeowner's Insurance** This loan requires homeowner's insurance on the property, which you may obtain from a company of your choice that we find acceptable.

**Late Payment** If your payment is more than *15* days late, we will charge a late fee of *5% of the monthly principal and interest payment.*

**Refinance** Refinancing this loan will depend on your future financial situation, the property value, and market conditions. You may not be able to refinance this loan.

**Servicing** We intend
- ☐ to service your loan. If so, you will make your payments to us.
- ☒ to transfer servicing of your loan.

### Confirm Receipt

By signing, you are only confirming that you have received this form. You do not have to accept this loan because you have signed or received this form.

Applicant Signature ______ Date ______ Co-Applicant Signature ______ Date ______

# Closing Disclosure

*This form is a statement of final loan terms and closing costs. Compare this document with your Loan Estimate.*

| Closing Information | | Transaction Information | | Loan Information | |
|---|---|---|---|---|---|
| **Date Issued** | 4/15/2016 | **Borrower** | Michael Jones and Mary Stone | **Loan Term** | 30 years |
| **Closing Date** | 4/15/2016 | | 123 Anywhere Street | **Purpose** | Purchase |
| **Disbursement Date** | 4/15/2016 | | Anytown, ST 12345 | **Product** | Fixed Rate |
| **Settlement Agent** | Epsilon Title Co. | **Seller** | Steve Cole and Amy Doe | | |
| **File #** | 12-3456 | | 321 Somewhere Drive | **Loan Type** | ☒ Conventional ☐ FHA |
| **Property** | 456 Somewhere Ave | | Anytown, ST 12345 | | ☐ VA ☐ ____________ |
| | Anytown, ST 12345 | **Lender** | Ficus Bank | **Loan ID #** | 123456789 |
| **Sale Price** | $180,000 | | | **MIC #** | 000654321 |

## Loan Terms

| | | Can this amount increase after closing? |
|---|---|---|
| **Loan Amount** | $162,000 | **NO** |
| **Interest Rate** | 3.875% | **NO** |
| **Monthly Principal & Interest**<br>*See Projected Payments below for your Estimated Total Monthly Payment* | $761.78 | **NO** |
| | | **Does the loan have these features?** |
| **Prepayment Penalty** | | **YES** • **As high as $3,240** if you pay off the loan during the first 2 years |
| **Balloon Payment** | | **NO** |

## Projected Payments

| Payment Calculation | Years 1-7 | Years 8-30 |
|---|---|---|
| Principal & Interest | $761.78 | $761.78 |
| Mortgage Insurance | + 82.35 | + — |
| Estimated Escrow<br>*Amount can increase over time* | + 206.13 | + 206.13 |
| **Estimated Total Monthly Payment** | $1,050.26 | $967.91 |

| | | This estimate includes | In escrow? |
|---|---|---|---|
| **Estimated Taxes, Insurance & Assessments**<br>*Amount can increase over time*<br>*See page 4 for details* | $356.13 a month | ☒ Property Taxes | **YES** |
| | | ☒ Homeowner's Insurance | **YES** |
| | | ☒ Other: Homeowner's Association Dues | **NO** |
| | | *See Escrow Account on page 4 for details. You must pay for other property costs separately.* | |

## Costs at Closing

| | | |
|---|---|---|
| **Closing Costs** | $9,712.10 | Includes $4,694.05 in Loan Costs + $5,018.05 in Other Costs – $0 in Lender Credits. *See page 2 for details.* |
| **Cash to Close** | $14,147.26 | Includes Closing Costs. *See Calculating Cash to Close on page 3 for details.* |

# Closing Cost Details

## Loan Costs

| | Borrower-Paid At Closing | Borrower-Paid Before Closing | Seller-Paid At Closing | Seller-Paid Before Closing | Paid by Others |
|---|---|---|---|---|---|
| **A. Origination Charges** | **$1,802.00** | | | | |
| 01 0.25 % of Loan Amount (Points) | $405.00 | | | | |
| 02 Application Fee | $300.00 | | | | |
| 03 Underwriting Fee | $1,097.00 | | | | |
| 04 | | | | | |
| 05 | | | | | |
| 06 | | | | | |
| 07 | | | | | |
| 08 | | | | | |
| **B. Services Borrower Did Not Shop For** | **$236.55** | | | | |
| 01 Appraisal Fee to John Smith Appraisers Inc. | | | | | $405.00 |
| 02 Credit Report Fee to Information Inc. | | $29.80 | | | |
| 03 Flood Determination Fee to Info Co. | $20.00 | | | | |
| 04 Flood Monitoring Fee to Info Co. | $31.75 | | | | |
| 05 Tax Monitoring Fee to Info Co. | $75.00 | | | | |
| 06 Tax Status Research Fee to Info Co. | $80.00 | | | | |
| 07 | | | | | |
| 08 | | | | | |
| 09 | | | | | |
| 10 | | | | | |
| **C. Services Borrower Did Shop For** | **$2,655.50** | | | | |
| 01 Pest Inspection Fee to Pests Co. | $120.50 | | | | |
| 02 Survey Fee to Surveys Co. | $85.00 | | | | |
| 03 Title – Insurance Binder to Epsilon Title Co. | $650.00 | | | | |
| 04 Title – Lender's Title Insurance to Epsilon Title Co. | $500.00 | | | | |
| 05 Title – Settlement Agent Fee to Epsilon Title Co. | $500.00 | | | | |
| 06 Title – Title Search to Epsilon Title Co. | $800.00 | | | | |
| 07 | | | | | |
| 08 | | | | | |
| **D. TOTAL LOAN COSTS (Borrower-Paid)** | **$4,694.05** | | | | |
| Loan Costs Subtotals (A + B + C) | $4,664.25 | $29.80 | | | |

## Other Costs

| | Borrower-Paid At Closing | Borrower-Paid Before Closing | Seller-Paid At Closing | Seller-Paid Before Closing | Paid by Others |
|---|---|---|---|---|---|
| **E. Taxes and Other Government Fees** | **$85.00** | | | | |
| 01 Recording Fees Deed: $40.00 Mortgage: $45.00 | $85.00 | | | | |
| 02 Transfer Tax to Any State | | | $950.00 | | |
| **F. Prepaids** | **$2,120.80** | | | | |
| 01 Homeowner's Insurance Premium ( 12 mo.) to Insurance Co. | $1,209.96 | | | | |
| 02 Mortgage Insurance Premium ( mo.) | | | | | |
| 03 Prepaid Interest ( $17.44 per day from 4/15/12 to 5/1/12 ) | $279.04 | | | | |
| 04 Property Taxes ( 6 mo.) to Any County USA | $631.80 | | | | |
| 05 | | | | | |
| **G. Initial Escrow Payment at Closing** | **$412.25** | | | | |
| 01 Homeowner's Insurance $100.83 per month for 2 mo. | $201.66 | | | | |
| 02 Mortgage Insurance per month for mo. | | | | | |
| 03 Property Taxes $105.30 per month for 2 mo. | $210.60 | | | | |
| 04 | | | | | |
| 05 | | | | | |
| 06 | | | | | |
| 07 | | | | | |
| 08 Aggregate Adjustment | – 0.01 | | | | |
| **H. Other** | **$2,400.00** | | | | |
| 01 HOA Capital Contribution to HOA Acre Inc. | $500.00 | | | | |
| 02 HOA Processing Fee to HOA Acre Inc. | $150.00 | | | | |
| 03 Home Inspection Fee to Engineers Inc. | $750.00 | | | $750.00 | |
| 04 Home Warranty Fee to XYZ Warranty Inc. | | | $450.00 | | |
| 05 Real Estate Commission to Alpha Real Estate Broker | | | $5,700.00 | | |
| 06 Real Estate Commission to Omega Real Estate Broker | | | $5,700.00 | | |
| 07 Title – Owner's Title Insurance (optional) to Epsilon Title Co. | $1,000.00 | | | | |
| 08 | | | | | |
| **I. TOTAL OTHER COSTS (Borrower-Paid)** | **$5,018.05** | | | | |
| Other Costs Subtotals (E + F + G + H) | $5,018.05 | | | | |

| | Borrower-Paid At Closing | Borrower-Paid Before Closing | Seller-Paid At Closing | Seller-Paid Before Closing | Paid by Others |
|---|---|---|---|---|---|
| **J. TOTAL CLOSING COSTS (Borrower-Paid)** | **$9,712.10** | | | | |
| Closing Costs Subtotals (D + I) | $9,682.30 | $29.80 | $12,800.00 | $750.00 | $405.00 |
| Lender Credits | | | | | |

## Calculating Cash to Close

**Use this table to see what has changed from your Loan Estimate.**

| | Loan Estimate | Final | Did this change? | |
|---|---|---|---|---|
| Total Closing Costs (J) | $8,054.00 | $9,712.10 | **YES** | • See **Total Loan Costs (D)** and **Total Other Costs (I)** |
| Closing Costs Paid Before Closing | $0 | – $29.80 | **YES** | • You paid these Closing Costs **before closing** |
| Closing Costs Financed (Paid from your Loan Amount) | $0 | $0 | **NO** | |
| Down Payment/Funds from Borrower | $18,000.00 | $18,000.00 | **NO** | |
| Deposit | – $10,000.00 | – $10,000.00 | **NO** | |
| Funds for Borrower | $0 | $0 | **NO** | |
| Seller Credits | $0 | – $2,500.00 | **YES** | • See Seller Credits in **Section L** |
| Adjustments and Other Credits | $0 | – $1,035.04 | **YES** | • See details in **Sections K and L** |
| **Cash to Close** | $16,054.00 | $14,147.26 | | |

## Summaries of Transactions

**Use this table to see a summary of your transaction.**

**BORROWER'S TRANSACTION**

| | | | | | |
|---|---|---|---|---|---|
| **K. Due from Borrower at Closing** | | | | | **$189,762.30** |
| 01 | Sale Price of Property | | | | $180,000.00 |
| 02 | Sale Price of Any Personal Property Included in Sale | | | | |
| 03 | Closing Costs Paid at Closing (J) | | | | $9,682.30 |
| 04 | | | | | |
| **Adjustments** | | | | | |
| 05 | | | | | |
| 06 | | | | | |
| 07 | | | | | |
| **Adjustments for Items Paid by Seller in Advance** | | | | | |
| 08 | City/Town Taxes | | to | | |
| 09 | County Taxes | | to | | |
| 10 | Assessments | | to | | |
| 11 | HOA Dues | 4/15/16 | to | 4/30/16 | $80.00 |
| 12 | | | | | |
| 13 | | | | | |
| 14 | | | | | |
| 15 | | | | | |
| **L. Paid Already by or on Behalf of Borrower at Closing** | | | | | **$175,615.04** |
| 01 | Deposit | | | | $10,000.00 |
| 02 | Loan Amount | | | | $162,000.00 |
| 03 | Existing Loan(s) Assumed or Taken Subject to | | | | |
| 04 | | | | | |
| 05 | Seller Credit | | | | $2,500.00 |
| **Other Credits** | | | | | |
| 06 | Rebate from Epsilon Title Co. | | | | $750.00 |
| 07 | | | | | |
| **Adjustments** | | | | | |
| 08 | | | | | |
| 09 | | | | | |
| 10 | | | | | |
| 11 | | | | | |
| **Adjustments for Items Unpaid by Seller** | | | | | |
| 12 | City/Town Taxes | 1/1/16 | to | 4/14/16 | $365.04 |
| 13 | County Taxes | | to | | |
| 14 | Assessments | | to | | |
| 15 | | | | | |
| 16 | | | | | |
| 17 | | | | | |

| **CALCULATION** | |
|---|---|
| Total Due from Borrower at Closing (K) | $189,762.30 |
| Total Paid Already by or on Behalf of Borrower at Closing (L) | – $175,615.04 |
| **Cash to Close ☒ From ☐ To Borrower** | **$14,147.26** |

**SELLER'S TRANSACTION**

| | | | | | |
|---|---|---|---|---|---|
| **M. Due to Seller at Closing** | | | | | **$180,080.00** |
| 01 | Sale Price of Property | | | | $180,000.00 |
| 02 | Sale Price of Any Personal Property Included in Sale | | | | |
| 03 | | | | | |
| 04 | | | | | |
| 05 | | | | | |
| 06 | | | | | |
| 07 | | | | | |
| 08 | | | | | |
| **Adjustments for Items Paid by Seller in Advance** | | | | | |
| 09 | City/Town Taxes | | to | | |
| 10 | County Taxes | | to | | |
| 11 | Assessments | | to | | |
| 12 | HOA Dues | 4/15/16 | to | 4/30/16 | $80.00 |
| 13 | | | | | |
| 14 | | | | | |
| 15 | | | | | |
| 16 | | | | | |
| **N. Due from Seller at Closing** | | | | | **$115,665.04** |
| 01 | Excess Deposit | | | | |
| 02 | Closing Costs Paid at Closing (J) | | | | $12,800.00 |
| 03 | Existing Loan(s) Assumed or Taken Subject to | | | | |
| 04 | Payoff of First Mortgage Loan | | | | $100,000.00 |
| 05 | Payoff of Second Mortgage Loan | | | | |
| 06 | | | | | |
| 07 | | | | | |
| 08 | Seller Credit | | | | $2,500.00 |
| 09 | | | | | |
| 10 | | | | | |
| 11 | | | | | |
| 12 | | | | | |
| 13 | | | | | |
| **Adjustments for Items Unpaid by Seller** | | | | | |
| 14 | City/Town Taxes | 1/1/16 | to | 4/14/16 | $365.04 |
| 15 | County Taxes | | to | | |
| 16 | Assessments | | to | | |
| 17 | | | | | |
| 18 | | | | | |
| 19 | | | | | |

| **CALCULATION** | |
|---|---|
| Total Due to Seller at Closing (M) | $180,080.00 |
| Total Due from Seller at Closing (N) | – $115,665.04 |
| **Cash ☐ From ☒ To Seller** | **$64,414.96** |

# Additional Information About This Loan

## Loan Disclosures

**Assumption**
If you sell or transfer this property to another person, your lender
☐ will allow, under certain conditions, this person to assume this loan on the original terms.
☒ will not allow assumption of this loan on the original terms.

**Demand Feature**
Your loan
☐ has a demand feature, which permits your lender to require early repayment of the loan. You should review your note for details.
☒ does not have a demand feature.

**Late Payment**
If your payment is more than *15* days late, your lender will charge a late fee of *5% of the monthly principal and interest payment.*

**Negative Amortization** (Increase in Loan Amount)
Under your loan terms, you
☐ are scheduled to make monthly payments that do not pay all of the interest due that month. As a result, your loan amount will increase (negatively amortize), and your loan amount will likely become larger than your original loan amount. Increases in your loan amount lower the equity you have in this property.
☐ may have monthly payments that do not pay all of the interest due that month. If you do, your loan amount will increase (negatively amortize), and, as a result, your loan amount may become larger than your original loan amount. Increases in your loan amount lower the equity you have in this property.
☒ do not have a negative amortization feature.

**Partial Payments**
Your lender
☒ may accept payments that are less than the full amount due (partial payments) and apply them to your loan.
☐ may hold them in a separate account until you pay the rest of the payment, and then apply the full payment to your loan.
☐ does not accept any partial payments.
If this loan is sold, your new lender may have a different policy.

**Security Interest**
You are granting a security interest in
*456 Somewhere Ave., Anytown, ST 12345*

You may lose this property if you do not make your payments or satisfy other obligations for this loan.

**Escrow Account**
***For now,*** your loan
☒ will have an escrow account (also called an "impound" or "trust" account) to pay the property costs listed below. Without an escrow account, you would pay them directly, possibly in one or two large payments a year. Your lender may be liable for penalties and interest for failing to make a payment.

| Escrow | | |
|---|---|---|
| Escrowed Property Costs over Year 1 | $2,473.56 | Estimated total amount over year 1 for your escrowed property costs: *Homeowner's Insurance* *Property Taxes* |
| Non-Escrowed Property Costs over Year 1 | $1,800.00 | Estimated total amount over year 1 for your non-escrowed property costs: *Homeowner's Association Dues* You may have other property costs. |
| Initial Escrow Payment | $412.25 | A cushion for the escrow account you pay at closing. See Section G on page 2. |
| Monthly Escrow Payment | $206.13 | The amount included in your total monthly payment. |

☐ will not have an escrow account because ☐ you declined it ☐ your lender does not offer one. You must directly pay your property costs, such as taxes and homeowner's insurance. Contact your lender to ask if your loan can have an escrow account.

| No Escrow | | |
|---|---|---|
| Estimated Property Costs over Year 1 | | Estimated total amount over year 1. You must pay these costs directly, possibly in one or two large payments a year. |
| Escrow Waiver Fee | | |

***In the future,***
Your property costs may change and, as a result, your escrow payment may change. You may be able to cancel your escrow account, but if you do, you must pay your property costs directly. If you fail to pay your property taxes, your state or local government may (1) impose fines and penalties or (2) place a tax lien on this property. If you fail to pay any of your property costs, your lender may (1) add the amounts to your loan balance, (2) add an escrow account to your loan, or (3) require you to pay for property insurance that the lender buys on your behalf, which likely would cost more and provide fewer benefits than what you could buy on your own.

## Loan Calculations

| | |
|---|---|
| **Total of Payments.** Total you will have paid after you make all payments of principal, interest, mortgage insurance, and loan costs, as scheduled. | $285,803.36 |
| **Finance Charge.** The dollar amount the loan will cost you. | $118,830.27 |
| **Amount Financed.** The loan amount available after paying your upfront finance charge. | $162,000.00 |
| **Annual Percentage Rate (APR).** Your costs over the loan term expressed as a rate. This is not your interest rate. | 4.174% |
| **Total Interest Percentage (TIP).** The total amount of interest that you will pay over the loan term as a percentage of your loan amount. | 69.46% |

**Questions?** If you have questions about the loan terms or costs on this form, use the contact information below. To get more information or make a complaint, contact the Consumer Financial Protection Bureau at **www.consumerfinance.gov/mortgage-closing**

## Other Disclosures

**Appraisal**
If the property was appraised for your loan, your lender is required to give you a copy at no additional cost at least 3 days before closing. If you have not yet received it, please contact your lender at the information listed below.

**Contract Details**
See your note and security instrument for information about
- what happens if you fail to make your payments,
- what is a default on the loan,
- situations in which your lender can require early repayment of the loan, and
- the rules for making payments before they are due.

**Liability after Foreclosure**
If your lender forecloses on this property and the foreclosure does not cover the amount of unpaid balance on this loan,

☒ state law may protect you from liability for the unpaid balance. If you refinance or take on any additional debt on this property, you may lose this protection and have to pay any debt remaining even after foreclosure. You may want to consult a lawyer for more information.

☐ state law does not protect you from liability for the unpaid balance.

**Refinance**
Refinancing this loan will depend on your future financial situation, the property value, and market conditions. You may not be able to refinance this loan.

**Tax Deductions**
If you borrow more than this property is worth, the interest on the loan amount above this property's fair market value is not deductible from your federal income taxes. You should consult a tax advisor for more information.

## Contact Information

| | Lender | Mortgage Broker | Real Estate Broker (B) | Real Estate Broker (S) | Settlement Agent |
|---|---|---|---|---|---|
| **Name** | Ficus Bank | | Omega Real Estate Broker Inc. | Alpha Real Estate Broker Co. | Epsilon Title Co. |
| **Address** | 4321 Random Blvd. Somecity, ST 12340 | | 789 Local Lane Sometown, ST 12345 | 987 Suburb Ct. Someplace, ST 12340 | 123 Commerce Pl. Somecity, ST 12344 |
| **NMLS ID** | | | | | |
| **ST License ID** | | | Z765416 | Z61456 | Z61616 |
| **Contact** | Joe Smith | | Samuel Green | Joseph Cain | Sarah Arnold |
| **Contact NMLS ID** | 12345 | | | | |
| **Contact ST License ID** | | | P16415 | P51461 | PT1234 |
| **Email** | joesmith@ ficusbank.com | | sam@omegare.biz | joe@alphare.biz | sarah@ epsilontitle.com |
| **Phone** | 123-456-7890 | | 123-555-1717 | 321-555-7171 | 987-555-4321 |

## Confirm Receipt

By signing, you are only confirming that you have received this form. You do not have to accept this loan because you have signed or received this form.

Applicant Signature Date

Co-Applicant Signature Date

# OTHER REAL ESTATE ISSUES

## SECOND CHILD IS UNFORESEEN CIRCUMSTANCE FOR REDUCED HOME SALE EXCLUSION

The IRS recently held that taxpayers who had a second child qualified for the reduced home sale exclusion under IRC §121 because the taxpayers' two bedroom condo was no longer suitable as their residence, and the birth of the second child was an unforeseen circumstance. (PLR 201628002)

### Reduced home sale exclusion

Gain from the sale or exchange of property is excluded from gross income if the taxpayers own and use the property as their primary residence for periods aggregating two out of the last five years, ending on the date of sale. A reduced exclusion is available when taxpayers fail to satisfy the ownership and use requirements, and the primary reason for the sale is due to change in place of employment, health, or unforeseen circumstances, based on all the facts and circumstances. (IRC §121(c); Treas. Regs. §1.121-3(b))

If taxpayers qualify for a reduced exclusion, it is calculated by multiplying the maximum exclusion available by a fraction, the denominator of which may be expressed in days or months as either 730 days or 24 months, and the numerator of which is the shortest of the following:

- The period of time that the taxpayer owned the property during the five-year period ending on the date of sale;
- The period of time that the taxpayer used the property as the taxpayer's principal residence during the five-year period ending on the date of sale; or
- The period of time between the date of a prior sale or exchange for which the taxpayer excluded gain under IRC §121 and the current sale.

***Example of reduced exclusion***

Scott and Kelly married and purchased their first home on November 2, 2014, which they used as their primary residence. Due to unforeseen circumstances, they sold their home on August 31, 2016. Scott and Kelly's reduced exclusion is calculated as follows:

668 days ÷ 730 days × $500,000 maximum exclusion = $457,534

### Defining unforeseen circumstances

All the facts and circumstances of a sale will determine whether the primary reason for the sale is the occurrence of unforeseen circumstances. (Treas. Regs. §1.121-3(b)) Factors that may be relevant in determining the primary reason for a sale include:

- The proximity in time from the sale and the circumstances giving rise to the sale;
- The suitability of the property as the taxpayer's principal residence materially changes;
- The taxpayer's financial ability to maintain the property is materially impaired;
- The taxpayer uses the property as the taxpayer's residence during the period of the taxpayer's ownership of the property;
- The circumstances giving rise to the sale or exchange are not reasonably foreseeable when the taxpayer begins using the property as a primary residence; and
- The circumstances giving rise to the sale or exchange occur during the period of the taxpayer's ownership and use of the property as a primary residence.

Divorce or legal separation is considered an unforeseen circumstance according to the regulations. Marriage is not unforeseen. An improvement in financial circumstances, such as receiving a large salary increase or winning the lottery, even if the result of unforeseen circumstances, does not qualify as unforeseen circumstances to claim a reduced exclusion.

## COD EXCLUSION — QUALIFIED REAL PROPERTY BUSINESS INDEBTEDNESS

Taxpayers (other than C corporations) may elect to exclude from gross income certain income from the discharge of qualified real property business indebtedness. The amount so excluded is treated as a reduction in the taxpayer's basis of certain depreciable real property and cannot exceed the basis of that property. (IRC §108(c))

Qualified real property business indebtedness (QRPBI) must meet three requirements:

- It was incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured by such real property;
- It was incurred or assumed before January 1, 1993, or if incurred or assumed on or after such date, is qualified acquisition indebtedness; and
- The taxpayer elects to exclude COD income with respect to such indebtedness. (IRC §108(c)(3))

Qualified acquisition indebtedness (the second requirement) is debt that is incurred or assumed to acquire, construct, or substantially improve real property used in a trade or business. (IRC §108(c)(4))

The amount excluded under this provision generally cannot exceed the lesser of:

- The amount by which the principal amount of the debt that is discharged exceeds the FMV of the property securing the debt; or
- The taxpayer's basis in depreciable real property. (IRC §108(c)(2))

The taxpayer must reduce the basis of the depreciable real property by the excluded amount at the beginning of the taxable year following the taxable year in which the discharge occurs.

### Real estate developer

In a Revenue Ruling, the IRS has provided guidance for when a real estate developer may exclude COD income under the exclusion for QRPBI. (Rev. Rul. 2016-15) The Revenue Ruling concludes that:

- Real property developed and held by a developer for use in a leasing business is QRPBI; but
- Real property developed and held by the developer primarily for sale to customers (inventory) is not QRPBI.

IRC §108 provides for an exclusion for trade or business real property but does not explicitly disqualify real property held from resale from its provisions.

However, in a lengthy analysis, the IRS noted that the statute requires the taxpayer to reduce the basis of depreciable property by the amount of COD income excluded. (IRC §108(c)(1)(A)) Rental real estate is depreciable property, but inventory or stock in trade is not. Moreover, IRC §1017(b)(3)(F)(ii) prevents a taxpayer from treating real property that is inventory as depreciable property, thereby preventing the taxpayer from reducing the basis of the secured property by the amount of the excluded COD income. This would create deferrals of COD income well beyond the period the taxpayer holds the inventory real property because the taxpayer would be forced to reduce the basis of depreciable real property instead. Typically, a taxpayer holds depreciable business property substantially longer than the taxpayer holds inventory real property.

Accordingly, debt incurred in connection with, and secured by, inventory real property cannot be QRPBI.

## Multiple business properties secure mortgage

In a Chief Counsel Advice, the IRS has clarified that, in computing the limit of the exclusion from income from the discharge of QRPBI, the only property to be taken into consideration is the property that qualified the indebtedness as QRPBI. (CCA 201623009)

A taxpayer owned Property A and Property B. The taxpayer had Mortgage 1 and Mortgage 2, and both mortgages were secured by both properties. However, proceeds from Mortgage 1 were used solely to improve Property A, and the proceeds from Mortgage 2 were used solely to improve Property B.

A portion of Mortgage 1 was discharged. In its calculation of the maximum exclusion amount, the taxpayer reduced the fair market value of Property A by the amount of Mortgage 2 without also adding the value of Property B to Property A.

In analyzing IRC §108(c)(2)(A), the IRS concluded that the taxpayer should neither add the value of Property B to Property A nor subtract the amount of Mortgage 2 in computing the maximum exclusion amount. The key issue in the CCA was the phrase contained in IRC §108(c)(2)(A)(ii) regarding the fair market value of the real property "reduced by the outstanding principal amount of any other qualified real property business indebtedness secured by such property."

Clearly, Mortgage 2 had been secured by Property 1. However, the IRS ruled that "such property" near the end of that clause refers to the single item of real property which relates to QRPBI. As one of the requirements for QRPBI is that the debt must be acquisition indebtedness, only Mortgage 1 was QRPBI, and the exclusion must be computed by subtracting the balance of only Mortgage 1 and not Mortgage 2.

***Example of COD exclusion***

John owns two rental properties, the Main Street property and the Central Avenue property. The Main Mortgage was incurred to improve Main Street, and the Central Mortgage was incurred to acquire Central Avenue. However, both mortgages are secured by both properties. Main Mortgage has a balance of $250,000, and Central Mortgage has a balance of $500,000.

Due to a decline in the FMV of Main Street, John negotiated to have Main Mortgage reduced to $125,000. Therefore, $125,000 of the loan was discharged. At the time the debt was reduced, the FMV of Main Street was $100,000, and the FMV of Central Avenue was $400,000. Main Street's basis was $150,000.

Even though Central Avenue was pledged as security for the Main Mortgage, the mortgage was only used to improve Main Street and therefore may only be considered QRPBI with respect to Main Street.

The limitation on the $125,000 of COD income that may be excluded is calculated as follows:

| | |
|---|---|
| Discharged amount | $125,000 |
| Main Street's FMV | (100,000) |
| Disallowed exclusion | $ 25,000 |

Thus, the $125,000 COD exclusion is reduced by $25,000 to $100,000. John must report $25,000 of COD income (unless another exclusion, such as the insolvency exclusion, applies).

## NO ABANDONMENT LOSS UNTIL FORECLOSURE

A company that engaged in real estate development was not allowed to take a loss on properties that it purportedly abandoned because the properties had not yet been sold in foreclosure. (***Tucker v. Comm.***, TCM 2015-185) The company executed recourse mortgages to buy property. When the real estate market soured, the company wrote off its holdings and took losses claiming that it had abandoned the properties.

## NO WRITE-OFF FOR BEACH RENTAL

A company was not able to claim the expenses of a beach property even though the company claimed that it was used primarily for a company retreat for its employees. (***WSK & Sons v. Comm.***, TCM 2015-204) The house was rented to the corporation's two shareholders, and it appeared that the alleged retreat location was actually a wedding site for one of the principal shareholder's sons.

# LIKE-KIND EXCHANGES: IRC §1031

## BASIC EXCHANGE RULES

IRC §1031 provides an exception to the general rule for recognition of gain on the sale of property.

Under IRC §1031, if certain conditions are met, a taxpayer defers the gain from the sale of property, either in part or in full.

There are three general requirements:

- There must be an exchange (as opposed to a separate sale and reinvestment);
- The replacement property must be like-kind to the property given up; and
- Both the property given up and the replacement property must be held for investment or productive use in a trade or business. Property held for personal use or primarily for sale is generally not eligible for nonrecognition treatment.

✐ **Practice Pointer**

The principal residence, second home, or vacation home of a taxpayer is **not** eligible for IRC §1031 treatment because it is held for personal use.

IRC §1031 and the related regulations lay out the following rules related to exchanges:

- No gain or loss shall be recognized on the exchange of business or investment property if the property is exchanged solely for property of like-kind, which is to be held either for productive use in a trade or business or for investment (IRC §1031(a)(1));
- Gain is recognized to the extent of cash or other boot (not like-kind property) received (IRC §1031 (b)); and
- Net relief of the transferor taxpayer's mortgage debt is considered boot received. (Treas. Regs. §1.1031(b)-1)

Additionally, IRC §1031(a)(2) explicitly excludes certain property, such as a partnership interest, from like-kind treatment:

- Gain on exchange of partnership interest cannot be deferred; and
- Taxpayers sometimes report the exchange of tenants-in-common interest in partnership property, when in reality a partnership interest was exchanged.

If, at any time during the exchange, the taxpayer has receipt or control of any portion of the sales proceeds, this will generally result in gain recognition. Further, if the taxpayer does not reinvest the full amount of proceeds into eligible replacement property or obtains other property in the exchange (referred to as "boot"), this may also result in gain recognition.

✐ **Practice Pointer**

Although we think of an IRC §1031 exchange as being "allowed," it is not an election. It is simply a situation where neither gain nor loss is recognized when one asset is exchanged for another. We rarely see a taxpayer go through the additional expense of an exchange of property to defer loss, but when trading in cars or other machinery, the exchange creates a mandatory deferral of tax consequences. If a taxpayer trades in a car, he or she is prevented from taking a loss on that transaction, even if it is a business asset. A better option would be to sell the car, take the loss, and then purchase a new car.

## DELAWARE STATUTORY TRUSTS AS PART OF AN IRC §1031 EXCHANGE

For many investors, the tenants-in-common §1031 exchange (TIC exchange) became an attractive alternative in the 1990s and 2000s often because they no longer wanted to manage rental property or finding replacement property can be time-consuming. However, although the IRS recognized the validity of TIC exchanges as long as certain conditions were satisfied, it is frequently difficult to obtain financing for such ventures. (Rev. Proc. 2002-22) An alternative to the TIC exchange is the Delaware Statutory Trust §1031 exchange (DST exchange).

Here are some of the pros and cons of using a DST exchange.

## What is a DST?

DSTs are a form of business trust, which is essentially an unincorporated corporation. DSTs are formed as private governing agreements under which either:

- Property (real, tangible, and intangible) is held, managed, administered, invested, and/or operated; or
- Business or professional activities for profit are carried on by one or more trustees for the benefit of the trustor entitled to a beneficial interest in the trust property. (Title 12 Del. Code §3801)

Although a DST is formed in Delaware, it can operate anywhere. Other states also have enacted similar statutory business trust provisions, but the DST is by far the most popular. California recognizes business trusts, but it does not authorize the formation of business trusts by statute.

For DSTs holding real property, beneficiary-investors purchase interests in the DST, which holds title to property and guarantees the mortgage loan. Investment in the real estate is shared among many investors. Because the beneficiaries of the trust are considered the owners of the trust property, the DST does not run afoul of the IRC §1031 partnership interest prohibition (Rev. Rul. 2004-86) discussed below. Therefore investing in a DST that holds real property will qualify as a replacement property in a like-kind exchange involving the sale of real property.

DST properties tend to be institutional grade commercial properties, e.g., apartment communities, office buildings, retail buildings, or shopping centers, thereby allowing the mom and pop investor to play with the big boys. An individual exchanging a house, condominium, small office/retail building would not have funds to purchase such high quality commercial properties without sharing the investment with other investors.

The DST has proven to be far more successful in terms of obtaining financing, making it the option of choice for many investors looking to make a §1031 exchange. Again, the IRS has recognized the validity of these transactions but has laid down very strict criteria as to what transactions will qualify. These criteria are laid out in Revenue Ruling 2004-86.

## IRC §1031 exchange partnership investment prohibition

IRC §1031 does not apply to certain types of property, including stocks, bonds, notes, and partnership interests. (IRC §1031(a)(2)) Thus, for example, a property owner who hates managing his own rental property cannot exchange his interest in real estate for a limited partnership interest.

Certain joint undertakings or contractual arrangements may create a separate entity for federal tax purposes and therefore may be classified as either a partnership or a corporation. Whether the joint ownership of real estate will be treated as a partnership or corporation depends on whether the joint ownership functions as a separate business entity or merely investment co-ownership. If the interests are treated as a co-ownership and not a separate business entity, taxpayers owning those interests may exchange them in a transaction qualifying for like-kind exchange treatment. If the ownership of the fractional interests qualifies as a business, like-kind exchange treatment is not permitted.

## TIC exchanges

TIC exchanges essentially allow taxpayers to either join forces with other investors to buy a replacement property and/or to buy into an existing investment arrangement. However, taxpayers must be extremely careful that any TIC exchange doesn't violate the §1031 prohibition against investing in a partnership interest.

Revenue Procedure 2002-22 clarifies the parameters necessary for a TIC interest to be treated as an interest in real estate (like-kind property) rather than an interest in a partnership (not like-kind property). Among other rules:

- Each TIC owner must hold title to the property;
- There can be no more than 35 co-owners;
- The group cannot file a partnership or corporation tax return or conduct business under a common name;
- Co-owners must retain the right to hire or fire managers, sell the property or refinance the property (these decisions must be made unanimously, so one TIC owner can block the majority's will); and
- Co-owners must share profits and losses proportionately.

## DST exchanges

Two years after the IRS issued Revenue Procedure 2002-22, the IRS also sanctioned the use of DST exchanges in Revenue Ruling 2004-86 as long as the DST does not violate specified prohibitions, commonly referred to as the "seven deadly sins." These prohibit the DST from the following activities:

- Entering into new leases or renegotiating current leases;
- Making additional capital contributions;
- Renegotiating the current loan or obtaining a new loan;
- Reinvesting the proceeds from any sale;
- Capital expenditures beyond normal maintenance items;
- Investing cash between distribution dates in anything other than short-term securities; and
- Failing to distribute cash to the owners, other than required reserves.

To avoid the seven deadly sins and to make the venture more attractive, commercial leases involving DSTs usually have the trustee enter into a master lease agreement with a core tenant who then sublets the building or building units. The DST is the entity that obtains the financing, which makes this more attractive to lenders as they do not need to approve all the individual TIC owners for the mortgage.

Additionally, large reserves are put aside at the initial offering so that additional loans or financing are not required to cover additional costs. The properties invested in tend to be newer or recently remodeled so that large expenditures beyond normal maintenance are not required.

### Pros and cons of TIC and DST exchanges

The following chart provides an overview of the advantages and disadvantages of TIC and DST exchanges:

| DST versus TIC Comparison | | |
|---|---|---|
| | **DST structure** | **TIC structure** |
| IRS guidance | Rev. Rul. 2004-86 | Rev. Proc. 2002-22 |
| Number of investors | Unlimited, thereby making investments in larger properties more plausible | Up to 35 |
| Ownership | Percentage of beneficial ownership of DST that owns real property | Undivided tenant-in-common interest in real property |
| Investors receive property deed | No | Yes |
| Investors form SMLLCs | One (the DST). Makes financing much more attractive to lenders | Up to 35, depending on the number of tenants-in-common. Can make it difficult to meet the IRC §1031 timelines if financing is required |
| Major decisions regarding property | No voting rights. Trustee makes all decisions. Not appropriate for those who like more hands-on involvement | Equal voting rights and unanimous approval required. Essentially gives one tenant the veto power over all decisions |
| Number of borrowers | One (the DST). Makes financing much more attractive to lenders | Up to 35, depending on the number of tenants-in-common. Can make it difficult to meet the IRC §1031 timelines if financing is required |
| Liability for entity obligations | No | Yes |

## CRITERIA OF HOBBY LOSS RULES NOT USED IN DETERMINING PROFIT MOTIVE UNDER §1031

In Chief Counsel Advices issued on consecutive days, the IRS twice dealt with the issue of "held for productive use in a trade or business or for investment" under IRC §1031. The issues were:

- Can the hobby loss provisions under IRC §183 be used to determine whether the property is "held for productive use in a trade or business?" (CCA 201601011)
- To what extent can the replacement property be used for personal purposes and still qualify as productive use in a trade or business? (CCA 201605017)

## Can IRC §183 (activities not engaged in for profit) define productive use?

> ***Comment***
>
> For a discussion of IRC §183, see page 4-22.

An aircraft was held in a partnership which then leased that aircraft to a related entity for business use. When the partnership traded one aircraft for another, the question arose regarding whether the transaction qualified for like-kind exchange treatment. Specifically, the CCA looked at whether the aircraft in this situation was held for productive use in a trade or business.

The agent who examined the transaction argued that the aircraft failed that test. He noted that the lease payments for the replacement aircraft were below market.

The agent's report noted that the term "held for productive use in a trade or business" is not defined in the Code or regulations, and stated that IRC §183 and accompanying cases and regulations were looked to in determining whether the taxpayer held the aircraft for productive use in a trade or business. (Citing Treas. Regs. §§1.183-1(d)(1), 1.183-2(b); ***Campbell v. Comm.*** (1989) 868 F. 2d 833, *aff'g. in part and rev'g. in part* TCM 1986-569) In addition, the report stated that, in making the evaluation under §183, entities should be examined solely on an entity-by-entity basis, and the profit motive of one entity should not be attributed to another entity, even if the two entities are closely related. (Citing ***United States v. Basye*** (1973) 410 U.S. 441; ***Moline Properties v. Comm.*** (1943) 319 U.S. 436; ***Polakof v. Comm.*** (1987) 820 F. 2d 321, *cert. denied*, 484 U.S. 1025 (1988)) Using the standards under §183, the report concluded that the taxpayer did not hold the aircraft for productive use in a trade or business.

### Chief Counsel says no to IRC §183

The CCA takes the position that IRC §183's rules are not appropriate to apply against the partnership standing alone. The memo agrees that the rent charged for the aircraft was not sufficient for the partnership to make a profit. However, many businesses hold and use properties in a way that, if the use of the property were viewed as an activity, do not and could not generate profit. Nevertheless, the property itself is held for productive use in that business. Thus, the partnership's lack of intent to make an economic profit on the aircraft rental does not establish that the aircraft fails the productive use in a trade or business standard of §1031.

Moreover, the CCA pointed out that businesses, for any number of reasons, opt to hold property, especially aircraft, in a separate entity. In the present instance, for business and legal reasons, the aircraft are owned not by the primary entity but by a related entity. If the primary entity owned the aircraft, the revenue agent would not have raised the issue of whether the aircraft were held for productive use in a trade or business. The CCA stated, "*Were we to disallow §1031 treatment based on the entity structure presented here, businesses would be forced to structure their transactions in inefficient and potentially risky ways to achieve §1031 treatment.*"

## How much personal use is allowable?

In the second CCA, a disregarded single-member LLC provides management and other administrative services to various related entities. The various related entities are dispersed throughout the U.S. so the LLC provides an aircraft to be used by those related entities.

The LLC exchanged the aircraft for a replacement aircraft. The IRS determined that a "low" percentage of the aircraft's use was for business purposes while the majority of its usage was by the LLC owner for personal purposes. Accordingly, the examining agent determined that the relinquished aircraft was not held for productive use in a trade or business, and the exchange did not qualify for nonrecognition treatment.

The taxpayer disputed the agent's finding making alternative arguments:

- The relinquished aircraft could be treated as two assets, one held for productive use in a trade or business and one held for personal use; or
- If the relinquished aircraft must be treated as one property and any portion of its use is business use, then the aircraft qualifies as held for productive use in a trade or business.

### Chief Counsel responds

The CCA concluded that, under the plain language of IRC §1031, property is either held for productive use in a trade or business or it's not. While IRC §1031(b) deals with situations in which non–like-kind property is received in an exchange, it does not support the position that one relinquished property is treated as two separate properties if the property is used for both business and personal purposes.

The CCA emphatically refuted the taxpayer's contention that the productive use test is met if any portion of the property's use is for business purposes. Noting that satisfaction of the productive use test is "intensely factual," the CCA cited Rev. Proc. 2008-16, which allowed some personal use of both the relinquished property and the replacement property in an exchange of dwelling units. However, the CCA noted that the personal use safe harbor under Rev. Proc. 2008-16 is "significantly less than" 50%.

The CCA concluded that, if the examining agent determines that personal use was over 50%, then the Chief Counsel would agree that the relinquished aircraft was not held for productive use in a trade or business. However, the CCA was emphatic that there is no general 50% personal use threshold.

## CALIFORNIA FILING REQUIREMENT

California conforms to IRC §1031 with one exception: For like-kind exchanges occurring in taxable years beginning January 1, 2014, and later, any taxpayer who completes an exchange of California property for property located out of state must file an information return with the FTB on Form FTB 3840, California Like-Kind Exchanges. (R&TC §§18032, 24953) (Form 3840 must be filed each year thereafter until the property is disposed of in a fully taxable transaction.

### Who must file

The Form FTB 3840 filing requirement applies to all taxpayers, including individuals, partnerships, LLCs, corporations, estates, trusts, and exempt organizations. The requirement applies to residents and nonresidents. The form is required for exchanges involving real property; taxpayers who exchange only personal property assets are currently not required to file Form FTB 3840.

***Comment***

The FTB has scheduled interested parties meetings to discuss how to report exchanges of tangible personal property. The interested parties meetings are the beginning of a regulation project, which will solidify filing requirements. Thus, there will be no filing requirement for 2016 returns.

### Disposition of property

Form 3840 must be filed each year by the owner(s) of the property. If the property changes hands due to divorce, gifting, or contribution of the property to an entity, the taxpayer who owns the property must file Form FTB 3840.

***Example of property changing hands***

Jenna and Jeff exchanged a piece of jointly owned California rental property in 2014 for property in Nevada. In 2015, they separate and file for divorce. They file separate returns in 2015. They divorce in December 2016, and he gets 100% of the property in the divorce. Here are the Form FTB 3840 filing requirements:

- **2015:** Each reports one-half of the deferred gain on their own Form FTB 3840; and
- **2016:** Jeff files Form FTB 3840, reporting 100% of the gain. Jenna files Form FTB 3840 and checks the box showing she is no longer required to file Form FTB 3840 and explains that Jeff received the property in the divorce and he will report the deferred gain.

In the year a taxpayer is deceased, the executor must file Form FTB 3840, check the final box, and indicate the death of the previous owner.

## Filing required even if no normal filing requirement

The information return must be filed for the year in which the exchange is completed and each subsequent year until the gain is fully recognized, regardless of whether the seller/exchanger has any other California franchise tax, income tax, or information return filing requirement.

If the taxpayer does not have a filing requirement, the form may be filed as a stand-alone form. You may e-file the income tax return that includes the form. If filing Form FTB 3840 alone, you must paper file the form.

### What goes on the form?

Form FTB 3840 asks for much of the same information as reported on the federal Form 8824, Like-Kind Exchanges, including computation of the realized and recognized gain and basis computation of the new property. California's form also includes additional information, including percentages of ownership and apportionment information. California also asks for the address or parcel number of the property rather than "description" requested on the federal form.

### Penalty for failure to file

If the taxpayer fails to report the exchange in the year of the transaction or any subsequent year, the FTB **may**, in the year the form was not filed, estimate net income — using any available information — and issue a Notice of Proposed Assessment on the previously deferred gain plus applicable penalties and interest.

## Recent questions and clarifications

Because the form and the filing process are still fairly new, we have been receiving questions from subscribers on the intricacies of filing.

The following are questions from Spidell customers on how a subsequent exchange affects the filing process, and how to report exchange expenses on the form. The questions are followed by information provided by the FTB's legal department.

### Subsequent like-kind exchange

**Q:** In 2014, a partnership sold property in California and did a like-kind exchange for multiple out-of-state properties. Form 3840 was filed. In 2015, one of the multiple out-of-state replacement properties was exchanged for another out-of-state replacement property.

How should the 2015 like-kind exchange be reported on Form 3840?

**A:** The exchange completed in 2014 results in California deferred gain, which is reported on the Form 3840. The California deferred gain allocated to each replacement property will carry over to any future replacement properties when properties from the original exchange are relinquished in a future exchange. The new replacement property will receive the same allocated deferred gain.

To report the subsequent exchange, the FTB recommends the taxpayer attach a second page 2 to the previously filed Form 3840 (i.e., a combined Form 3840) and include the address of the property given up and the address of the new replacement property. The "allocation of California-source deferred gain to properties received," line 10, for the new replacement property will be the same as the line 10 allocated deferred gain to the specific replacement property that was exchanged. It is not necessary to complete Schedule A lines 2–7 for the property given up.

It is important to note, however, that any "boot" recognized in the later exchange would result in recognition of the California previously deferred gain, and thus, would change the amounts reported on page 2, line 10 of Form 3840.

***Example of subsequent exchange***

In 2015, Derrick exchanged a California apartment building for three plots of land in New Jersey and deferred $300,000 of gain ($100,000 was allocated to each plot of land on the Form FTB 3840).

In 2016, he exchanged one of the plots of New Jersey land for an apartment building in Maine. As part of the exchange, he received $10,000 boot.

He must continue to file the original Form FTB 3840 with California, even though one of the New Jersey properties was subsequently exchanged. He will report the subsequent exchange on a second attached page 2 of Form FTB 3840.

He will report the $10,000 boot received in Part 2 of Form FTB 3840.

### Exchange expenses

**Q:** I am concerned about Form 3840 and reporting selling expenses on Schedule A line 4, which asks for selling expenses but not exchange expenses. Is this creating a difference between what is reported on the IRS Form 8824?

This seems to be in conflict with California's conformity to IRC §1031, which includes those exchange expenses. By not including the exchange expenses on the new property, you could be creating a taxable gain for California — not federal.

Do I need to file a statement explaining this difference, or will the FTB be aware of what is creating the difference? The Form 3840 instructions for line 4 indicate that the line should include only the expenses of sale on the California property, not including qualified intermediary (QI) fees or expenses of buying the replacement property — all of which also are included in exchange expenses in the exchange computation.

Is this the correct interpretation of the instructions? QI fees would arguably be part of the cost of sale, which should be deductible from the gain.

**A:** California conforms to IRC §1031 and allows exchange expenses in calculating recognized and deferred gain in an exchange. According to the FTB, other than what is already requested, there is no need to file a statement explaining differences between the numbers provided in Form 3840 and Form 8824.

You should not be concerned because Form 3840 calculates "deferred gain" for California purposes on Side 2, Schedule A, line 8, and should have included the exchange expenses. California is not creating additional taxable gain on the sale of the relinquished property in the exchange. The exchange expenses are taken into account on federal Form 8824 at lines 15 or 18, before realized and recognized gain are determined.

The purpose of Form 3840 is to provide the FTB with information on the exchanges of California properties so that when an out-of-state replacement property is sold, previously deferred gain can be identified, as well as to specifically identify the source(s) of those deferred gains if multiple relinquished properties are included in a single like-kind exchange. The purpose of Form 3840 is not to identify or report recognized gain of the relinquished property.

The FTB believes the form accomplishes its intended purpose, and in an effort to keep Form 3840 as simple as possible, the FTB excluded exchange expenses from the schedule on Side 2, Schedule A. However, they will be revisiting the phrasing of the instructions to take into account this concern.

## FTB'S §1031 AUDITS

Over the past few years, the FTB has maintained a major audit program targeting §1031 exchanges. The FTB says they don't audit *every* exchange, but they do *look at* every return where the taxpayer reported a §1031 exchange.

Common issues include:

- Gains not being properly sourced to California upon disposition of non-California replacement property received in a California deferred exchange;
- Taxpayers who fail to report other property (boot) in the exchange;
- Taxpayers who do not meet identification or other technical requirements of IRC §1031;
- Relinquished and/or replacement property is not held for investment or for productive use in a trade or business (i.e., property is used for personal purposes or is held primarily for sale); and
- The taxpayer who transfers relinquished property is a different taxpayer than the party who acquires replacement property.

**✎ Practice Pointer**

Be sure you advise your clients to keep all documentation because the FTB will likely audit the §1031 exchange on the tax return. In fact, they should keep all information on the exchange and property involved until there is a final disposition and reporting of deferred gain.

This is evidenced by the §1031 cases we have seen recently.

## Board of Equalization decisions

### Exchange of TIC interests

The Board unanimously held that an exchange of numerous taxpayers' tenants-in-common interests in an apartment building for equivalent tenant-in-common ownership interests in a shopping mall and its surrounding property was a valid IRC §1031 like-kind exchange, even though the owners subsequently transferred the property to an LLC. (***Appeal of Rago Development Corp. et al.*** (June 23, 2015) 2015-SBE-001)

### Angry member demands cash

An IRC §1031 exchange failed when a taxpayer constructively received the proceeds from the sale of the original property while the proceeds were being held by the intermediary. (***Appeal of Korman***, Cal. St. Bd. of Equal., No. 680322 Not yet published 2015)

The taxpayer, Metro LLC, was owned equally by two members, Esther and Lieb. The LLC sold a California property and was in the process of purchasing another property in Arizona as part of a §1031 exchange. Metro entered into an exchange agreement with an intermediary, Windsor Exchange Corp., and under the terms of the agreement, and as required by regulation, the proceeds from the California property sale were treated as Windsor's "sole and exclusive property" until the closing date of the exchange.

During the period of the exchange, Lieb insisted that he be bought out of the LLC and threatened to sue both Esther and Windsor if he did not receive almost $3 million from the sale proceeds. An amendment to the agreement with Windsor, signed by both members but not by Metro and Windsor, stated that Lieb had left Metro, that he had assigned his rights to Esther, and that Windsor could pay him his share of the proceeds.

Esther argued that she did not direct Windsor to pay out the funds and that Windsor paid Lieb because they did not want to be sued. She claimed that neither she nor Metro received any funds and that they continued to complete the exchange and therefore should not be penalized by Lieb's and Windsor's actions. However, the Board ruled that because the funds were released, it demonstrated that the LLC did in fact have constructive receipt of the funds, and therefore the exchange failed.

### Was it an exchange at all?

A like-kind exchange treatment was disallowed because the taxpayer received the cash from the transaction. (***Appeal of Howard B. Han and Seung W. Han*** (April 24, 2013) Cal. St. Bd. of Equal., Case No. 577081)

It was a stretch whether like-kind property was even involved in this case. Han sold corporate stock and then purchased an annuity with the proceeds. He tried to argue that even though the statute excludes stock from like-kind treatment, it represented his entire interest in his business.

The larger problem was that the taxpayer held the cash during the exchange. He tried to argue this point too, claiming the FTB interpreted the term "exchange" too narrowly, and that the courts have given IRC §1031 a liberal interpretation and allowed taxpayers some latitude in structuring an exchange if the parties truly intended to have one. Sorry, no good — he took receipt of unrestricted cash consideration for the sale of stock. It was a taxable sale.

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Tax • Analysis • Education

Chapter 9

# Tax Reform: Comparison and California Reaction

# TAX REFORM: COMPARISON AND CALIFORNIA REACTION

## THE PRESIDENT-ELECT'S TAX PLAN

Donald Trump's election victory, along with Republican control of both houses of Congress, means that there will likely be big changes in tax law coming soon. Trump will be inaugurated on January 20, 2017, and considering the "100-day rule" (i.e., much of what a president accomplishes is done in the first 100 days), we can expect the tax law changes to be swift. Whether those changes will be effective in the 2017 or 2018 tax years is unknown at this time, but the effective dates of any changes would likely be spread over those two years.

In reviewing Trump's tax plans, two points should be kept in mind:

- His tax plans are largely broad-brush, with few specifics. The plan is briefly stated on his website, and he didn't fill in many details in his campaign speeches; and
- The House GOP has its own "A Better Way" tax reform blueprint (see page 9-5). While that blueprint shares some similarities with Trump's proposals, there are also many differences. Compromise will be likely if a quick consensus cannot be reached.

For more information on the President-elect's plan, go to:

**Website**
www.donaldjtrump.com/policies/tax-plan

### BASIC INDIVIDUAL TAX CHANGES

Trump's plan would collapse the current seven tax brackets to three brackets:

| Proposed Tax Brackets | | |
|---|---|---|
| **Tax rate** | **Married filing joint** | **Single** |
| 12% | Less than $75,000 | Less than $37,500 |
| 25% | $75,000–$225,000 | $37,500–$112,500 |
| 33% | More than $225,000 | More than $112,500 |

*Comment*

These rates correspond somewhat closely to current rates, with the exceptions of the current 35% and 39.6% rates. For example, the current 25% rate for married filing joint kicks in at taxable income of $75,300, whereas under the Trump plan it would be $75,000. The 33% rate under current law begins at $231,400, versus $225,000 under the Trump plan. However, under current law there's an in-between rate of 28% that starts at $151,900.

Further changes to basic individual taxation would:

- Eliminate personal and dependent exemptions;
- Eliminate the head of household filing status; and
- Increase the standard deduction to $30,000 for joint filers and $15,000 for single filers.

***Comment***

The increase in the standard deduction means that many taxpayers who currently itemize would no longer itemize. This is likely to remain true as long as mortgage interest rates are low and taxpayers pay relatively little in home mortgage interest.

Also, the increase in the standard deduction would likely mean that most low- to mid‑income taxpayers will have a slightly reduced tax burden. However, with the loss of head of household filing status and the loss of exemptions, a single parent would likely pay more, especially if that single parent has more than one dependent child.

***Example of single parent***

Bruce is a single parent who has two dependent children. He files as head of household, has salary income of $70,000, and takes the standard deduction.

For 2016, his taxable income is $48,500, consisting of his $70,000 income less three exemptions of $12,150 (3 × $4,050) and less his standard deduction of $9,300. He is in the 15% tax bracket. His tax liability is $6,620.

Under the Trump tax plan, his taxable income is $55,000 consisting of his $70,000 income less his standard deduction of $15,000. He is in the 25% tax bracket. His tax liability is $8,875.

## OTHER INDIVIDUAL TAX CHANGES

Other individual tax changes proposed under the Trump tax plan would:

- Cap itemized deductions at $200,000 for joint filers and $100,000 for singles;
- Eliminate the alternative minimum tax; and
- Specifically eliminate the 3.8% net investment income tax. However, under other portions of his platform, Trump intends to repeal the Affordable Care Act (ACA). This would presumably also eliminate the 0.9% Additional Medicare Tax, the penalty for not having insurance, the Premium Tax Credit, and other taxes under the ACA.

The existing capital gains rate structure (maximum rate of 20%) would be retained "with new tax brackets."

***Comment***

It is not clear what capital gains rates would be associated with what new tax brackets. Under current law, capital gains are taxed at a 0% rate for taxpayers in the 10% and 15% tax brackets, 15% for the 25%–35% brackets and 20% for taxpayers in the 39.6% tax bracket. Obviously, those tax brackets do not correspond to the tax brackets under Trump's plan.

 

# CHILD AND ELDER CARE

The Trump plan puts a great deal of emphasis on child care and elder care, proposing to replace the current Child and Dependent Care Credit with a more complex but broader system.

Eligible taxpayers would get an above-line deduction for child care for children under age 13 and for elder care for a dependent parent. The deduction would be available to families who "use" stay-at-home parents or grandparents to provide the child care.

There are several limitations on the deduction:

- No deduction would be available to taxpayers with "total income" over $500,000 for joint filers or $250,000 for single filers;
- The deduction for child care would be limited to four children per taxpayer;
- The deduction for child care would be limited to the "state average for a child of the child's age"; and
- For elder care, the deduction would be capped at $5,000 per year, indexed for inflation.

For lower-income individuals who would not benefit from the deduction, the plan would offer spending rebates for child care expenses through the Earned Income Tax Credit. The rebate would be equal to 7.65% of "remaining" eligible child care expenses subject to a cap of half of the payroll taxes paid by the taxpayer; in a two-earner household, the cap would be based on the lower-earning parent. This rebate would be available to joint filers earning $62,400 or less, or single taxpayers earning $31,200 or less.

***Comment***

The child care benefits might significantly offset the increase in tax for single parents noted in the previous discussion and example.

In addition, the plan would create a new Dependent Care Savings Account (DCSA) for the benefit of specified individuals including unborn children. Total annual contributions are limited to $2,000 per year. When established for children, funds remaining in the account when the child reaches age 18 could be used for education expenses.

***Comment***

Whether there would be a deduction for contributions or whether income in the account would be tax-deferred or tax-free is not clear. The accounts would likely work much like Health Savings Accounts.

To encourage lower-income families to establish DCSAs for their children, the government would provide a 50% match on parental contributions of up to $1,000 per year. Apparently, this government match would be made in the form of a refundable tax credit administered through the Earned Income Tax Credit.

***Comment***

Eliminating dependent exemptions and the head of household filing status has the potential to eliminate the complex rules that determine who is a dependent and who gets to claim the dependent. However, with the EITC and the child care rules, that difficult determination is still in play. It is not clear at this time whether IRC §152 (Dependent Defined) will be retained along with all of the regulations, rulings, and court cases under that provision.

## BUSINESS PROVISIONS

There are several provisions benefitting business taxpayers. Chief among those provisions is that the plan would lower the "business tax rate from 35% to 15%." Further, this provision provides that "this rate is available to all businesses, both large and small, that want to retain the profits within the business."

***Comment***

As broad-brush as many of the plan's provisions are, this one is causing considerable speculation. The provision is simple when applied to a C corporation. But the phrase "is available" seems to imply that other business entities could elect to be treated like a C corporation. It would seem to mean that a partnership, for example, could elect to pay a 15% tax at the partnership level with the partners paying tax on distributions. Whether any such election would be made on an annual basis or whether the election, once made, is in effect for all future years is not clear at all.

Moreover, the phrase "all businesses" would seem to indicate that even sole proprietors operating Schedule C businesses could take advantage of the 15% rate.

## BUSINESS TAX INCENTIVES

The Trump plan would raise the IRC §179 expensing cap from $500,000 (adjusted for inflation) to $1 million. Moreover, businesses engaged in manufacturing in the U.S. could make an election to expense all equipment purchases and lose the deductibility of interest expense. The election could only be revoked within the first three years of making the election.

The plan would eliminate "most corporate tax expenditures," except for the Research and Development Credit. The phrase "most corporate tax expenditures" is not defined. The plan also would greatly enhance tax benefits for on-site child care expenses and for businesses that pay a portion of an employee's child care expenses.

## DEATH TAXES

The Trump plan states: "The Trump Plan will repeal the death tax, but capital gains held until death and valued over $10 million will be subject to tax to exempt small businesses and family farms."

***Comment***

It is impossible to interpret that sentence because of its many grammatical errors. The final clause beginning with "to exempt" implies that that final clause is the result of what precedes it, but there's nothing in what precedes it that leads to the conclusion of the final clause. And, strictly read, "valued over $10 million" refers to the amount of capital gains, not the value of the estate. So, does that mean that an estate with built-in gain of more than $10 million will be taxed and, if so, at what rate and when?

The most common interpretation is that if an estate has a valuation of more than $10 million, the estate will be taxed on its built-in gains at the capital gains rate of 20%. It appears to be a cliff test. It is assumed that after paying the tax, the heirs will receive the assets at a stepped-up basis.

Another interpretation is that if the estate has a value of more than $10 million, the heirs will pay tax when they sell the assets. This interpretation means that the heirs receive the assets without a stepped-up basis. Apparently, if the estate has a value of under $10 million, the heirs receive the assets with a stepped-up basis.

# THE GOP'S "A BETTER WAY" TAX PLAN

In addition to President-elect Trump's tax plan, House Republicans have produced their own tax blueprint as part of their "A Better Way" plan for the country. We can expect rapid tax law changes in at least those areas where Donald Trump and the House GOP agree.

To read more about the House GOP plan, go to:

**Website**
http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf

## GOP TAX REFORM GOALS

The GOP's plan states that one of its primary goals is simplification of the tax code to the point where most Americans can prepare their own taxes "on a form as simple as a postcard."

*Sample "postcard" tax form*

The GOP blueprint contains a simple, 14-line postcard tax form as an example of the sweeping simplification it creates.

**SIMPLE, FAIR "POSTCARD" TAX FILING**

| | | | |
|---|---|---|---|
| 1 | Wage and compensation income | 1 | |
| 2 | Add 1/2 of investment income | 2 | |
| 3 | Subtract contributions to specified savings plans | 3 | |
| 4 | Subtract standard deduction OR | 4 | |
| 5 | Subtract mortgage interest deduction | 5 | |
| 6 | Subtract charitable contribution deduction | 6 | |
| 7 | Taxable income | 7 | |
| 8 | Preliminary tax (from tax table) | 8 | |
| 9 | Subtract child credit | 9 | |
| 10 | Subtract earned income credit | 10 | |
| 11 | Subtract higher education credit | 11 | |
| 12 | Total tax | 12 | |
| 13 | Subtract taxes withheld | 13 | |
| 14 | **Refund due / taxes owed** | 14 | |

## TAX RATES FOR INDIVIDUALS

Like Trump's plan, the GOP plan would consolidate the seven current individual tax brackets into three at 12%, 25%, and 33%. The blueprint does not define at what taxable income level each rate kicks in, but we can expect the tax rates to largely follow current taxable income amounts:

- The 12% rate would replace the current 10% and 15% rates;
- The 25% rate would replace the current 25% and 28% rates; and
- The 33% rate would replace the current 33%, 35%, and 39.6% rates.

According to the GOP plan, because of the increased standard deduction (discussed below), taxpayers who are currently in the 10% bracket "always will pay lower taxes than under current law."

## REDUCED TAX ON INVESTMENT INCOME

The GOP blueprint would reduce taxes on investment income by allowing taxpayers to exclude 50% of their net capital gains, dividends, and interest income, leading to effective rates of 6%, 12.5%, and 16.5% on investment income.

## SHIFTING FAMILY TAX DEDUCTIONS

The tax code currently includes five basic family tax deductions and credits:

- Basic standard deduction;
- Additional standard deduction;
- Personal exemptions for taxpayer and spouse;
- Personal exemptions for dependents; and
- Child Tax Credit.

The GOP plan would consolidate these deductions and credits into a larger standard deduction and an enhanced Child Tax Credit. The stated purpose is to simplify these deductions and credits while achieving the same policy and distributional goals as current law. The GOP proposed standard deductions are:

| | |
|---|---:|
| Married filing joint | $24,000 |
| Single with child in household | $18,000 |
| Single | $12,000 |

The Child Tax Credit is currently $1,000 and phases out for individual taxpayers earning over $75,000 and joint filers earning over $110,000. To the extent the Child Tax Credit exceeds the taxpayer's tax liability, the taxpayer is eligible for a refundable credit equal to 15% of earned income in excess of $3,000. Taxpayers are not required to provide the child's Social Security number to claim the refundable portion of the credit, which has led to substantial fraud.

The GOP plan would increase the Child Tax Credit to $1,500 with only the first $1,000 refundable. A new nonrefundable $500 credit would also be allowed for nonchild dependents. Additionally, married couples would not see either of these credits phased out until their earnings reach $150,000. By increasing the phase out threshold to double the individual threshold of $75,000, the GOP's plan would eliminate the marriage penalty as it applies to the Child Tax Credit.

## TAX BENEFITS FOR HIGHER EDUCATION

The GOP blueprint would consolidate the different education credits and deductions into a single higher education credit and expand qualified expenditures to include vocational training. The plan also includes savings incentives for §529 plans and other tax relief targeted at helping low- and middle-income taxpayers, but there are no details.

## INDIVIDUAL EXCLUSIONS AND DEDUCTIONS

In conjunction with the increased standard deduction, the GOP plan would eliminate all itemized deductions except the home mortgage interest deduction and the charitable contribution deduction.

Even though the GOP plan keeps these two deductions, many taxpayers who currently itemize would not have enough charitable contributions and mortgage interest to overcome the larger standard deduction. For homeowners on the lower end of the tax scale, tax practitioners and real estate professionals may find themselves performing more rent versus buy analyses for their clients.

## AFFORDABLE CARE ACT

The GOP has made repeal of the ACA one of its priorities, including repeal of the:

- 3.8% net investment income tax;
- 0.9% additional Medicare surcharge;
- Excise tax on medical devices;
- Tax on Cadillac health plans; and
- Penalties associated with individual and employer mandates.

## OTHER INDIVIDUAL PROVISIONS

The GOP plan would also:

- Eliminate the alternative minimum tax (AMT);
- Continue the Earned Income Tax Credit (EITC);
- Continue incentives for retirement savings, such as the current structure for contributions to IRAs, 401(k) plans, and all other retirement savings arrangements; and
- Completely repeal the estate and generation-skipping transfer taxes (aka the "death tax").

## TAX RATES FOR SMALL BUSINESSES

For businesses, the GOP plan would create a new 25% maximum tax rate for small businesses that are organized as sole proprietorships or passthrough entities, which means that small business income would no longer be subject to the proposed top individual tax rate of 33%.

However, similar to S corporations that are required to pay reasonable compensation, the GOP blueprint would treat sole proprietors and partners as having paid themselves reasonable compensation, which would be subject to the individual rates, before the maximum business rate of 25% takes over. How this provision would be implemented or enforced is unclear.

## TAX RATES FOR LARGE BUSINESSES

For large businesses, the GOP blueprint would reduce the tax rate for C corporations to a flat 20%. Earnings distributed from C corporations would still be double-taxed, but the burden would be severely diminished with the 50% exclusion on investment income of individuals, discussed earlier.

## FULL AND IMMEDIATE WRITE-OFF OF TANGIBLE AND INTANGIBLE ASSETS

In addition to reducing tax rates for businesses, the GOP blueprint would allow businesses the benefit of full and immediate write-offs of investments in both tangible and intangible assets. According to the GOP plan, this approach to cost recovery is equivalent to a 0% tax rate on new investment and would be a move toward taxation based on business cash flow.

## INTEREST EXPENSE

Interest expense would be allowed against interest income, but no current deduction would be allowed for net interest expense. This is a trade-off for allowing full and immediate write-offs for investments. The GOP plan states that it will work to develop special rules with respect to interest expense for financial services companies, such as banks, insurance, and leasing, which will take into account the role of interest income and expense in their business models.

## NET OPERATING LOSSES

Net operating losses would be allowed to be carried forward indefinitely and would be increased by an interest factor that compensates for inflation and a real return on capital to maintain the value of amounts that are carried forward. NOL carrybacks would not be permitted, and the deduction allowed with respect to an NOL carryforward in any year would be limited to 90% of the net taxable amount for such year determined without regard to the carryforward.

## BUSINESS DEDUCTIONS AND CREDITS

Without much detail, the GOP blueprint states that the tax code contains too many special interest deductions and credits that are designed to encourage particular business activity and that those provisions create incentives for businesses to make decisions because of the tax consequences rather than because of the underlying economics. The blueprint states that it feels the special interest provisions are a source of both complexity and controversy because such provisions adversely affect the public's confidence in the fairness of the tax system.

Even though not many details were provided, the blueprint does single out the domestic production activities deduction of IRC §199 as no longer necessary under the GOP plan. However, the blueprint would continue the Research and Development Credit.

## OTHER BUSINESS PROVISIONS

The plan would also:

- Eliminate the corporate alternative minimum tax (AMT); and
- Preserve the last in, first out (LIFO) method of accounting.

## PLAN SIMILARITIES

The House GOP's "A Better Way" plan shares these similarities with the Trump plan:

- A reduction of the top tax rate to 33% with three tax brackets;
- The elimination of the AMT;
- A larger standard deduction;
- A reduction of the corporate tax rate to 20%; and
- Repealing the ACA and, as a result, the tax provisions that go along with it.

The Trump plan is significantly different from the "Better Way" plan in that it would:

- Continue the EITC but look for ways to improve it;
- Eliminate all itemized deductions except for home mortgage interest and charitable contributions;
- Completely repeal the estate tax; and
- Allow interest expense to be deducted by businesses only against interest income.

## California conformity

What will happen with California's tax system if Congress follows the Trump tax plan, the GOP's "A Better Way" tax plan, or a combination of the two?

In California, we like to make our own decisions, not necessarily following federal tax changes. At first blush, California would likely not conform to a major federal tax overhaul. But there does appear to be some interest in at least partial conformity.

Although the Legislature is talking about circumventing federal policies in the areas of immigration and the environment, comments made by those in the know appear to open the door for at least some tax conformity.

For example, state Finance Director Michael Cohen said that California can't just go its own way and ignore the federal tax changes. He has stated that state officials must be nimble in reacting to whatever comes out of Washington.

In general, we believe California will conform to some provisions, but conformity would not likely happen right away. So we would potentially have a year or two of big differences, depending on what really happens in Washington.

# TAX PLAN COMPARISON CHART

<table>
<tr><th colspan="7">Tax Plan Comparison Chart</th></tr>
<tr><th></th><th colspan="3">Trump</th><th colspan="2">House GOP</th><th>California</th></tr>
<tr><td colspan="7">Individuals</td></tr>
<tr><td rowspan="4"></td><td>Tax rate</td><td>Joint</td><td>Single</td><td>Tax rate</td><td>Current brackets replaced</td><td rowspan="4">California tax rates are not tied to federal rates, and California does not have a reduced capital gain rate</td></tr>
<tr><td>12%</td><td>< $75,000</td><td>< $37,500</td><td>12%</td><td>10% / 15%</td></tr>
<tr><td>25%</td><td>$75,000–$225,000</td><td>$37,500–$112,500</td><td>25%</td><td>25% / 28%</td></tr>
<tr><td>33%</td><td>> $225,000</td><td>> $112,500</td><td>33%</td><td>33% / 35% / 39.6%</td></tr>
<tr><td>Filing status</td><td colspan="3">Eliminates head of household and contemplates two filing statuses:<br>• Married filing joint; and<br>• Single</td><td colspan="2">Contemplates three filing statuses:<br>• Married filing joint;<br>• Single with child in household; and<br>• Single</td><td>California generally conforms to federal filing statuses. We believe California would not eliminate the head of household filing status</td></tr>
<tr><td>Personal and dependent exemptions</td><td colspan="3">Eliminates in lieu of higher standard deduction</td><td colspan="2">Eliminates in lieu of higher standard deduction</td><td>California has exemption and dependent credits. These could possibly be reduced or eliminated if done in conjunction with a higher standard deduction</td></tr>
<tr><td>AMT</td><td colspan="3">Eliminates</td><td colspan="2">Eliminates</td><td>We don’t believe California would eliminate the AMT</td></tr>
<tr><td>Investment income</td><td colspan="3">Maintains capital gain structure with new tax brackets</td><td colspan="2">50% excluded from gross income (presume elimination of capital gain rates as trade-off for 50% exclusion)</td><td>We don’t believe California would conform here</td></tr>
<tr><td>Standard deduction</td><td colspan="3">Increased to:<br>• $30,000 joint return; and<br>• $15,000 single</td><td colspan="2">Increased to:<br>• $24,000 married filing joint;<br>• $18,000 single with child in household; and<br>• $12,000 single</td><td>California could increase the standard deduction, possibly in conjunction with changes in exemption credits</td></tr>
<tr><td>Itemized deductions</td><td colspan="3">Maintains current deductions but caps them at:<br>• $200,000 joint return; and<br>• $100,000 single</td><td colspan="2">Eliminates all itemized deductions except home mortgage interest and charitable contributions</td><td>California could cap the itemized deductions. Note that if only mortgage interest and charitable contributions were allowed, Californians would suffer an increase in federal tax due to the loss of the state income tax deduction</td></tr>
<tr><td colspan="7">(continued)</td></tr>
</table>

| Tax Plan Comparison Chart (continued) | | | |
|---|---|---|---|
| | **Trump** | **House GOP** | **California** |
| **Individuals (continued)** | | | |
| Children and dependents | • Replaces Child and Dependent Care Credit with broader system;<br>• Creates above-line deduction for child care for children under age 13 and for elderly dependents;<br>• Makes deduction available where stay-at-home parent or grandparent is caregiver;<br>• Phase out when income is over $250,000 ($500,000 for joint filers);<br>• Limited to four children;<br>• Limited to the "state average" for the child's age; and<br>• Elder care deduction capped at $5,000 annually, indexed for inflation | • Increases Child Tax Credit to $1,500 (only $1,000 refundable);<br>• Creates $500 nonrefundable credit for nonchild dependents; and<br>• Increases phase out threshold for joint filers to eliminate marriage penalty | California does not have a child credit. However, if dependent credits were eliminated, the state could enact a child credit |
| Earned income credits | Modifies and expands | Silent | We believe California could expand the EITC |
| Higher education expenses | Mostly silent, but adds Dependent Care Savings Account (DCSA) to help save for education — government-provided matching contributions available for low income taxpayers | Simplifies and consolidates various deductions and credits into a single credit and expands eligible expenditures to include vocational training | California has not conformed in the past |
| Retirement savings | Silent | Maintains current tax benefits for contributions to 401(k)s, IRAs, and all other retirement savings arrangements | California automatically conforms to federal law in these areas |
| Estate taxes | Repeals (sort of) — exception for capital gains held until death in excess of $10,000,000 | Full repeal | N/A |
| ACA provisions | Repeal, including:<br>• 3.8% NIIT;<br>• 0.9% Medicare tax;<br>• Cadillac tax;<br>• Medical expense excise tax; and<br>• Penalties for individual and business mandates | Repeal, including:<br>• 3.8% NIIT;<br>• 0.9% Medicare tax;<br>• Cadillac tax;<br>• Medical expense excise tax; and<br>• Penalties for individual and business mandates | N/A |
| | | | *(continued)* |

| Tax Plan Comparison Chart (continued) | | | |
|---|---|---|---|
| | **Trump** | **House GOP** | **California** |
| **Businesses** | | | |
| Tax rates (Schedule C and flow-throughs) | 15% maximum rate, including flow-throughs and sole proprietors | 25% maximum rate, but caveat that flow-throughs and sole proprietors deemed to pay reasonable compensation (prevents partners/sole proprietors from totally avoiding 33% tax rate) | We doubt California would conform to any of the business changes, except as noted |
| Tax rates (C corporations) | 15% maximum rate | 20% flat rate | See above |
| AMT | Eliminated | Eliminated | See above |
| Depreciation | • Increased IRC §179 to $1,000,000; and<br>• Available election for manufacturers for immediate expensing of 100% of equipment | 100% immediate expensing of all tangible and intangible property (unclear if includes real property and probably does not include land) | See above |
| Interest expense | If manufacturer elects 100% immediate expensing of equipment, then no interest deduction is allowed | Only deductible to the extent of interest income (trade-off for allowing 100% immediate expensing of property) | See above |
| NOLs | Silent | • Carry forward indefinitely;<br>• No carryback;<br>• Utilization limited to 90% of net taxable income; and<br>• Annual inflation adjustments | California could eliminate the carryback and California has suspended NOLs in the past |
| Inventory | Silent | Preserves LIFO inventory method | California conforms to LIFO inventory method |
| Other deductions | Eliminates "most corporate tax expenditures," but does not define what that means | Eliminates most "special interest" deductions. Does not define what "special interest" deductions are, but does single out domestic production activities deduction (DPAD) as an example | We believe California could conform to these provisions |
| Credits | Continues R&D credit, but expect elimination of most others | Continues R&D credit, but expect elimination of most others | California will likely retain its own credits |
| On-site child care | Enhanced benefits for employers that pay child care expenses for employees | Silent | California let child care credits expire |
| Repatriation of corporate profits | 10% tax on deemed repatriation of corporate profits | Silent | N/A |
| **Note:** Where either plan is silent, it can be assumed that it does not seek to change current law | | | |

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Chapter 10

# California Legislation and Conformity

# CALIFORNIA LEGISLATION AND CONFORMITY

## LEGISLATION OF INTEREST

### NO BILL FOR SALES TAX ON SERVICES THIS YEAR

California's sales tax on services bill, SB 1445 (Hertzberg), was not enacted this year.

However, we expect that this tax proposal will probably return in some form next year, and we will keep you posted on any developments. Currently, four states (Hawaii, New Mexico, South Dakota, and West Virginia) tax almost all services. With all states desperate for money, that list is likely to grow in the not too distant future.

### BALLOT INITIATIVES

| Notable Tax-Related Initiatives Passed in 2016 | |
|---|---|
| **Initiative** | **Description** |
| **Proposition 55:** Tax extension to fund education and healthcare | Proposition 55 extends for an additional 12 years the "temporary" 1% to 3% surtax imposed on incomes above $250,000 that voters approved when they passed Proposition 30 in 2012. The revenues will be directed to K–12 education, community colleges, and government healthcare programs |
| **Proposition 64:** Marijuana legalization | Proposition 64 legalizes recreational marijuana for use by adults age 21 or older. Excise taxes of 15% will be imposed on retail sales of recreational marijuana, as well as state cultivation taxes of $9.25 per ounce of flowers and $2.75 per ounce of leaves. Most of these funds will be required to be spent for specific purposes such as youth programs, environmental protection, and law enforcement. The proposition also allows for local regulation and taxation of marijuana, and allows for resentencing and expungement of records for prior marijuana convictions. For more information on Proposition 64, see the discussion beginning on page 14-18 |
| **Proposition 67:** Ban on single-use plastic bags | Proposition 67 implements SB 270 (Ch. 14-850), which prohibits grocery and other stores from providing customers with single-use plastic or paper carryout bags and requires these stores to charge at least 10 cents for any other carryout bag provided for customers at checkout. Revenues would be used by the stores to cover compliance and educational outreach |

# VETOED LEGISLATION

| Bills Vetoed in 2016 | |
|---|---|
| **Bill No.** | **Description** |
| AB 567 | Would have enacted a six-month sales and use tax amnesty program for medical cannabis-related businesses. The Governor stated it was too early to enact this legislation |
| AB 717 | Would have enacted a new state and local sales and use tax exemption for sales and purchases of diapers for infants and toddlers. The Governor stated all new tax breaks should be considered as part of budget negotiations. Estimated revenue loss for the exemption was $36.3 million per year |
| AB 724 | Would have exempted from state sales and use taxes, sales of tangible personal property purchased by the Jimmy Doolittle Air and Space Museum Education Foundation to be used exclusively for display purposes within the museum. The Governor stated all new tax breaks should be considered as part of budget negotiations. The BOE estimated a one-time state and local revenue loss of $39,000 |
| AB 1561 | Would have enacted a new state and local sales and use tax exemption for sales and purchases of tampons, sanitary napkins, menstrual sponges, and menstrual cups. The Governor stated all new tax breaks should be considered as part of budget negotiations. Estimated revenue loss for the exemption was $20 million per year. Bill sponsor plans to work with Governor to include this provision in next year's budget bill |
| AB 1952 | Would have made numerous changes to the Senior and Disabled Citizens Property Tax Postponement (PTP) Program, including augmenting the amount of funds provided from the general fund in case of shortfalls |
| AB 2365 | Would have provided an exclusion from the computation of sales or use tax of pawnbroker's receipts derived from a transaction where customers buy back their property after defaulting on a loan. The Governor stated all new tax breaks should be considered as part of budget negotiations. Estimated revenue loss for the exemption was $33,000 |
| AB 2728 | Would have extended the Community Development Financial Investment Credit for an additional year. The Governor stated all new tax breaks should be considered as part of budget negotiations. Estimated revenue loss for the exemption was $3.8 million per year |
| ABX2 10 | Would have authorized county board of supervisors to impose a local tax on cigarettes and tobacco products |
| SB 526 | Would have allowed a court in a divorce proceeding to assign complete income tax liability to one party |
| SB 898 | Would have enacted a sales and use exemption for sales and purchases of animal blood. The Governor stated all new tax breaks should be considered as part of budget negotiations. Estimated revenue loss for the exemption was $80,000 |
| SB 907 | Would have retroactively extended the exclusion for COD on a qualified principal residence (see pages 1-13 and 8-1) |
| SB 1304 | Would have allowed for retroactive property tax assessments for those affected by the Porter Ranch gas leak and would have expanded the basis for future tax relief in similar circumstances. The bill specified that "damage" includes a diminution in the value of property as a result of environmental contamination. The Governor stated that county assessors already have the ability to reduce assessed values due to change in market conditions |

 

# ENACTED LEGISLATION

| Bills Enacted in 2016 (Assembly) | | |
|---|---|---|
| **Bill No.** | **Chapter No.** | **Description** |
| AB 691 | Ch. 16-551 | Enacts the Revised Uniform Fiduciary Access Act, which authorizes a decedent's personal representative or trustee to access and manage a person's digital assets and electronic communications |
| AB 821 | Ch. 16-811 | Authorizes until January 1, 2022, medical cannabis dispensaries to remit sales and use taxes by means other than electronic funds transfer (see page 10-4) |
| AB 908 | Ch. 16-5 | Increases the maximum amount of Paid Family Leave benefits recipients can receive from EDD from 55% to 70% of wages |
| AB 1559 | Ch. 16-257 | Authorizes the BOE, in the case of a disaster, to extend for up to three months the time to file and pay sales and use taxes and other BOE-administered fees (see page 14-3) |
| AB 1700 | Ch. 16-64 | Allows a trustee to issue a notice of proposed action for a preliminary and final distribution of trust assets |
| AB 1775 | Ch. 16-348 | Conforms to federal changes to business entity return filing due dates (see page 4-2) |
| AB 1847 | Ch. 16-294 | Expands the employer mandate to inform employees of possible eligibility for the federal EITC to include information regarding potential eligibility for the California EITC |
| AB 1856 | Ch. 16-98 | Allows taxpayers making installment payments on outstanding sales and use taxes and any other tax or fees administered by the BOE to file a single claim for refund to cover all subsequent installment payments (see page 14-14) |
| AB 1920 | Ch. 16-611 | Authorizes the imposition of fines against low income housing credit recipients who violate agreement terms |
| AB 2201 | Ch. 16-264 | Reinstates expired provisions that allowed the Board of Equalization to prorate the interest due on a tax or fee electronic payment made one business day late |
| AB 2562 | Ch. 16-332 | Expands eligibility for property tax postponements for military reservists |
| AB 2900 | Ch. 16-582 | Mandates GO-Biz to post on its website information about California Competes Tax Credit awards |

| Bills Enacted in 2016 (Senate) | | |
|---|---|---|
| **Bill No.** | **Chapter No.** | **Description** |
| SB 3 | Ch. 16-4 | Increases the minimum wage and expands paid sick leave mandate to include in-home support services workers (see page 10-5) |
| SB 826 | Ch. 16-23 | Budget bill includes 2016-17 filing cost recovery and collection fees and annual adjustment factor for California's Earned Income Tax Credit (see page 11-6 for the updated fees, and see page 1-40 for more information on California's Earned Income Tax Credit) |
| SB 836 | Ch. 16-31 | Expands the criteria GO-Biz may consider when evaluating a California Competes Tax Credit allocation and moves forward by one year the operative date of the Advanced Strategic Aircraft Credit against corporation franchise tax (see page 13-5) |
| SB 837 | Ch. 16-32 | Reinstates a modified agricultural food products donation credit and allows sales of and partnership allocations of low-income housing credits (see page 13-4) |
| SB 838 | Ch. 16-339 | Increases the motor vehicle registration fee from $43 to $53 |
| SB 909 | Ch. 16-425 | Expands the property tax postponement program to include special needs trust claimants (see page 14-18) |
| SB 1073 | Ch. 16-722 | Maintains the increased EITC amount for families with three or more children (see page 1-40) |
| SB 1234 | Ch. 16-804 | Authorizes the implementation of the California Secure Choice Retirement Savings Trust Act (a state-run employee retirement plan for private employers) (see page 10-7) |
| SB 1255 | Ch. 16-114 | Defines "date of separation" for purposes of divorce (see page 12-12) |
| SB 1265 | Ch. 16-140 | Modifies provisions governing marital deduction trusts (see page 10-8) |
| SB 1458 | Ch. 16-871 | Expands eligibility for the disabled veterans' property tax exemption and extends statute of limitations to file for exemption and/or related refunds (see page 14-17) |

To view the full text of these bills, go to:

**Website**
http://leginfo.legislature.ca.gov/

Subscribers to Spidell's Online Research Package will have access to complete analysis of all of these bills beginning in mid-January.

## MEDICAL MARIJUANA DISPENSARIES EXEMPT FROM EFT REQUIREMENTS

Medical cannabis dispensaries with a seller's permit may remit sales and use tax payments by means other than electronic funds transfers, effective from January 1, 2017, until January 1, 2022. (AB 821 (Ch. 16-811); R&TC §6479.3(k)) By exempting them from the EFT requirements, such dispensaries are no longer subject to the 10% EFT penalty and no longer are required to submit a waiver request to the Board each time they fail to remit their sales and use taxes by EFT.

*Comment*

The BOE had previously allowed taxpayers to make cash payments and would waive the penalty for reasonable cause. AB 567, which would have provided a six-month tax-penalty amnesty program for medical cannabis-related businesses, was vetoed. Consequently there is no retroactive relief.

## FTB process

All FTB field office public counters have the ability to accept cash from taxpayers who are unable to pay by other means, including cannabis businesses. Taxpayers who must pay by cash can request an exemption using Form FTB 3711 PC, No Cash Policy Exemption Request.

The form is available at:

**Website**
www.ftb.ca.gov/forms/misc/3711.pdf

When the exemption is approved, generally within 24 hours, the taxpayer will be instructed to make an appointment with the field office of their choice to make the payment.

## EDD process

If an employer comes into an EDD office to make a deposit with cash, they will accept their payment or request they convert it to a money order. If EDD staff are out in the field, however, they are not allowed to accept cash for safety and security reasons.

### New e-pay mandate

Beginning January 1, 2017, employers with 10 or more employees will be required to electronically file their employment tax returns and to electronically remit payroll tax deposits (see page 11-2 for more information). This means many cannabis businesses will be subject to the mandate. However, the EDD has informed us that they will accept waiver requests from these employers because they are unable to pay electronically.

To request a waiver, file Form DE 1245W, E-file and E-pay Mandate Waiver Request. The waiver will be valid for one year beginning with the quarter of the request date and must be resubmitted each year.

The form is available at:

**Website**
www.edd.ca.gov/pdf_pub_ctr/de1245w.pdf

# MINIMUM WAGE INCREASED

California's minimum wage will rise to $10.50 per hour on January 1, 2017, for employers with 26 or more employees. The minimum wage will then rise each year until it reaches $15 per hour. However, the timeline for phasing in the increases depends on the number of employees that a business has. (SB 3 (Ch. 16-4))

**Caution**

The state minimum wage may be lower than the minimum wage laws enacted by certain cities and or counties. In such instances, the higher city (or county) minimum wage will prevail.

For businesses with 26 or more employees, the $15 per hour wage will be fully phased in by 2022. The bill allows additional time for employers with 25 or fewer employees to phase in the increases.

| Scheduled Minimum Wage Increases | | |
|---|---|---|
| **Date** | **Minimum wage (26 or more employees)** | **Minimum wage (25 or fewer employees)** |
| January 1, 2017–December 31, 2017 | $10.50 per hour | $10.00 per hour |
| January 1, 2018–December 31, 2018 | $11.00 per hour | $10.50 per hour |
| January 1, 2019–December 31, 2019 | $12.00 per hour | $11.00 per hour |
| January 1, 2020–December 31, 2020 | $13.00 per hour | $12.00 per hour |
| January 1, 2021–December 31, 2021 | $14.00 per hour | $13.00 per hour |
| January 1, 2022–December 31, 2022 | $15.00 per hour | $14.00 per hour |
| January 1, 2023–December 31, 2023 | $15.00 per hour + CPI adjustment | $15.00 per hour |

**Note:** The law is silent as to how and when the 26 or more employees is determined.

After January 1, 2023, the minimum wage will be increased annually, but no more than 3.5% in a year. The resulting increase will be rounded to the nearest $0.10. The increase will be calculated on August 1 to take effect on January 1 of the following year.

There is a provision that allows the Governor to suspend the incremental wage increases in certain situations, such as in the event of decreased nonfarm and retail employment over certain time periods, or if an increase would put the state budget into a deficit. The Governor may only suspend increases due to a budget deficit twice.

## IHSS WORKERS INCLUDED IN PAID SICK LEAVE MANDATE

Existing law excluded In-Home Supportive Services (IHSS) employers from the requirement to provide at least three days of paid sick time to their employees. (Lab. Code §245.5)

SB 3 (Ch. 15-4) phases in sick leave for IHSS workers as follows:

- 8 hours or one paid sick day in each year of employment beginning July 1, 2018;
- 16 hours or 2 paid sick days in each year of employment beginning when the minimum wage reaches $13 per hour; and
- 24 hours or 3 paid sick days in each year of employment beginning when the minimum wage reaches $15 per hour.
  (Labor Code §246(e))

For this purpose, "year of employment" means either a calendar year or 12-month period.

 

# PRIVATE EMPLOYERS REQUIRED TO OFFER STATE-SPONSORED RETIREMENT SAVINGS PLANS

The California Secure Choice Retirement Savings Investment Board is now authorized to implement the California Secure Choice Retirement Savings Program. (SB 1234 (Ch. 16-804)) Starting in January 2017, it will begin the development and build-out of the retirement program. Once Secure Choice completes that phase and opens its doors, the program will be phased in over time depending on the size of the employer.

Under the program, private sector employees may contribute at least 3% of their earnings to the savings program. Employees will be given the option to opt out of the program or to choose a different contribution rate. Neither the state nor employers will be responsible for any of the costs associated with the program.

**Caution**

It is anticipated that the program will not actually be operational for at least a year or two. We've heard from the California treasurer's office that some financial planners are telling employers that the program is in effect now, and they will be subject to fines unless they offer their employees some form of retirement program. This is not true.

Information about the program is available on the California State Treasurer's website at:

**Website**
www.treasurer.ca.gov/scib/

The program is similar to the optional myRA program available on the federal level (see page 6-20 for more information).

# CONFORMITY ISSUES

We often are asked about various conformity issues. Here are some of the most common questions we have received and some new conformity/nonconformity items.

## California conforms — Porter Ranch gas leak

Aliso Canyon gas leak victims, who received relief payments to reimburse them for living expenses, cleaning costs, additional travel expenses, etc., are not required to include these payments or reimbursements in gross income (see page 1-11). (IRS Announcement 2016-25; R&TC §§17071, 17131)

Because the California Revenue and Taxation Code conforms to the federal definition of gross income in IRC §61, to the extent that the IRS is taking the position that the relief payments are not included in gross income, we believe the FTB will follow that interpretation.

## Repair regulations

California follows the partial asset disposition rules for corporate taxpayers because the rules do not conflict with the personal income tax and corporate tax law. But for corporate tax purposes, California does not fully conform because taxpayers must still use California asset classes and useful lives for purposes of determining the depreciation amount, so the actual depreciation deduction will likely be different. (R&TC §§17201, 17250, 24349)

The FTB has stated that California will follow the increase in the repair regulation *de minimis* safe harbor amount from $500 to $2,500 for taxable years beginning on or after January 1, 2016. However, the FTB will not follow the Notice 2015-82 with respect to amounts included in the safe harbor in excess of $500 for pre-2016 taxable years.

## In-Home Support Services

California conforms to IRS Notice 2014-7, which excludes In-Home Supportive Service payments from gross income, and taxpayers may file amended returns for all open years. (IRC §131; R&TC §17131)

## IRA rollover treatment of qualified airline payments

California recognizes the extended rollover period authorized by an uncodified provision of the Protecting Americans from Tax Hikes (PATH) Act of 2015 for current and former American Airlines employees to rollover a portion of their bankruptcy-related settlement payments to an IRA. Therefore, these payments are not subject to early withdrawal penalties and were not required to be included in the employees gross income in the year received from the airline. (Sec. 307, PATH Act (P.L. 114-113); R&TC §17501(b); FTB Summary of Federal Income Tax Changes (2015))

## IRA to charity

California conforms to the federal IRA-to-charity provision for individuals age 70 ½ or older, made permanent in the PATH Act of 2015. (R&TC §17501)

## Marital deduction trusts

SB 1265 (Ch. 16-140) brings Probate Code §21524 into conformity with federal law by:

- Allowing marital deduction trusts to make unitrust payments, or other reasonable allocations of income, to surviving spouses. This brings the law into conformity with IRC §§643 and 2056, and allows surviving spouses a marital deduction and an income stream that is flexible based on the return of the trust's investments; and
- Deleting (d) of the law, which required all undistributed income in the trust to be distributed to the surviving spouse's estate on his or her death. This section of the law had been added to comply with previous interpretations of federal law, which have been rejected by the courts.

## Unrelated business income (UBI)

An issue sometimes overlooked by practitioners, clients, and possibly even retirement plan trustees is UBI being passed through to a retirement plan through an investment in a limited partnership.

To level the playing field with taxable entities, IRC §§511–514 impose a tax on the business income of certain tax-exempt organizations if such income is unrelated to their tax-exempt purpose. (Treas. Regs. §1.513-1(b)) Thus, fiduciaries of IRAs, SEPs, SIMPLEs, Roth IRAs, ESAs, MSAs, and qualified tuition programs that have $1,000 or more of unrelated trade or business gross income must file Form 990-T, Exempt Organization Business Income Tax Return, and are subject to tax on that income. (Treas. Regs. §1.6012-3(a)(5))

California generally conforms to the federal law. (R&TC §§17651; 23732-23735) So, for your client who has an IRA account or accounts that contain UBI for federal purposes, California will tax that income at the applicable trust rate.

These provisions are applicable to IRAs (but not the IRA owner) under IRC §408(e)(1). So it is the IRA that pays the tax out of the IRA funds. These rules also apply to many other qualified retirement plans and tax-exempt entities, but our focus is on IRAs.

### Tax rates

For federal purposes, UBTI is subject to the maximum tax rate for the type of entity. The instructions for Form 990-T indicate that IRAs, SEPs, SIMPLEs, Roth IRAs, Coverdell IRAs (ESAs), and Archer MSAs are treated as "Other trust" and are subject to trust tax rates. An IRA with long-term capital gains is eligible for the rates on net capital gains and reflected on the Form 990-T.

For California UBTI is taxed at the graduated trust rate.

Thus, the UBTI is taxed at:

- Federal: 39.6% for ordinary income and capital gain rates for capital gains; and
- California: Use graduated trust rates (the same rates applicable to single individuals).

### Tax return preparation

Assume we open a tax packet from an individual client, and it contains 17 limited partnership Schedules K-1. We see that 10 K-1s are in the husband's name, five are in the wife's name, and two are in the name of the husband's IRA. We may (erroneously) think to ourselves, "Ah, these two are for his IRA — nothing further is needed," and we set it aside. (If it's a new client, we may even discover the previous preparer blindly included the entire Schedule K-1 in the prior year's Form 1040, reporting $20,000 of retirement fund capital gain, which didn't even belong there.)

Rather than setting the Schedule K-1 aside thinking it's inapplicable to our client, what we should do is look at Line 20V on the Schedule K-1 and see if there is a reported amount. Line 20V is the line for the flow-through entity to report UBI. If no amount is shown, and to be thorough, we might peruse the statements to the Schedule K-1, as some partnership return preparers have been known to miss the Line 20V requirement. However, if one IRA Schedule K-1 shows $600 of UBI, and the other IRA Schedule K-1 shows $500 of UBI, the trustee of the IRA has a Form 990-T filing requirement, as the cumulative total for that particular plan exceeds $1,000.

Even though Line 20V in excess of $1,000 does not impact the client's Form 1040, we as practitioners perhaps have an obligation to inform our client of the Form 990-T filing requirement and recommend that he/she discuss it with the plan's trustee.

However, if the account is an IRA and the taxpayer has multiple accounts at different firms holding his IRA, the UBI on all accounts must be aggregated, and one Form 990-T is filed.

For practitioners with clients fitting the above situation, we have created a sample letter that you might consider for such an occasion.

To download the client letter, go to:

**Website**
www.caltax.com/spidellweb/public/editorial/IRAUBIletter.doc

# NONCONFORMITY

## COD principal residence exclusion

Citing fiscal concerns, the Governor vetoed SB 907, which would have retroactively reinstated California's partial conformity to the qualified principal residence COD exclusion. As a result, taxpayers are forced to look to the insolvency exclusion to forgive the tax on this income on their California returns.

### Insolvency

California conforms to the insolvency provision, and taxpayers may use the insolvency exclusion on the California return even if they use the principal residence exclusion on the federal return. (R&TC §§17024.5, 17131)

> ✐ **Practice Pointer**
>
> California does not have its own version of Form 982. When using different elections on the federal and California returns, create a separate Form 982 for the California return, listing the exclusions that were used on that return, along with any basis adjustments.

## Olympic medal exclusion

H.R. 5946, the "United States Appreciation for Olympians and Paralympians Act," excludes from income medals or other prizes awarded to Team USA athletes during the Olympic and Paralympic games for those athletes whose adjusted gross income does not exceed $1 million ($500,000 for a married individual filing a separate return).

California does not conform. The bill that would have created a similar exclusion for California purposes, AB 1944, died.

## Extenders

Although AB 154, enacted in 2015, was labeled "conformity legislation," California still does not conform to major federal provisions, including these, some of which continue to be extended by Congress:

- Bonus deprecation;
- Increased IRC §179 deduction;
- 15-year depreciation on qualified leasehold, retail, and restaurant improvements;
- Expensing election for costs of film and television production;
- Reduction to five-year holding period for built-in gains;
- Real estate professional treatment;
- Small business stock gain exclusion;
- State and local sales tax deduction;
- Teacher's deduction for classroom supplies;
- Mortgage insurance premium deduction;
- Liberalized rules for qualified conservation contributions (corporation franchise/income);
- Enhanced deduction for contribution of food inventories; and
- Above-the-line deduction for qualified tuition expenses.

| Quick Guide to California Nonconformity for Taxable Year 2016 | | | |
|---|---|---|---|
| **General notes**<br>The following potential differences are not reflected in this guide:<br>● Qualified nonmilitary spouses of nonresident military servicemembers stationed in California are not subject to California tax on income they earn in California. As California nonresidents, qualified spouses may also exclude from California income their interest and dividends and other intangible income, which is taxed to the state of residence. (Military Spouses Residency Relief Act (P.L. 111-97))<br>● Registered domestic partners (RDPs): There will be a number of differences between federal and California because the couple will file as single for federal purposes and as married for California. This means that phaseouts, limitations, and computations will be different (e.g., taxable Social Security, deductible passive losses, mortgage interest, etc.). | | | |
| | **IRC§** | **PITL R&TC§** | **CTL R&TC§** |
| **Filing Status and Personal Exemptions** | | | |
| Taxpayers must use the same filing status on the California return that they used on the federal return, unless: | 2 | 18521 | N/A |
| ● One spouse is a nonresident with no California source income; | N/A | 18521 | N/A |
| ● One spouse is a nonresident military servicemember; or | N/A | 18521 | N/A |
| ● They are in a registered domestic partnership (RDP). | N/A | 18521 | N/A |
| In the first two cases above, the spouses may elect to file married filing separate for California and married filing joint for federal purposes. | N/A | 18521 | N/A |
| **RDPs** | | | |
| RDPs must file as single taxpayers for federal purposes, and must file their California income tax returns as married taxpayers (generally either married/RDP filing joint or married/RDP filing separate). | N/A | 18521 | N/A |
| **Dependent exemption** | | | |
| A parent who elects to forgo the exemption for a child in order to claim an education credit may claim the child for California purposes. | 152 | 17056 | N/A |
| **Phaseouts** | | | |
| California phases out exemption credits and itemized deductions based on 6% of federal AGI. | 151 | 17054 | N/A |
| **Wages, Salaries, Tips, Etc.** | | | |
| Military pay — Military wages earned by nonresident military domiciled in a state other than California are not included in federal AGI when computing California tax. | N/A | P.L. 108–189<br>17140.5 | N/A |
| Income earned by a qualified nonmilitary spouse with the same domicile as his or her servicemember spouse is excluded from income. (Military Spouses Residency Relief Act (P.L. 111-97)) | N/A | P.L. 111-97 | N/A |
| Sick pay under the Federal Insurance Contributions Act and Railroad Retirement Act — Excludable from California wages. | 86 | 17087 | N/A |
| Income exempt by U.S. treaties — Taxable by California unless the treaty specifically excludes the income for state purposes. | N/A | FTB Pub. 1001 | N/A |
| Employer-provided transportation benefits — California exclusions are different from federal. | 132 | 17090<br>17149 | 24343.5 |
| California qualified stock option income — Not taxable by California if exercised by certain individuals. | N/A | 17502 | N/A |
| Employer-provided medical insurance and reimbursements for RDPs who are not dependents — Not taxable by California. | 105<br>106 | 17021.7 | N/A |

| ***Wages, Salaries, Tips, Etc. — continued*** | **IRC§** | **PITL R&TC§** | **CTL R&TC§** |
|---|---|---|---|
| Native Americans — Earnings not taxable by California when earned by tribal members who live on their tribal reservation and receive income earned on their tribal land or who receive military compensation — Excludable from California wages. | N/A | FTB Pub. 1001 | N/A |
| Clergy housing — Exclusion not limited to the fair rental, and California allows state-employed clergy to allocate up to 50% of their salary to either the rental value or the rental allowance. (Gov't Code §19827.5) | 107 | 17131.6 | N/A |
| Nonresident wages — Not taxable by California when a taxpayer earned wages while a resident, but receives the wages after becoming a nonresident and services were not performed in California. | N/A | 17951 | N/A |
| HRA rollover to an HSA — Included in California income. | 106 | 17131.4<br>17131.5 | N/A |
| Employer-paid HSA contributions — Included in California wages. | 106 | 17131.4<br>17131.5 | N/A |
| Tip income — Actual amount if federal amount is estimated. | N/A | N/A | N/A |
| Reimbursement by employer for federal tax cost of RDP medical §§105 and 106 expenses not taxable by California. | 105<br>106 | 17141–<br>17141.3 | N/A |
| Amounts received under the Work Colleges Program — California does not conform. | 117 | 17024.5<br>17131 | N/A |
| **Interest** | | | |
| **Interest from the following is not taxable by California** | | | |
| U.S. savings bonds, U.S. Treasury bills, notes, or any other bonds or obligations (excluding Fannie Mae, Ginnie Mae, and FHLMC bonds or securities) of the U.S. and its territories, including California. | 103<br>141–150 | 17133 | 24272 |
| Interest earned on qualified tax credit bonds (for example, Build America Bonds). | 54 | 17143 | 24272 |
| **Interest from the following is taxable by California** | | | |
| Bonds issued by other states and the government of America Samoa. | N/A | 17143 | 24272 |
| Municipal bonds issued by a county, city, town, or other local government unit in a state other than California. | N/A | 17143 | 24272 |
| District of Columbia obligations issued after December 27, 1973. | | 17143 | 24272 |
| HSAs. Interest on HSAs included in California income. | 223 | 17215.4 | N/A |
| Canadian RRSPs. Interest on Canadian RRSPs included currently in California income. | N/A | 17501 | N/A |
| **Dividends** | | | |
| Exempt-interest dividends — Dividends that relate to exempt interest from tax exempt assests are excludable if the mutual fund has at least 50% of its assets invested in tax-exempt government obligations. Fully taxable if less than 50%. | N/A | 17145 | 24272 |
| Non-cash patronage dividends from farmers' cooperative or mutual associations — California amounts may be different if election is made. | 1385 | 17086 | 24273.5 |
| Controlled foreign corporation dividends — Taxable by California in the year distributed rather than the year earned. | N/A | FTB Pub. 1001 | FTB Pub 1001 |
| Distributions of pre-1987 earnings from S corporations — Taxable by California. | N/A | FTB Pub. 1001 | FTB Pub 1001 |
| Undistributed capital gains from a regulated investment company — Taxable by California in the year distributed rather than earned. | N/A | 17088 | N/A |
| Dividends from HSAs invested in stocks or mutual funds — Taxable by California. | 223 | 17215.4 | N/A |
| **State Tax Refund** | | | |
| State income tax refunds — Not taxable to California. | N/A | 17131<br>17220 | 24345 |

| | | | |
|---|---|---|---|
| **Alimony** | | | |
| Nonresident aliens with alimony income — Taxable by California. | 71 | FTB Pub 1001 | N/A |
| **Business Income and Loss** | | | |
| **Income differences** | | | |
| Business conducted partially in California — Worldwide income included in nonresident's AGI from all sources; California-source business income determined using an apportionment formula. | N/A | 17951 | N/A |
| Prevention of certain losses from tax-indifferent parties — California does not conform. | 267 | 17201 | 24427 |
| **Credits that may create basis differences** | | | |
| Income may be different due to different basis adjustments for federal and/or California credits. | Var | Var | Var |
| **Business Expensing and Depreciation** | | | |
| **Expensing** | | | |
| Prior to 1999 and after 2002, California's IRC §179 expense is less than federal. This could cause a depreciation and basis adjustment. | 179 | 17250<br>17255 | 24356 |
| California's IRC §179 deduction limited to $25,000 and $200,000 in assets. IRC §179 for qualified property (leasehold improvement, restaurant, and retail improvement property) placed in service on or after January 1, 2010 — Not allowed for California. | 179 | 17250<br>17255 | 24356 |
| IRC §179 off-the-shelf computer software expensing — California does not conform. | 179 | 17255 | 24349<br>24356 |
| Revocation of IRC §179 election without IRS consent — California does not conform. | 179(c)(2) | 17255(e) | 24356(b)(6) |
| $8,000 bonus depreciation for luxury auto — Not allowed for California. | 168 | 17250<br>17255 | 24349<br>24356 |
| 50%/100% bonus depreciation — Not allowed for California. | 168 | 17250<br>17255 | 24349<br>24356 |
| Economic development area business property expensing (EZ, LAMBRA, TTA) — California allowed expensing up to $40,000 for the cost of qualified property for taxable years beginning before January 1, 2014. May create basis difference. | N/A | 17276.2<br>17276.6<br>17268 | 24356.6<br>24356.7<br>24356.8 |
| Federal film and television cost expensing — California does not conform. | 181 | 17201.5 | 24356 |
| Mine safety equipment expensing — California does not conform. | 179E | 17250<br>17257.4 | 24349<br>24356 |
| Reforestation cost expensing — California does not conform. | 194 | 17278.5 | 24372.5 |
| Additional first-year depreciation for cellulosic biomass ethanol plant property placed in service before January 1, 2017 — California does not conform. | 168 | 17250 | 24349 |
| **Depreciation that will create a basis difference** | | | |
| Recovery period for nonresidential real property placed in service on or after May 13, 1993, but before January 1, 1997 — California's recovery period is 31.5 years; the federal recovery period is 39 years. | 168 | 17250 | 24349 |
| Recovery period for qualified leasehold improvements, retail improvement property, and qualified restaurant property is 15 years for federal purposes — California's recovery period is 39 years. | 168 | 17250 | 24349 |
| Business property moves into California — If depreciation method or useful life is unacceptable to California before the move, you must use the straight-line method. | N/A | 17250 | 24349 |
| Recovery period for property on Indian reservations placed in service after 1993 and before 2017 is shorter depending on the property class — California does not conform. | 168 | 17250 | 24349 |
| Five-year recovery period for grapevines replaced in a California vineyard for phylloxera infestation and for Pierce's Disease. | 168 | 17250 | 24349 |
| Income forecast method — California conforms to the federal income forecast method, except for the treatment of participations and residuals and the treatment of distribution costs for property placed in service after October 22, 2004. | 167 | 17250<br>17250.5 | 24349<br>24356 |

| ***Business Expensing and Depreciation — continued*** | IRC§ | PITL R&TC§ | CTL R&TC§ |
|---|---|---|---|
| Three-year recovery period for racehorses placed in service in 2015 and 2016 — California does not conform. | 168 | 17250 | 24349 |
| Water utility property — California does not conform to special MACRS. | 168 | | 24354.1 |
| Small aircraft recovery method — California does not conform. | 168 | 17250 | 24349 |
| Expensing of energy-efficient commercial building for buildings placed in service prior to 2017 — California does not conform. | 179D | 17257.2 | 24349 |
| Commercial revitalization for buildings placed in service prior to 2010 — Difference in depreciation if taxpayer claimed or took the 120-month amortization. | 1400I | 17250 | 24349 |
| Seven-year recovery period for motorsports entertainment complexes placed in service prior to January 1, 2017 — California does not conform. | 168 | 17250 | 24349 |
| Basis difference when insolvency elected for California but not federal and depreciable basis (tax attribute) is reduced. | 108 | 17144 | 24307 |
| Basis difference on asset acquired from decedent dying in 2010 if no estate tax was elected — California basis is equal to FMV rather than adjusted carryover basis. | 1022 | 18035.6 | N/A |
| Federal ten-year depreciation for qualified smart electric meters and grids — California does not conform. **Note**: California conforms for personal income tax. | 168 | 17201<br>17250 | 24349 |
| **Amortization** | | | |
| **The following will create a basis difference** | | | |
| California limited the maximum expense to $5,000 with a limit of $50,000 rather than $10,000/$60,000 in 2010. | 195 | 17201 | 24414 |
| Intangibles — IRC §197 property acquired before January 1, 1994 — California requires amortization over the remaining federal amortization period. | 197 | 17279 | 24355 |
| Music costs — California did not conform to five-year amortization election for expenses related to property placed in service prior to 2011 until the 2010 taxable year. | 167(g)(8) | 17250<br>17250.5 | 24349 |
| Pollution control facilities — California conforms to the federal accelerated write-offs, but only for facilities located in California. | 169 | 17250 | 24372.3<br>24449 |
| Geological and geophysical costs — Starting in 2010, California does not conform. | 167(h) | 17250.5 | 24349 |
| **Other Business Expense Differences** | | | |
| **Taxpayers may need to adjust federal amounts for these California differences** | | | |
| Increase California deduction for any federal credits taken when expense must be reduced by credit amount. | Var | Var | Var |
| Decrease California deduction for any California credits taken when expense must be reduced by credit amount. | Var | Var | Var |
| Club dues — California does not allow a deduction for payments made to clubs that discriminate. | 274 | 17269 | 24443 |
| No Form W-2 or 1099 filed for personal services — California does not allow a deduction. | N/A | 17299.8 | 24447 |
| Tertiary injectants expenses incurred in the crude oil industry — California allows depreciation; federal allows expensing. | 193 | 17260 | 24341<br>24401 |
| Abandonment or tax-recoupment fees for open space easements and timberland preserves. | N/A | 17275 | 24441 |
| Domestic production activities federal deduction — California does not conform. | 199 | 17201.6 | 24341<br>24401 |
| Illegal activities For PIT, conformity to IRC §280E. For CTL, all deductions are allowed. No COGS or deductions if taxpayer subject to a state statutory court actions for profiteering. | 280E | 17024.5<br>17282 | 24436.1 |
| Differences in what may be claimed for research credit will result in different research expenses that may be deducted. | 41<br>280C<br>174 | 17052.12<br>17201 | 24365<br>24440<br>23609 |

| *Other Business Expense Differences — continued* | IRC§ | PITL R&TC§ | CTL R&TC§ |
|---|---|---|---|
| Percentage depletion for oil and gas wells and geothermal deposits. | 611–638 | 17681.6 | 24831.6 |
| Qualified environment (remediation) clean-up costs paid or incurred before January 1, 2012. California did not conform after 2003. | 198 | 17279.4 | 24369.4 |
| Enhanced deduction for food inventories — California does not conform. | 170 | 17275.2 | 24357 |
| Basis of vehicle acquired in an exchange using the 2009 Cash for Clunkers program may be higher for California purposes because California did not allow exclusion from income for government payment. | N/A | FTB Pub. 1001 | |
| Insolvency election — Reduction in tax attributes may change depreciable basis if California election is different from federal. | 108 | 17144 | 24307 |
| No California deduction allowed for penalties assessed against owners of a professional sports franchise by the professional sports league that includes the franchise. | 162 | 17228 | 24343.8 |
| **Rents, Royalties, Partnerships, Estates and Trusts, etc.** | | | |
| **Deduction, depreciation, and basis differences** | | | |
| Substandard housing — California does not allow a deduction for interest, taxes, depreciation, or amortization. | N/A | 17274 | 24436.5 |
| Passive activity loss rules for real estate professionals — California does not conform to the federal law that treats certain passive income as nonpassive. | 469 | 17561 | N/A |
| Although California conforms to federal passive rules, there may be differences in depreciation that will make the California numbers different from federal numbers. | | | |
| Difference in basis due to COD for S corporations for distributions after October 11, 2001, and before January 1, 2003. | 108 | | 24307 |
| Differences in K-1 income due to net income differences. | | | |
| Differences in accumulation distributions to beneficiaries. | | | |
| Difference in basis due to insolvency provision elected for COD. | | | |
| **Farm Income and Loss** | | | |
| Same as items listed in the "Business Income and Loss" section. In addition: | | | |
| Federal limit of farm loss — California does not conform. | 461(j) | 17560.5 | N/A |
| **Capital Gains and Losses** | | | |
| **The gains/losses can be different in the following situations** | | | |
| Gain rollover on the exchange of qualified small business stock — California does not allow. | 1045 | 18038.4<br>18038.5<br>18044 | N/A |
| Exclusion on gain of small business stock — California does not allow. | 1202 | 18152.5,<br>FTB Notice 2012-03 | N/A |
| Basis differences resulting from prior-year differences between California and federal law. | | | |
| Basis differences due to basis adjustments for federal or California credits. | | | |
| Gain or loss on stock and bond transactions due to basis difference. | | | |
| Installment sale gain — Basis differences or different elections. | 453 | 17551 | 24667<br>24668.1 |
| Gain on the sale or disposition of a qualified housing project that provided rental or cooperative housing for low-income families. | N/A | 18041.5 | 24955 |
| Gain on the sale of a principal residence when depreciation was allowable and different methods or rates were used for California and federal purposes. | 121 | 17152 | N/A |

| *Capital Gains and Losses — continued* | IRC§ | PITL R&TC§ | CTL R&TC§ |
|---|---|---|---|
| Different capital loss carryovers. | 1211–1260 | 18151 | 24990<br>24990.5 |
| Undistributed capital gains from a regulated investment company are taxable for California purposes. | 852(b) | 17088 | 24871 |
| Gain or loss on the sale of property inherited before January 1, 1987. | N/A | 18035.6, FTB Pub. 1001 | N/A |
| Passthrough gain or loss from a partnership, S corporation, trust, or LLC. | | | |
| Gain on disposition of S corporation stock may be different. | | | |
| Different election for 2001 deemed sale. (Tax Reform Act of 1997 §311(e)) | | 17024.5 | N/A |
| Gain realized on disposition of stock acquired from a California qualified stock option. | N/A | 17502 | N/A |
| Capital loss carryover adjustment for part-year resident year. | N/A | 17041 | N/A |
| Difference in basis if taxpayer claimed the commercial revitalization deduction. | 1400I | 17250 | 24349 |
| **IRA Distributions** | | | |
| Pre-1987 IRA and SEP contributions commonly have a higher California basis. | 219 | 17203 | N/A |
| Lower IRA deduction for California purposes due to self-employment or farm income for 1987–1995. | 219 | 17203 | N/A |
| Basis difference due to different election to treat IRA contributions as nondeductible for federal but not California or vice versa. | 219 | 17203 | N/A |
| Basis difference due to catch-up contributions in 2005–2009 for former employees of bankrupt companies. | 219(b)(5) | 17501 | N/A |
| Basis difference due to lower California AGI limitations in 2007–2009. | 219 | 17024.5 | N/A |
| IRA rolled over to an HSA is taxable to California. | 408 | 17215.4 | N/A |
| **Pensions and Annuities** | | | |
| Railroad retirement benefits — Tier 1 and Tier 2 are not taxable to California. | 86 | 17087 | N/A |
| U.S. Social Security benefits — Not taxable to California. | 86 | 17081 | N/A |
| Basis differences: | | | |
| • Pre-1987 Keogh and SEP deductions may have been higher for federal than for California purposes. | 219 | 17085 | N/A |
| • After 1986 and before 1996, if California self-employment or farm income was lower. | 219 | 17507 | N/A |
| • Annuity starting date after July 1, 1986, and before January 1, 1987, if the taxpayer elected to use the three-year recovery rule for California purposes. | 219 | FTB Pub. 1001 | N/A |
| • Annuities with a starting date after November 18, 1996, and before January 1, 1998, may have basis recovered under a different method. | 219 | FTB Pub. 1001 | N/A |
| Canadian RRSP earnings — Taxable by California in the year earned. | 408 | 17501 | N/A |
| Foreign Social Security and foreign pensions exempt by treaty — California taxes these distributions. | 86 | 17071 | N/A |
| **Other Income/Exclusions/Deductions** | | | |
| State tax refunds are not taxable to California. | 111 | 17131<br>17142 | 24345 |
| Unemployment compensation — Not taxable to California. | 85 | 17083 | N/A |
| Paid family leave benefits — Not taxable to California. | 85 | 17083 | N/A |
| Income exempt by U.S. treaties including foreign Social Security and foreign pensions — California does not conform to most U.S. treaties. (***Appeal of de Mey Van Streefkerk*** (November 6, 1985) 85-SBE-135) | | | |

| *Other Income/Exclusions/Deductions — continued* | IRC§ | PITL R&TC§ | CTL R&TC§ |
|---|---|---|---|
| $250 educator expense deduction — California does not allow. | 62(a)(2)(D) | 17072 | N/A |
| California lottery winnings — Not taxable to California. (Gov't. Code §8880.68) | | | |
| Disaster loss carryovers — May be different due to different election, basis difference or carryback from Governor-only declared disaster. | 165 | 17201<br>17207 | 24347<br>24347.5 |
| Differences in California and federal NOLs. | 172 | 17201<br>17276.05–<br>17276.22 | 24416.05–<br>24416.22 |
| Differences in federal and state COD and principal residence exclusion — California does not allow exclusion after 2013 taxable year. | 108 | 17144.5 | N/A |
| Insolvency election — Reduction in tax attributes may change depreciable basis if California election is different from federal. | 108 | 17144 | 24307 |
| COD: California does not conform to IRC §108(i)(1), which allowed a taxpayer to elect to report applicable debt incurred in 2009 and 2010 to be reported ratably over a period of five years beginning in 2014. Subtraction from income. | 108(i)(1) | 17144 | 24307 |
| Excludable student loan forgiveness under the income-based repayment (IBR) program. | N/A | 17132.11 | N/A |
| Federal exclusion for prescription drug subsidies — California does not conform. | 139A | 17139.6 | N/A |
| Crime hotline rewards — Not taxable to California. | N/A | 17147.7 | N/A |
| Beverage container recycling income — Not taxable to California. | N/A | 17153.5 | 24315 |
| Cost share payments for forest landowners — Not taxable to California. | N/A | 17135.5 | 24308.5 |
| Federal foreign-earned income or housing exclusion — Not allowed by California. | 911 | 17024.5 | N/A |
| Settlement payments made by the Canadian government to redress injustices done during World War II to persons of Japanese ancestry — Not taxable to California. | N/A | 17156.5 | N/A |
| Rebates from water agencies and suppliers — Not taxable to California. | N/A | 17138<br>17138.1 | 24323 |
| Turf removal rebates not taxable to California. | N/A | 17138.2 | 24308.2 |
| Wrongful incarceration payments — CA allows maximum of $140 per day. | 139F | 17157, Penal Code 4904 | N/A |
| Nonresident aliens must include worldwide income on California return. | N/A | 17954 | N/A |
| Commodity Credit Corporation loans — Different elections for income exclusion. | 77 | 17081 | 24273 |
| California conforms to claim-of-right provisions for personal, but not corporate tax purposes. | 1341 | 17049 | N/A |
| Percentage depletion for oil and gas wells and geothermal deposits. | 611–638 | 17681.6 | 24831.6 |
| HSA funds withdrawn for nonqualified purposes are not taxable for California due to basis in HSA. | 223 | 17215.4 | N/A |
| Different election to include child's income on parent's return. | 1 | 17041 | N/A |
| California exclusion for death benefits received from the California National Guard, State Military Reserve, or Naval Militia. | | 17132.4 | N/A |
| Native American per capita payments — California does not tax Native Americans living on their tribal land receiving payments from their tribe. | N/A | FTB Pub. 1001 | N/A |
| Seismic retrofit assistance is excluded from California gross income. | N/A | 17138.3 | 24308.7 |
| §529 plan expansion of qualified expenses to include computers and equipment and allowance of 60-day rollover — California does not conform. | 529 | 17140.3 | N/A |
| Exclusion from gross income of certain clean coal power grants to noncorporate taxpayers — California does not conform. | Uncodified Sec. 343 (P.L. 114-113) | N/A | N/A |

| *Other Income/Exclusions/Deductions — continued* | IRC§ | PITL R&TC§ | CTL R&TC§ |
|---|---|---|---|
| Ottoman Turkish Empire Settlement Payments. | N/A | 17131.2 | 24272 |
| **Adjustments to Income** | | | |
| Nonresident aliens who did not deduct alimony payments on their federal return can deduct alimony payments on their California return. | N/A | 17302 | N/A |
| Student loan interest deduction — Non-California domiciled military taxpayers exclude military wages, which may increase deduction. | 221 | P.L. 108–189 | N/A |
| Self-employed health insurance paid on behalf of a nondependent RDP deductible for California. | N/A | 17021.7 | N/A |
| Contributions to HSA not deductible. | 223 | 17215.4 | N/A |
| Deductions for tuition and related expenses — Not excludable for California purposes. | 222 | 17024.7 | N/A |
| **Itemized Deductions** | | | |
| When using standard deductions on the federal return but itemizing on the California return, complete and attach a copy of the federal Schedule A (even though the taxpayer did not file one with his or her federal return). | | | |
| Itemized deduction phaseout amount is 6% of federal AGI for California purposes. | 68 | 17077 | N/A |
| Any deductions subject to AGI limitations may be different for RDPs because they must file as married for California and single for federal. | | | |
| Medical expenses paid on behalf of a nondependent RDP — Deductible for California purposes. | | 17021.7 | N/A |
| Medical expenses paid with HSA funds are deductible. | 223 | 17215.4 | N/A |
| California's AGI threshold for medical expense deduction remains at 7.5%. | 213 | 17241 | N/A |
| Adoption-related medical expenses — Adjust for differences between California and federal Adoption Credit rules. | | 17052.25 | N/A |
| State and local income taxes or sales and use tax paid (including foreign income taxes, SDI, sales tax on vehicles, $800 annual tax paid by LPs and LLCs, and income or franchise taxes paid by S corporations) — Not deductible for California. | 164 | 17220 | 24345 |
| Federal Mortgage Interest Credit — Interest deductible for California. | | FTB Pub. 1001 | N/A |
| Qualified interest paid to public utility — Deductible for California as a miscellaneous itemized deduction not subject to 2%. | | 17073<br>17208.1 | N/A |
| Deduction for mortgage insurance premiums — California does not conform. | 163 | 17225 | N/A |
| Expenses related to income taxed under federal law but not taxed under California law — Not deductible for California. | 265 | FTB Pub. 1001 | |
| Expenses related to income taxed under California law but not under federal law — Deductible for California. | 265 | FTB Pub. 1001 | |
| Investment interest differences. | 163 | 17280 | 24425 |
| Different elections to capitalize carrying charges. | 266 | 17201 | 24426 |
| Different election to include capital gain and dividends as investment income. | 163 | 17201 | N/A |
| Differences in employee education expense due to federal education credits/deduction. | 127 | 17151 | N/A |
| Gambling losses — May be different. California lottery losses are not deductible, or there may be a difference in taxable gambling income. | N/A | FTB Pub. 1001 | N/A |
| Federal estate tax — Not deductible for California. | N/A | FTB Pub. 1001 | N/A |
| Generation-skipping transfer tax — Not deductible for California. | 2601 | 17024.5 | N/A |
| State Legislators' travel expenses incurred while at legislative session pursuant to IRC §162(h) — Not deductible for California. | N/A | 17270 | N/A |

| *Itemized Deductions — continued* | IRC§ | PITL R&TC§ | CTL R&TC§ |
|---|---|---|---|
| Different throwback elections for disaster victims under IRC §165(i), or where the California Governor declared a disaster but the President did not. | 165 | 17201<br>17207 | 24347<br>24347.5 |
| Increased individual charitable contribution limits for contributions to agricultural research organizations. California does not conform. | 170(b)(1) | 17201 | N/A |
| Enhanced deduction for charitable contributions of food inventories — California does not conform. | 170(e)(3)<br>(C) | 17275.2 | 24357.1,<br>24358 |
| No California deduction for contribution to the College Access Tax Credit Fund if a credit for the contribution was claimed. Subtraction to itemized deductions. | 170 | 17053.86 | 23686 |
| Liberalized rules for qualified conservation contributions. | 170(b)(1)<br>(B), 170(b)<br>(2)(B) | 17201 | 24358 |
| Extended deduction for charitable contributions patents and intellectual property does not apply for corporate purposes. For corporate purposes, the property is valued at basis. | 170(m) | 17201 | 24357.1 |
| **Provisions Applicable Only to Corporations** | | | |
| **Income** | | | |
| Interest received on all government (federal, state, municipal, and tax credit bond) obligations (franchise taxpayers only) | N/A | N/A | 24272 |
| Difference in basis due to COD for S corporations for distributions after October 11, 2001, and before January 1, 2003. | 108 | N/A | 24307 |
| Differences due to built-in gains tax holding periods for federal and California. | 1374 | N/A | 23809 |
| ACRS and MACRS — California does not conform for C corporations. | 168 | N/A | 24349<br>24349.1<br>24350<br>24356 |
| Bonus depreciation — In lieu of electing IRC §179 expensing California allows additional $2,000 first-year depreciation for C corporations, but no other general bonus depreciation. | N/A | N/A | 24356 |
| California's IRC §179 property expensing limited to $25,000 and $200,000 in assets. | 179 | 17255 | 24356 |
| Luxury automobiles and listed property — C corporations must use California corporate depreciation methods. | 280F | 17201<br>17250 | 24349.1 |
| Organizational expenses incurred prior to January 1, 2005, and years beginning after 2009 must be amortized. | 248<br>709 | N/A | 24349 |
| Charitable deduction limited to 10% of California income. | 170 | N/A | 24358 |
| Basis adjustment to stock of S corporations making charitable contributions of property — California does not conform. | 1367(a)(2) | N/A | 23051.5,<br>23800 |
| Restriction on tax-free spin-offs involving REITs. | 355(a) | N/A | 24451 |
| Alternative maximum capital gains tax rate for qualified timber gain of a C corporation. | 1201(b) | N/A | 24990.5 |
| California excludes certain income for health plans and insurers | N/A | N/A | 24330 |

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Chapter 11

# California Filing Issues

# CALIFORNIA FILING ISSUES

## FORM, E-FILING, AND E-PAYMENT UPDATES

### FORM CHANGES

#### Earned income credit

The IRS will modify Form 8867, renamed Paid Preparer's Due Diligence Checklist and Paid Preparer's Earned Income Credit Checklist, to incorporate the PATH Act provisions that have the same due diligence as the EITC. For the 2016 taxable year, the IRS penalty for failure to satisfy the Form 8867 due diligence requirement is $510 per credit, per return. The amount is indexed for inflation under the PATH Act. The IRS has created Form 8862, Information to Claim Earned Income Credit After Disallowance.

California does not conform to:

- The inflation increase to the due diligence penalty. The California penalty remains at $500; and
- Although California conforms to the due diligence requirement, California does not have credits comparable to the Child Tax Credit and the American Opportunity Tax Credit, so Form FTB 3514 will only address the EITC and Form FTB 3514 will include provisions regarding the disallowance of the EITC.

#### Change of address forms change

The FTB has created a new Form FTB 3533-B, Change of Address for Business, Exempt Organizations, Estates and Trusts, to change the address for a business. Use this form for all taxpayers except individuals.

For individual taxpayers, use revised Form FTB 3533, Change of Address for Individuals.

A change of address may also be submitted using MyFTB.

#### Film credit forms

The 2016 Form FTB 3541, California Motion Picture and Television Production Credit, will include both the original film credit (Code 223) and the new motion picture and television credit (Code 237) (see page 13-6 for details on these credits).

#### New enrolled tribal member certification

Form FTB 3504, Enrolled Tribal Member Certification, is new and is used to certify that the individual meets all of the following requirements to qualify for the exemption for income earned on Indian country:

- The individual is an enrolled member of a federally recognized Indian tribe;
- The individual lives in his/her tribe's Indian country; and
- The income earned is sourced in the same Indian country in which the individual lived and where he or she is an enrolled member.

File the form with the California Form 540 series, or if no filing requirement, file as a stand-alone form to:

**Address**
Franchise Tax Board
P.O. Box 1998
Sacramento, CA 95471-1998

## DON'T FILE PAPER RETURNS DOUBLE-SIDED

To speed processing, the FTB requests that taxpayers filing paper returns print them one-sided rather than duplexed.

## NEW: STAND-ALONE ELECTRONIC PAYMENTS

Beginning January 2017, taxpayers and tax practitioners may submit stand-alone Electronic Fund Withdrawal (EFW) requests for extension and estimated tax payments using tax preparation software. These payment requests will be accepted as stand-alone and can be submitted separately from the e-filed return. The return can be filed at a later date. Your software must support the program.

**Practice Pointer**

Contact your software provider to see if they are supporting stand-alone EFW payments.

The following payment types may be made:

- Individuals (estimate and extension);
- Fiduciary (estate/trust) (estimate and extension); and
- Business entities (corporations/limited liability companies/partnerships) (extension).

Taxpayers and tax practitioners will still have the ability to submit EFW requests for return and estimate payments with the e-filed return using tax preparation software.

## NEW EDD E-FILE REQUIREMENTS

AB 1245 (Ch. 15-222) requires employers to e-file unemployment insurance and personal income tax withholding returns and to make payments by EFT. The mandate is being phased in over a two-year period and applies to employers as follows:

- Employers with 10 or more employees beginning January 1, 2017; and
- All employers beginning January 1, 2018.

Penalties for failure to comply with the mandates will be imposed beginning January 1, 2019. Waivers from the mandate are available for good cause, including but not limited to lack of automation, severe economic hardship, or a current exemption from federal electronic filing requirements. For information on how to request a waiver, see page 10-5.

For more information, visit:

**Website**
www.edd.ca.gov/EfileMandate

### Penalties

Failure to comply with this mandate will result in the following penalties, which are in addition to any other penalties that apply:

| **E-file Requirements** | |
|---|---|
| Tax Returns (DE 9, DE 3HW, DE 3D) | $50 per tax return |
| Wage Reports (DE 9C, DE 3BHW) | $20 per wage item |
| Payroll Tax Deposits (DE 88) | 15% of amount due |

### Waivers

Employers who are unable to electronically submit tax returns, wage reports, or payroll tax deposits may request a waiver using Form DE 1245W, E-file and E-pay Mandate Waiver Request.

Approved waivers are valid for one year, beginning with the quarter of the request date.

## FILING AND TAX DUE DATES

As we discussed in Chapter 4, California conforms to the new federal filing deadlines. While California generally conforms to the original due date, there are some differences in the extended due dates (see the table on page 4-3).

**Note:** There was no change in the filing due dates for individual taxpayers.

## BUSINESS

### Filing/payment requirements

The LLC return filing deadline depends on how the LLC is classified (see page 4-3 for details). Although the due dates for the returns have changed, the due dates for paying the annual tax, the estimated LLC fee, and the LLC fee **have not changed** and remain as follows:

- **Annual tax due date:** three and one-half months after the close of the taxable year (April 18, 2017) (R&TC §17941(c));
- **Estimated LLC fee due date:** five and one-half months after the close of the taxable year (June 15, 2017) (R&TC §17942(d)); and
- **Balance of LLC fee due date:** due at the time the LLC return is due (March 15, 2017, or April 18, 2017, depending on classification). (R&TC §17942(c))

## Estimated tax and fee due dates

Here are the estimated tax due dates for 2017 calendar year businesses:

| Estimated Tax Due Dates for 2017 Calendar Year Businesses | | |
|---|---|---|
| | **Federal** | **California** |
| C and S corporations | April 18, 2017<br>June 15, 2017<br>September 15, 2017<br>December 15, 2017 | April 18, 2017<br>June 15, 2017<br>September 15, 2017<br>December 15, 2017 |
| LLC annual tax (including SMLLCs) | N/A | April 18, 2017 |
| LLC fee | N/A | June 15, 2017 (estimate)<br>March 15, 2018 (due date) |
| Trust | April 18, 2017<br>June 15, 2017<br>September 15, 2017<br>January 15, 2018 | April 18, 2017<br>June 15, 2017<br>September 15, 2017<br>January 15, 2018 |

## Extended due date nonconformity

California conforms to the federal extended due dates, except that the extended due date for trusts is:

- September 30 for federal; and
- October 15 for California.

## Underpayment of estimated tax nonconformity

### Corporations

The PATH Act changed the period of underpayment for purposes of calculating the corporate estimated tax underpayment penalty to reflect the change in the return filing date from March 15 to April 15, generally effective for returns filed for tax years beginning after December 31, 2015. However, California has not conformed, meaning that the estimated tax underpayment penalty period is shorter for California.

Under federal law, the period of underpayment for C corporations runs from the due date for the installment until the earlier of:

- Three and one-half months (previously two and one-half months) following the close of the taxable year; or
- The date on which the underpayment is paid.
  (IRC §6655(b)(2))

For California, the underpayment period runs from the due date of the installment until the earlier of:

- Two and one-half months following the close of the taxable year; or
- The date on which the underpayment is paid.
  (R&TC §19145)

***Example of different underpayment penalty periods***

ABC corporation's income for the 2016 tax year took a sharp rise for the 4th quarter. Even after annualizing the income, ABC had an estimated tax underpayment. It pays its outstanding balance with its state and federal corporate tax returns filed on April 15, 2017.

The federal underpayment penalty period runs for three months from January 15, 2017, to April 15, 2017. California's underpayment period is only two months, from January 15, 2017, to March 15, 2017.

## Individuals

Differences in California's computation of the underpayment of estimated tax include:

- Payments are front-loaded. Estimated tax payments must be made in these amounts:
  - 30% in the first quarter;
  - 40% in the second quarter;
  - 0% in the third quarter; and
  - 30% in the fourth quarter.
- A taxpayer with AGI greater than $1 million must pay 90% of the current-year tax and may not use the prior-year exception. For an exception to this law, see below;
- California law provides an exception to the estimated tax underpayment penalty that results when a law change retroactively increases a taxpayer's estimated tax payments; and
- There is no penalty if the amount of the tax liability (not including tax on lump-sum distributions and accumulation distribution of trusts) less credits (including the withholding credit) but not including estimated tax payments for either 2015 or 2016 was:
  - Less than $500 (or less than $250 if married/RDP filing a separate return);
  - The 2015 return was for a full 12 months (or would have been if there had been a filing requirement); and
  - There was no tax liability on that return.

## Relief for million dollar taxpayers

A subscriber recently asked whether the prior-year $500 threshold exemption from the estimated tax underpayment penalty applies to taxpayers with AGI greater than $1 million. The answer: Yes.

California does not assess an underpayment penalty on the current year if, in the prior year, the taxpayer had a liability (minus credits for withholding, but not including estimated tax payments) of $500 or less ($250 for married filing separately). (R&TC §19136(c)(2)) This means that a taxpayer whose prior-year withholding covered the tax could have no withholding or estimates paid in the current year and owe no penalty.

The FTB has programmed its computer system to consider this provision when assessing the penalty.

***Example of no penalty***

In Year 2, Janet's AGI was over $1 million, but she did not pay 90% of her liability through withholding or estimates.

In Year 1, Janet's total tax liability was $7,700. She paid $7,400 through withholding, and $500 through estimates. Janet received a refund of $200.

Janet qualifies for the prior-year exception because her prior-year liability after withholding credits was $300 ($7,700 - $7,400).

## 2016–2017 COST RECOVERY AND COLLECTION FEES

The cost recovery and collection fees for the 2016-17 fiscal year are as follows:

The FTB filing enforcement fee is:

- $81 (formerly $79) for an individual, partnership, or LLC classified as a partnership; and
- $100 (formerly $92) for a corporation or LLC classified as a corporation.

The collection fee is:

- $266 (formerly $226) for an individual, partnership, or LLC classified as a partnership; and
- $365 (formerly $334) for a corporation or LLC classified as a corporation.
  (SB 826 (Ch. 16-23))

# MYFTB

The MyFTB online service was launched on January 4, 2016. Since then there have been many upgrades and changes — some applauded by tax professionals; others not so popular. Here is what you need to know for the upcoming filing season.

MyFTB provides two levels of access for tax professionals:

- Tax preparer access, which primarily allows the tax professional to view estimates, payments, account status, and more; and
- Power of attorney (POA) access, providing:
  - The ability for tax professionals to receive an e-mail alerting them to activity on the account;
  - The ability to correspond with the FTB through online secure chat and send a secure message; and
  - Copies of all correspondence, bills, and returns provided in the taxpayer's folder if there is a POA on file.

When you have clients entered into your practitioner page, you will be able to view and access account and notice information about your clients. See the chart below.

| Individual Clients | Added Client to Client List (no POA) | Client with POA Processed by the FTB |
|---|---|---|
| *You can view:* | | |
| Estimated payments, real estate withholding, recent payments, liabilities, and penalties | Yes | Yes |
| Prior-year balances, including zero balance years | Yes | Yes |
| Account information | Yes | Yes |
| Contact information, such as name, address, and IDs | Yes (cannot make changes) | Yes (can make changes) |
| Summary return information, including status | Yes | Yes |
| State W-2 information (wage and withholding) | Yes | Yes |
| Subject to mandatory e-pay | Yes | Yes |
| FTB-issued Form 1099-G and Form 1099-INT information | Yes | Yes |
| Notices sent to the taxpayer | No | Yes |
| Correspondence sent to the taxpayer | No | Yes |
| Images of clients' returns | No | Yes |
| *Actions you can take:* | | |
| File a protest (including updating and withdrawing protests) | No | Yes |
| File a nonresident withholding waiver request (FTB Form 588) | Yes | Yes |
| Initiate chat with the FTB | Yes | Yes |
| Send message to the FTB (with or without attachments) | Yes | Yes |

| Business Clients | Added Client to Client List (no POA) | Client with POA Processed by the FTB |
|---|---|---|
| *You can view:* | | |
| Estimated payments, real estate withholding, and recent payments | Yes | Yes |
| Prior years, including zero-balance years | Yes | Yes |
| Account information | Yes | Yes |
| Contact information, such as name, address, and IDs | Yes (cannot make changes) | Yes (can make changes) |
| Summary return information, including status | Yes | Yes |
| Exact entity name to use when filing a return | Yes | Yes |
| FTB-issued Form 1099-INT information | No (PIT only) | No (PIT only) |
| Notices sent to the taxpayer | No | Yes |
| Correspondence sent to the taxpayer | No | Yes |
| Images of clients' returns | No | Yes |
| *Actions you can take:* | | |
| File a nonresident withholding waiver request (FTB Form 588) | Yes | Yes |
| File a protest (including updating and withdrawing protests) | No | Yes |
| Initiate chat with FTB | Yes | Yes |
| Send message to FTB (with or without attachments) | Yes | Yes |

## SECURITY

The FTB continues to make upgrades to the MyFTB system, many of which concern security. But there have also been enhancements to make the system more usable.

### 10-business-day hold

In June, the FTB implemented a 10-business-day hold on a tax preparer's or POA's access to their client's MyFTB account after entering them as a client.

#### Why?

This hold period allows the FTB time to notify the taxpayer that you requested access to their information as a tax preparer or that a POA was processed on their behalf. This means it will be approximately two weeks from the date the FTB processes and approves the POA until the hold is released. Remember, weekends and state holidays don't count toward the 10 business days.

This process was put in place when taxpayers began receiving notices indicating that they were added to a practitioner account that they did not authorize. We had three subscribers contact us and tell us all of their clients were fraudulently added to a MyFTB account.

*Example of waiting for POA to be processed*

Rex submitted a POA for his client on August 2. His POA was processed and approved by the FTB on August 31. The POA moves into a hold status on August 31, and a letter is generated to his client. The POA will remain in this hold status for 10 business days from the date it is processed and approved. Let's count the 10 business days:

| September | | | | | | |
|---|---|---|---|---|---|---|
| **Sun.** | **Mon.** | **Tues.** | **Weds.** | **Thurs.** | **Fri.** | **Sat.** |
| | | | 31 Yes | 1 Yes | 2 Yes | 3 No |
| 4 No | 5 No[1] | 6 Yes | 7 Yes | 8 Yes | 9 Yes | 10 No |
| 11 No | 12 Yes | 13 Yes | 14 Yes[2] | 15[3] | | |

[1] Labor Day holiday
[2] 10th business day
[3] Representative can access client's account information

In this case, it's actually 15 calendar days before the POA becomes active.

## Helping the client while waiting for your access

This 10-day wait for tax preparer access or the 30+ day wait for POA access while the POA is processed is extremely inconvenient, particularly if there is an urgent collection issue. An FTB representative will help you during this interim period if you have the notice and prior-year tax return in front of you. You can:

- Stop/postpone a wage garnishment;
- Negotiate an installment agreement (the FTB will mail an agreement that the client must sign and return within 15 days);
- Get information on an assessment or Notice of Proposed Assessment;
- Handle an audit while the POA is being processed;
- Solve a filing enforcement issue;
- Have a demand to file removed; or
- Get information needed to file a return or request an extension of time to reply.

You may not:

- Finalize an installment agreement;
- Change a taxpayer's address or contact information; or
- File an online protest on behalf of a taxpayer.

✐ **Practice Pointer**

You do not mail or fax a copy of the POA to the FTB representative. They are unable to process the POA and have been directed not to ask for a copy.

## What do I do during filing season?

Probably the most common reason we want access to our client's information is to verify estimated taxes paid. Waiting two weeks is certainly not the most convenient way to work.

Our only suggestion is that you use the time between now and the end of the year to register your clients in MyFTB so you will have access during the filing season. You can:

- Enter all of them; or
- Enter only those that make estimated tax payments or who are making installment payments.

## RENEWING MyFTB

As with most online accounts, you must periodically change your password for your MyFTB account. For security purposes, you must also renew your tax preparer client accounts.

### Resetting your MyFTB password

You must reset your password every 12 months. The FTB will send an e-mail to you 30 days prior to the password expiring. Once the password has expired, you will be prompted to change your password when you log in to your MyFTB account.

### Renewing your MyFTB clients

Access to your tax preparer clients in your practitioner account expires 13 months from the date you added the client. The FTB will have an improved renewal process available January 3, 2017.

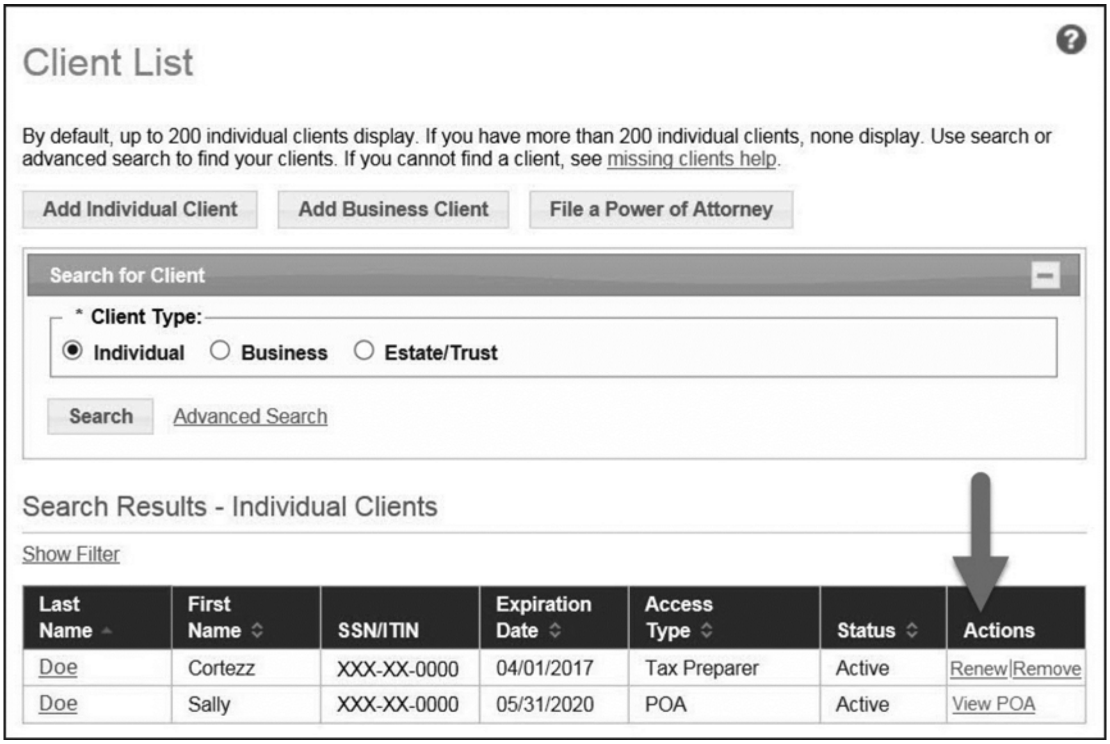
Until then, you may renew clients on your client list any time prior to the 13-month expiration date by entering specific information from your client's filed California tax return from any of the last five tax years. Once you request renewal, the FTB will place a 10-business-day hold on the access to your client's account, and will again send a confirmation letter to your client notifying them that you have added them as a client.

If a client is renewed prior to the expiration date, following the current functionality, the following happens:

- You re-add the client by selecting the Add Individual Client or Add Business Client button and enter required information (follow current steps for adding a client);
- Once this new relationship is established, the old relationship essentially expires. You will only see the client on the client list once, with a new 13-month expiration date; and
- There is a 10-business-day hold on access to the client's account while the FTB notifies the client that they have been added to your account (again, during this 10-business-day hold period, you (the tax preparer) will not have access to the client's account because the previous relationship was ended when the new relationship was established).

### New process beginning January 3

Starting January 3, 2017, you will be able to renew clients on your client list without entering information from a previously filed California tax return. This will allow your access to continue uninterrupted. However, the FTB will send the 10-business-day letter to the client to approve the renewal. If the renewal is not requested more than 10 business days before the current 13-month period expires, the access will be suspended until the 10-day period has passed.




Whether you are adding or renewing a client in MyFTB, you need your client's authorization to access their account. The FTB recommends using FTB Form 743, Online Account View Access Authorization. You can also include the authorization request in your client engagement letter.

✐ **Practice Pointer**

You do not need to renew access to your POA clients. They will remain in your client list until either the POA expires, or you or the taxpayer revokes the POA.

If you fail to start the process prior to the 13-month period expiration, you must start the process of entering that client all over again.

***Example of renewing client***

Jim has two clients he has registered as tax preparer clients. ABC, Inc. was added on January 31, 2016, and Kitty Client was added on February 15. Jim renews both clients on March 3.

ABC will drop off his client list on February 29 while the FTB waits for the 10-day period to expire.

Assuming Kitty does not advise the FTB that she doesn't want Jim to have access to her account, his access to Kitty's tax preparer account will remain continuously active as the 10-business-day period will not expire until after the 10-business-day hold.

## FRAUDULENT ACTIVITY IN MyFTB

We have recently been informed that some taxpayers are receiving notices indicating that they have been added to a practitioner account that they did not authorize. If this happens to you or your clients, immediately contact the FTB Tax Practitioner Hotline at (916) 845-7057 and request that they remove the taxpayer from the unauthorized account.

When a practitioner adds a client to their MyFTB account, the FTB mails the taxpayer Form FTB 4099, Access Granted to Your MyFTB Account, alerting them that the practitioner now has the ability to see their tax information. This is done to help prevent identity theft.

### Client information at risk of being stolen

It is important to stop the unauthorized access as soon as possible because even without a POA, a practitioner with MyFTB access can view important client information (see the chart on pages 11-7 and 11-8).

## IDENTITY THEFT VICTIMS CAN'T USE MyFTB

Taxpayers who are victims of identity theft will be unable to access their MyFTB accounts until the FTB removes the ID theft indicator from their account. The taxpayer's practitioner will also be prevented from viewing their client's information, but they will be able to file POAs and view notices mailed to the affected taxpayers.

Due to the growth in identity theft and the potential increase in the number of taxpayers that will not be able to use MyFTB, the FTB is evaluating how to allow victims to use MyFTB while still protecting the taxpayer.

### How long is the access limited?

An ID theft indicator is placed on a taxpayer's account any time the taxpayer files a Form FTB 3552, Identity Theft Affidavit, or the FTB is otherwise notified of identity theft issues.

Access to MyFTB will be restricted as long as the ID theft indicator is on the taxpayer's account. The FTB's current practice is to keep the indicator on the account for three years to protect both the taxpayer and the state.

### How do I file a POA for these clients?

The FTB has informed us that practitioners will still be able to upload a POA signed by the taxpayer through the POA wizard. We recommend using this process because POAs uploaded through the wizard are processed faster than mailed POAs.

Once the POA is processed, the client will show as "Active" on the practitioner's Client List in the practitioner's MyFTB account. However, the representative will not be able to access the client's account online if a theft indicator is on the account. If they need to gather information or perform actions on behalf of the client, they must either call the FTB or send in paper correspondence.

### Still no paper notices

The FTB no longer mails copies of taxpayer notices to practitioners. The only way for a practitioner to receive a copy of client notices from the FTB is through their MyFTB tax preparer account. If a practitioner holds a POA for a taxpayer with an ID theft indicator, they will still be able to view client notices.

Once the POA has been processed, the representative will be able to see the ID theft client's notices on the Client Notices List page. Again, they won't be able to access any other information in the client's account online, but they can view the notices when they have the appropriate privileges.

If you file your declaration on paper, indicate your applicable exception to submitting online on your Form FTB 3520, Power of Attorney Declaration. If you submit a declaration on paper without an exception, the FTB will process it, but the FTB's processing time for paper declarations will take longer than declarations submitted online.

# POWERS OF ATTORNEY

There are four methods to register your POA:

**Option 1:** Submit the POA via the POA wizard, and the taxpayer will receive confirmation via their MyFTB account and will certify that the POA is correct by responding via their MyFTB. The turnaround is 30 days, but no confirming letter will be issued. The taxpayer must have a MyFTB account. This is the fastest method as there is no 10-business-day letter sent because the taxpayer authorizes via their account.

**Option 2:** Go through the POA wizard on MyFTB and upload a properly signed POA. The turnaround is 30 days plus time for the confirming letter.

**Option 3:** File a paper POA with an exception to online filing (e.g., identity theft issues). The turnaround time is 45 days plus time for the confirming letter — this is not recommended by Spidell.

**Option 4:** File a paper POA without an exception. Turnaround time is 90 days or more plus time for the confirming letter — don't do this. Your client will get a letter telling them they need to go online.

| **POA Processing Times** | | |
|---|---|---|
| **Online using the wizard to complete the POA, or upload a signed POA** | **Mail a paper Form FTB 3520 (with an exception)** | **Mail a Form FTB 3520 (without an exception)** |
| 30 days | 45 days* | 90 days* |
| * Add 10 business days because of the FTB hold noted above | | |

## Finding your POA client

One complaint tax professionals have shared with us is the difficulty in finding a client if there are more than 200 clients in their file. This should be resolved in the upcoming January 3, 2017, upgrade to the MyFTB account portion of the website.

By default, the Client List will display all active Individual clients. It will show 20 clients per page and have pagination to move to the next page for all clients of that client type selected.

To view Business, Estate, or Trust clients, change the Client Type to display the Client List for the type of client you want to view.

Filter boxes will display at the top of the Client List table columns. You may filter the clients by:

- Client type;
- Expiration date (expiration of your "tax preparer" status);
- First or last name;
- Social Security number or ITIN (for individual), ID type (for business), or FEIN or Social Security number for estate/trust; or
- Status.

The filters may differ dependent on the Client Type selected.

✎ **Practice Pointer**

Filter by expiration date with the earliest date on top to see which clients you need to renew.

### POA status

When searching for the client, by default this field is set to "Active." First search the Active clients. If your client doesn't appear, go back and search by Pending only, and do not include any additional search criteria.

These are the status types:

- **Active**;
- **Pending:** The declaration was submitted via MyFTB and is being processed by the FTB;
- **Pending Taxpayer Approval:** The declaration was submitted via MyFTB without a signed copy of the declaration attached. The FTB has processed and approved the declaration, and the declaration is pending taxpayer approval (taxpayer must log in to their MyFTB account and approve the declaration); and
- **Inactive:** The POA has expired or been revoked.

If the client still doesn't appear, set the field to "Inactive." Finally, if you are still unable to locate your client, contact the Tax Practitioner Hotline at:

☎ **Telephone**
(916) 845-7057

✎ **Practice Pointer**

Need more details on how to use MyFTB? Order Spidell's MyFTB Update: Issues and Changes on-demand webinar. It's free! To order, see the sales booth or go to www.caltax.com.

## Comparison of IRS and FTB POAs

The following chart compares IRS and POA authorizations and requirements:

| Comparison of IRS and FTB POA Requirements | | |
|---|---|---|
| | **Federal POA** | **California POA** |
| Form | IRS Form 2848, Power of Attorney and Declaration of Representative | Form FTB 3520, Power of Attorney Declaration |
| Powers granted | Unless specifically limited, authorizes representative to:<br>• Receive and inspect confidential tax information;<br>• Appear on behalf of taxpayer at any IRS office;<br>• Sign an offer or waiver of restriction on assessment/collection of deficiency or disallowance of credit/refund;<br>• Waive the statute of limitations; and/or<br>• Sign a closing agreement.<br>POA must specifically state:<br>• Tax matter (e.g., income, withholding, excise, penalty, etc.). Must specify (cannot state "all taxes");<br>• Tax years/periods if applicable. Must specify (cannot state "all years");<br>• Tax form number if applicable; and<br>• If applicable, specific matters.<br>If Section 5a is completed, representative may also:<br>• Authorize disclosure to third parties;<br>• Substitute or add representatives;<br>• Sign a return; and<br>• Perform other acts as specified. | Unless specifically limited, authorizes representative to:<br>• Talk to the FTB about taxpayer's account;<br>• Execute settlement and closing agreements;<br>• Request copies of information received from the IRS;<br>• View images of notices, correspondence, and returns;<br>• Waive the California statute of limitations;<br>• Receive e-mail alerts when a notice has been sent to client;<br>• Submit online protests and withdraw or update a protest;<br>• Update your client's name, ID number, e-mail address, address, and phone number; and<br>• Respond to an FTB letter.<br>If part 5 is filled out, representative may also:<br>• Add or delete representative;<br>• Receive (not endorse) refund check;<br>• Sign an individual tax return if taxpayer is incapacitated or out of the country for at least 60 days; and<br>• Perform other acts, as specified. |
| Authorization for all matters and all periods | No provision available. | Check box in Part 3. Expires four years from date of signature. |
| | | *(continued)* |

| Comparison of IRS and FTB POA Requirements (continued) | | |
|---|---|---|
| | **Federal POA** | **California POA** |
| Authorization for future periods | Limited to first 3 years after December 31 of year of receipt. | Same as federal for periods listed in Parts 4 or 8. |
| Expiration | Remains in effect until revoked or withdrawn. | Remains in effect until revoked or withdrawn. (Also applies to nontax issues such as vehicle registration and court-ordered debt.) |
| Additional representatives | Four representatives may be listed on Form 2848, with no limit to additional representatives included on supplemental list. | Two additional representatives may be listed on Form FTB 3520, with no limit to additional representatives included on supplemental list. |
| Filing method | Must mail or fax.<br><br>No electronic processing.<br><br>Specific-use POAs sent directly to IRS employee/office handling the matter. | Electronic processing using MyFTB (30-day processing): Representative either uploads signed POA in MyFTB or uploads unsigned POA and the FTB contacts taxpayer for approval. Taxpayer may also enter the POA declaration.<br>By mail: If specified exceptions to using MyFTB. |
| Other authorized POA forms (with required modifications) | Other POA forms allowed as long as they meet requirements outlined in 26 CFR §601.503(a). (In order for other POA forms to be recorded on CAF, Form 2848 must still be attached, but does not need to be signed.) | **Federal Form 2848:** Must specify applicable FTB Forms, tax years, and representative's e-mail address.<br>**BOE 392:** Check FTB box, indicate representative is an attorney-in-fact for FTB purposes, indicate what representative is authorized to do, and provide representative's e-mail address.<br>**Other handwritten, general, or durable POA declarations:** Accepted as long specified information provided. |
| Confirmation of POA | None | FTB will send letter or e-mail via taxpayer's MyFTB confirming the requested POA. |
| Notices sent to POA | Notices will only be sent to maximum of two representatives. | Representative will receive e-mail notification that notices are available on client's MyFTB account. |

# BALANCE DUE AND OTHER NOTICES

## WHAT HAPPENED LAST YEAR?

The FTB experienced a slow ramp up to this filing season due to the immediate need to implement the Earned Income Tax Credit Program, and FTB staff learning its new return analysis (RA) system for the processing of personal income tax returns.

There were a few reasons for the delays:

- As with any computer system upgrade, there were some implementation issues. There were some situations where taxpayer refunds were impacted. However, for electronically filed returns, the FTB issued 85% of refunds in less than seven days and almost 95% in fewer than 21 days; and
- There were also identity theft and refund fraud issues. The IRS, the FTB, and practitioners have seen new and more sophisticated methods where taxpayers' and practitioners' identities have been compromised, and much of the delay was due to new measures designed to curb the fraud.

However, for a variety of reasons, 640,000 taxpayers did not receive their refunds within the FTB's expected time frames. For one thing, due to changes made by EDR (Enterprise Data to Revenue project), the FTB tightened the system and sent a Notice of Tax Return Change (NTRC) when withholding did not exactly match the withholding in the FTB's records, received from the EDD.

Also, with the growth of identity theft, the FTB sent a large volume of Forms 4734D, Request for Tax Information and Documents, which was a follow-up questionnaire sent to taxpayers whose return reflected the possibility of identity theft. In many cases, if the taxpayer called, the FTB employee could approve the return and process the refund based on the information obtained by the FTB employee during the call to confirm the validity of the return. If the taxpayer did not respond, the FTB did not process the return,

### Form FTB 4734D

When the FTB receives a tax return for processing, it is analyzed via the new RA system, and if the return looks suspicious, it is put on hold and the FTB contacts the taxpayer by mail. The FTB sends Form FTB 4734D when there is a question as to the taxpayer's identity. If however, the FTB highly suspects identity theft, Form FTB 3904, Request to Confirm Tax Return Filing, is sent (see below).

Form FTB 4734D requests copies of:

- The taxpayer's Social Security card(s);
- W-2 and 1099-R forms; and
- Paycheck stubs.

According to the FTB, the best way to answer the notice is to fax the requested information to the number on the notice. Information may also be mailed to the address on the notice. Or, you can call the number on the notice. If you call, have a copy of the client's current and prior-year returns. Do not call the practitioner hotline, or the toll free number, as it is the employees in this particular unit who can help you.

**Caution**

Verify the address on the notice by going to the FTB's website to ensure that the notice your client has was actually sent by the FTB (see below).

For security reasons, a sample of this notice and other notices are not available on the FTB's website. However, the FTB provides details on its website regarding the letters, including the address, phone, and fax numbers. This information allows you and your clients to ensure it is a valid FTB request and not a criminal requesting the information.

To confirm the contact information, go to:

**Website**
www.ftb.ca.gov/Bills_and_Notices/notices.shtml

The FTB handled over 100,000 calls as a result of potential identity theft and refund fraud. Some were because the taxpayer received a Form FTB 4734D, while others were from taxpayers who received Form FTB 3904 or who had other identity theft and refund fraud issues.

***Comment***

According to the FTB, they do not receive a response on the majority of the 4734Ds sent. This is an indication that there could truly have been an identity theft or refund fraud situation, as a thief is unlikely to respond, often because the taxpayer does not live at the address shown on the return.

However, the FTB will continue to follow up if the taxpayer fails to respond so the taxpayer's return can be validated and processed. This is done by notifying the taxpayer that they did not receive a response, or by reaching out to the employer. The FTB will not process the return until they can validate the taxpayer's identity.

### Other verification notices

- Form FTB 3904, Request to Confirm Tax Return Filing, is sent when the FTB highly suspects ID theft. The FTB generates this letter to the last good address on file for the taxpayer (not the address on the return). This is a higher threshold of concern than the Form FTB 4734D referred to above. Contact the FTB to confirm you filed the return. While waiting for the taxpayer to confirm that he or she filed the return, the return is on hold. Again, confirm the FTB fax number and mailing address online.
- Form FTB 4502, Additional Documentation Required — Refund Pending, is sent to taxpayers when the FTB does not have enough information to approve the claimed California Earned Income Tax Credit prior to issuing a refund.
- Form FTB 4579, Demand to Furnish Information, is sent to employers when the FTB is unable to validate wages and withholding claimed based on historical information and/or other third party data sources.

## THE WITHHOLDING ISSUE

Annually, the FTB holds its current-year notices until late May to ensure returns and payments are matched up to avoid erroneous bills. When the FTB began mailing notices in May 2016, they mailed 1.288 million pieces of correspondence over a 10-business-day period. This was a huge increase over the 866,000 pieces that were mailed over the same period in 2015.

The staff added by the FTB to answer the phones was not enough to handle the additional calls. When the notices generated more calls than expected, additional staff members were added to answer the calls.

The notices consisted primarily of NTRCs, but there were some Forms 4734D requesting withholding information, filing enforcement notices, and head of household audit letters. Due to the number of notices involving withholding mismatches, an FTB task force investigated the issue and found there were certain groups of taxpayers where the notices may have been erroneous. At this point, the FTB responded by announcing on their home page and in Tax News:

- The FTB would allow an additional two weeks from the due date on a Notice of Tax Return Change dated May 18 through June 15 in order to contact the FTB if necessary; and
- The FTB would take steps to reduce wait times for their customer service channels.

Unfortunately, a second problem arose when staff was redirected from the correspondence section to the call center to reduce the wait times. The reduction in staff in the correspondence group increased the processing time for mailed-in correspondence. In some cases, this resulted in follow-up notices or bills being mailed out before correspondence could be processed.

The FTB ultimately adjusted the accounts to provide the taxpayer the additional refund owed or eliminate balances due, and sent an apology explanation letter to each affected taxpayer.

In some cases second bills went out to taxpayers who had filed in February or early March, which had not yet been corrected.

## Why did this happen?

Over the past few years, the FTB has implemented the new EDR project, which was to modernize enterprise operations and systems. The project is scheduled to be completed by December 31, 2016.

One of the major purposes of the system was to find ways to collect tax due to the state of California by using increased data capture and validation ability.

It's the validation ability that went a bit awry here. In the past, if an employer failed to send one quarter of data — most commonly the fourth quarter — we believe the FTB and the IRS would estimate the withholding based on the information from the other three quarters. We also think it's likely that if employers mailed a paper copy of the fourth quarter report, it could take additional time to process this data, which, although timely filed, was not received until after the deadline. However, unlike in years past, this year the FTB's process did not account for lags in receiving employer records, and the missing withholding claimed by a taxpayer was denied.

***Comment***

It is for this reason the IRS will not mail refunds for returns with an EITC or refundable Child Tax Credit until February 15, even if the return is filed earlier.

Earlier in the year, we reported that there was a problem with approximately 5,000 taxpayer records that did not come over correctly from the EDD. The FTB identified a technical issue on their end that resulted in a discrepancy in the wage and withholding information used to verify the withholding credits. A practitioner also reported Northern Trust Company was late transmitting their payroll. According to the FTB, these problems were fixed, but thousands of other taxpayers were affected by the mismatches due to both changes in the FTB's process to allow withholding and unfiled or late reports to the EDD by employers.

Last year the FTB and EDD, at Spidell's request, formed a joint committee to deal with issues of employees' W-2s not matching company records. Although we understand that the FTB and EDD have been working on this issue, nothing has yet been resolved. The EDD is silent on what they are doing to resolve the situation. We are talking to the agencies and will let you know what we find out.

✎ **Practice Pointer**

According to the FTB, the posting of payments is delayed when these issues occur:

1. The payment was sent without enough identifying information on the check or without a voucher for the FTB to quickly associate it to the taxpayer's 2015 account. These types of payments are sent to a unit to do manual research using the check information, which delays the processing of the payment and could result in a bill being issued for the return balance due;
2. Some taxpayers send payment with a paper copy of the previously e-filed return. In this case, the FTB will process the second filed return and payment together. The return and payment will be seen as a duplicate return by the system and must be manually reviewed by a technician. In the meantime, the originally filed return remains as a return with no payment. Once the technician looks at the second return and the payment, the duplicate return is cancelled and the payment moved to pay the tax on the original return; and
3. The payment was lost or misplaced in the FTB's system.

## SOLUTIONS FROM SPIDELL

It was a challenging post-filing season. In an effort to prevent similar problems in the future, we suggested that:

- The FTB and EDD determine what can be done to get late-filed quarterly return information sent to the FTB immediately;
- The FTB put procedures in place that avoid an automatic disallowance when problems like these occur;
- The EDD put procedures in place to assist employees whose W-2s don't match the information submitted by the employer; and
- The FTB return to the pre-2016 processes of temporarily validating mismatched W-2 withholding and follow up later after all EDD data has been received (they agreed with this one; see discussion below).

### Situations that will need additional follow-up

There will be situations where the FTB will not immediately adjust your client's account. Here are a few situations where you may need to do more to follow up:

- Your client is the shareholder/employee, and information does not match EDD records, in which case the EDD may need to be contacted. In some situations, if the entity, which is owned by the employee, failed to file or pay withholding tax to the EDD, the taxpayer/shareholder will not get credit;
- If your client received a Form FTB 4734D, the FTB is concerned about the potential for identity theft or refund fraud, and the employee may be asked to provide year-end pay stubs as discussed above. If the employee cannot provide a year-to-date or all pay stubs to the FTB, and the EDD records don't match what was reported on the taxpayer's return, the FTB may reach out to the employer to verify the credit; and
- There may be other situations where the FTB cannot match the information, but the FTB will work with the EDD in these situations. An example would be where a company changed its ID number, but the W-2 was under the old number.

In these situations, the account will be put on hold while the FTB attempts to resolve the discrepancy with the taxpayer and, potentially, the EDD. The FTB will begin collection action only if an NTRC was issued and an adjustment was made that caused a balance due.

If your client receives an NTRC and you disagree with the notice, contact the Tax Practitioner Hotline for assistance.

## WHAT ABOUT NEXT YEAR?

The FTB has conducted an extensive "lessons learned" evaluation from the problems taxpayers experienced during the 2016 filing season.

The FTB is instituting an enterprise call center escalation plan to ensure additional customer service staff assist when certain minimum levels of access occur in the call centers. Among other improvements, the FTB will modify its method to be similar to how it previously handled withholding mismatches. Under this method, the FTB will allow the withholding if it meets certain criteria. Conversely, if it does not meet that criteria, they will reduce the refund and notice the taxpayer accordingly.

They also are making a number of changes to the NTRC based on taxpayer and tax professional feedback. These changes are meant to clarify what adjustments have been made, why, and how to resolve it, if necessary.

The FTB is also working with the EDD to improve upon the exchange of information and how the FTB uses that information.

We have been working with the FTB on these problems and will continue to monitor progress and keep you posted during the next filing season.

### Timing issues

Often a taxpayer mails a payment, and the posting process has not been completed before the FTB sends a bill. If your client says they made their tax payment, check their MyFTB.

If you see a recent payment posted in the taxpayer's MyFTB account but the taxpayer has received a billing notice, check the account summary and if it shows no balance due, you don't need to do anything. It takes a week or so for the payment to post to the system after it is received.

### Handling notices next year

If in the 2017 filing season your client receives any of the notices we have discussed, and you believe the notice is incorrect or have questions, contact the phone number on the notice. If you have a POA on file, for an NTRC use the Secure Chat function of MyFTB to get information on the client's account.

In either case, if you are calling on behalf of your client, have the notice in front of you as well as a copy of their 2015 tax return, and the representative will assist you.

# 2016 California Tax Rates, Exemptions, and Credits

The rate of inflation in California, for the period from July 1, 2015, through June 30, 2016, was 2.1%. The 2016 personal income tax brackets are indexed by this amount.

**Exemption credits**

- Married/RDP filing joint, and surviving spouse.............. $222
- Single, married/RDP filing separate, and HOH ............ $111
- Dependent................................................................ $344
- Blind........................................................................ $111
- Age 65 or older ....................................................... $111

**Phaseout of exemption credits**

Higher-income taxpayers' exemption credits are reduced as follows:

| | Reduce each credit by: | For each: | Federal AGI exceeds: |
|---|---|---|---|
| Single | $6 | $2,500 | $182,459 |
| Married/RDP filing separate | $6 | $1,250 | $182,459 |
| Head of household | $6 | $2,500 | $273,692 |
| Married filing joint | $12 | $2,500 | $364,923 |
| Surviving spouse | $12 | $2,500 | $364,923 |

When applying the phaseout amount, apply the $6/$12 amount to each exemption credit, but do not reduce the credit below zero.

If a personal exemption credit is less than the phaseout amount, do not apply the excess against a dependent exemption credit.

**Example of exemption credit phaseout**

Joe is a single taxpayer with one dependent. His federal AGI is $187,000. He must phase out each of his exemptions by $12. That is, ($187,000 – $182,459) ÷ $2,500 = 2 (always round up); 2 × $6 = $12. His exemption credit for 2016 is $431, calculated as follows:

| | |
|---|---|
| Joe's personal exemption credit is | $ 111 |
| Less phaseout amount | ($ 12) |
| Personal exemption credit allowed is | $ 99 |
| Joe's dependent credit exemption is | $ 344 |
| Less phaseout amount | ($ 12) |
| Total dependent credit allowed is | $ 332 |
| Total exemption credits allowed is | $ 431 |

**Reduction in itemized deductions**

Itemized deductions must be reduced by the lesser of 6% of the excess of the taxpayer's federal AGI over the threshold amount or 80% of the amount of itemized deductions otherwise allowed for the taxable year.

- Single and married/RDP filing separate.............$182,459
- Head of household .........................................$273,692
- Married/RDP filing joint and surviving spouse.......$364,923

**Standard deductions**

The standard deduction amounts for:

- Single and married/RDP filing separate.................$4,129
- Married/RDP filing joint, head of household, and surviving spouse..........................$8,258
- Minimum standard deduction for dependents........$1,050

**Miscellaneous credits**

- Qualified Senior Head of Household Credit is 2% of California taxable income, with a maximum California AGI of $71,370, and a maximum credit of ..... $1,345
- Joint Custody Head of Household Credit and Dependent Parent Credit are each 30% of net tax, with a maximum credit of ........................................................ $440

**Nonrefundable Renter's Credit**

This nonrefundable, noncarryover credit for renters is available for:

- Single and married/RDP filing separate with a California AGI of $39,062 or less..................................$60 credit
- Married/RDP filing joint, head of household, and surviving spouse with a California AGI of $78,125 or less......$120 credit

**Individual tax rates**

- The maximum rate for individuals is....................... 12.3%
- The AMT rate for individuals is .................................. 7%

The Mental Health Services Tax Rate is 1% for taxable income in excess of $1,000,000.

**AMT exemption**

- Married/RDP filing joint, and surviving spouse ........$89,467
- Single and head of household ...........................$67,101
- Married/RDP filing separate, estates, and trusts.......$44,732

**AMT exemption phaseout**

- Married/RDP filing joint, and surviving spouse........$335,502
- Single and head of household ......................... $251,626
- Married/RDP filing separate, estates, and trusts........ $167,749

**FTB cost recovery fees**

- Bank and corporation filing enforcement fee ............$100
- Bank and corporation collection fee ........................$365
- Personal income tax filing enforcement fee.................$81
- Personal income tax collection fee...........................$266

The personal income tax fees apply to individuals and partnerships, as well as limited liability companies that are classified as partnerships. The bank and corporation fees apply to banks and corporations, as well as limited liability companies that are classified as corporations. Interest does not accrue on these cost recovery fees.

**Corporate tax rates**

- Corporations other than banks and financials ........ 8.84%
- Banks and financials ......................................... 10.84%
- AMT rate............................................................. 6.65%
- S corporation rate .................................................. 1.5%
- S corporation bank and financial rate ...................... 3.5%

# 2016 California Tax Rate Schedules

## Schedule 1 — Single or Married/RDP Filing Separate

If the taxable income is…

| Over | But not over | Tax is… | | | Of amount over… |
|---|---|---|---|---|---|
| $0 | $8,015 | $0.00 | plus | 1.00% | $0 |
| $8,015 | $19,001 | $80.15 | plus | 2.00% | $8,015 |
| $19,001 | $29,989 | $299.87 | plus | 4.00% | $19,001 |
| $29,989 | $41,629 | $739.39 | plus | 6.00% | $29,989 |
| $41,629 | $52,612 | $1,437.79 | plus | 8.00% | $41,629 |
| $52,612 | $268,750 | $2,316.43 | plus | 9.30% | $52,612 |
| $268,750 | $322,499 | $22,417.26 | plus | 10.30% | $268,750 |
| $322,499 | $537,498 | $27,953.41 | plus | 11.30% | $322,499 |
| $537,498 | and over | $52,248.30 | plus | 12.30% | $537,498 |

## Schedule 2 — Married Filing Joint or Qualifying Widow(er) with Dependent Child

If the taxable income is…

| Over | But not over | Tax is… | | | Of amount over… |
|---|---|---|---|---|---|
| $0 | $16,030 | $0.00 | plus | 1.00% | $0 |
| $16,030 | $38,002 | $160.30 | plus | 2.00% | $16,030 |
| $38,002 | $59,978 | $599.74 | plus | 4.00% | $38,002 |
| $59,978 | $83,258 | $1,478.78 | plus | 6.00% | $59,978 |
| $83,258 | $105,224 | $2,875.58 | plus | 8.00% | $83,258 |
| $105,224 | $537,500 | $4,632.86 | plus | 9.30% | $105,224 |
| $537,500 | $644,998 | $44,834.53 | plus | 10.30% | $537,500 |
| $644,998 | $1,074,996 | $55,906.82 | plus | 11.30% | $644,998 |
| $1,074,996 | and over | $104,496.59 | plus | 12.30% | $1,074,996 |

## Schedule 3 — Head of Household

If the taxable income is…

| Over | But not over | Tax is… | | | Of amount over… |
|---|---|---|---|---|---|
| $0 | $16,040 | $0.00 | plus | 1.00% | $0 |
| $16,040 | $38,003 | $160.40 | plus | 2.00% | $16,040 |
| $38,003 | $48,990 | $599.66 | plus | 4.00% | $38,003 |
| $48,990 | $60,630 | $1,039.14 | plus | 6.00% | $48,990 |
| $60,630 | $71,615 | $1,737.54 | plus | 8.00% | $60,630 |
| $71,615 | $365,499 | $2,616.34 | plus | 9.30% | $71,615 |
| $365,499 | $438,599 | $29,947.55 | plus | 10.30% | $365,499 |
| $438,599 | $730,997 | $37,476.85 | plus | 11.30% | $438,599 |
| $730,997 | and over | $70,517.82 | plus | 12.30% | $730,997 |

**Individual Filing Requirements**

| Filing Status | Age as of December 31, 2016* | California Gross Income | | | California Adjusted Gross Income | | |
|---|---|---|---|---|---|---|---|
| | | Dependents | | | Dependents | | |
| | | 0 | 1 | 2 or more | 0 | 1 | 2 or more |
| Single or head of household | Under 65<br>65 or older | $16,597<br>$22,147 | $28,064<br>$30,747 | $36,664<br>$37,627 | $13,278<br>$18,828 | $24,745<br>$27,428 | $33,345<br>$34,308 |
| Married filing joint, RDP, or separate | Under 65 (both spouses/RDPs)<br>65 or older (one spouse)<br>65 or older (both spouses/RDPs) | $33,197<br>$38,747<br>$44,297 | $44,664<br>$47,347<br>$52,897 | $53,264<br>$54,227<br>$59,777 | $26,558<br>$32,108<br>$37,658 | $38,025<br>$40,708<br>$46,258 | $46,625<br>$47,588<br>$53,138 |
| Surviving spouse | Under 65<br>65 or older | | $28,064<br>$30,747 | $36,664<br>$37,627 | | $24,745<br>$27,428 | $33,345<br>$34,308 |
| Dependent of another person — Any filing status | Under 65<br>65 or older | More than your standard deduction<br>More than your standard deduction | | | | | |

* If you turn 65 on January 1, 2017, you are considered to be age 65 at the end of 2016.

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SPIDELL

Tax • Analysis • Education

Chapter 12

# California Individuals

# CALIFORNIA INDIVIDUALS

## MUNICIPAL BOND INTEREST INCOME CASE

Taxpayers have filed suit in Los Angeles Superior Court, challenging California's law that says tax-exempt government bond interest passed through from a mutual fund invested less than 50% in U.S. government obligations or California municipal obligations is taxable for state purposes. (***Ronald & Pamela Mass v. FTB*** (July 20, 2016) Los Angeles Superior Court, Case No. BC627648)

The lawsuit means taxpayers who have been paying tax on this income can now file protective refund claims to protect their refund rights if the taxpayers ultimately succeed in this battle.

## THE CALIFORNIA LAW

Under R&TC §17145, interest can only be excluded if at least 50% of the assets held by a mutual fund consists of interest-bearing obligations that are tax-free for California purposes. This includes U.S. and California obligations. Thus, if the fund holds less than 50% of these obligations, all distributions are taxable, even though this income is exempt under the U.S. Code and California Constitution. (31 U.S.C. §3124(a); Cal. Const., Art. XIII, §26(b)) If the fund holds 50% or more in qualifying obligations, the flow-through character of the distributions is retained.

After the FTB assessed over $60,000 in additional tax on California obligation interest because the mutual fund contained less than 50% of exempt California obligations, the taxpayers filed an appeal with the Board of Equalization. (***Appeal of Ronald D. Mass and Pamela S. Mass*** (April 26, 2016), Cal. St. Bd. of Equal., Case No. 874820) The Board declined to rule on the case, thus affirming the FTB's decision. This was based on ***Appeal of Henry***, in which the Board ruled that Article III, §3.5 of the California Constitution precludes the Board from deciding constitutional issues and from declaring statutory provisions to be unconstitutional. (***Appeal of H. Lon Henry*** (March 14, 1996) 96-SBE-006)

## FILING PROTECTIVE CLAIMS

If your clients have paid tax on California-exempt muni bond income, they could be entitled to refunds when the dust settles in this case. In order to protect those refund rights, file protective refund claims now.

A refund claim must be made prior to the expiration of the later of:

- Four years from the date a return was timely filed, including extensions;
- Four years from the last day prescribed for filing the return, determined without regard to any extensions; or
- One year from the date of overpayment.
  (R&TC §19306)

Currently, the FTB has not established any special procedures for accepting these protective refund claims. At this point, they recommend that taxpayers follow the instructions for filing a protective claim on Form 540X, Amended Individual Income Tax Return:

- Write "PROTECTIVE CLAIM" in red ink at the top of the completed form; and
- On Part II, Line 5, specify that the claim is being filed in reference to the pending litigation in ***Ronald & Pamela Mass v. FTB***, Los Angeles Superior Court, Case No. BC627648.

These claims will remain on hold until there is a final resolution of the case. Remember that this could take years, as we have seen with other cases in the past.

***Comment***

Marty Dakessian is representing the taxpayers in this case. Dakessian is the founder of Dakessian Law, a practice dedicated to representing California taxpayers. He can be reached at (213) 516-5510 or marty@dakessianlaw.com.

## HOW DOES THE FTB KNOW?

California law requires mutual fund firms and brokerage houses that report interest or dividends from bonds issued by another state that are exempt from federal taxation to file information returns with the FTB. (IRC §6049; R&TC §18631(c)(8)) So taxpayers who fail to report this income properly will likely receive notices from the FTB.

# NONRESIDENTS

## SELLING ASSETS AND LEAVING CALIFORNIA

Any taxpayer who wants to move to a nontax state prior to selling a business or other asset not sourced to California must make the move and become a nonresident before the sale.

This can be a bit trickier than it might seem, and the FTB pays close attention. Prior Board decisions indicated that a taxpayer who wants to become a nonresident must truly move and change residence, including:

- Selling the California home or show reason why it wasn't sold;
- Leaving California employment;
- Establishing and spending time in a residence located in the new state. This residence should be of equal or greater size, cost, and amenities as the California home unless taxpayers can show why a smaller home was more appropriate (e.g., downsizing after kids left);
- Establishing business and social ties in the new state; and
- Discontinuing business and social ties in California.

It is not easy to undo California residency. Under prior Board rulings, when the taxpayer keeps ties to California, the only criterion that positively established nonresidency is the work contract test (R&TC §17014(d)), under which a taxpayer is employed under a contract that requires the taxpayer to be absent from California for at least 546 days.

### Taxpayer wins

With the current Board however, we're seeing a shift in how they are evaluating residency cases. The Board is no longer providing a rubberstamp approval of the FTB residency determinations. In two recent cases discussed below (***Appeal of Bills*** and ***Appeal of Lau***), the Board took a much more taxpayer-friendly position, focusing on whether the taxpayer had the intent to establish a new residence rather than focusing solely on objective factors. See page 12-5.

## Sale of a California business

If your client wants to become a nonresident, you must help carefully plan the exit when there is a business involved.

Structuring a sale too soon can make the gain taxable to California. Waiting until the client is a nonresident could save big tax dollars.

The same will hold true if the client is selling appreciated stocks, bonds, or non-California property or investments.

### Nonresident selling stock in a closely held corporation

We've heard the argument that if a nonresident sells stock in a California corporation or a partnership interest, the gain on the sale of the stock is taxable to California if the stock is not publicly traded. We brought this issue to FTB staff, who stated that this is not their position.

The sale of the stock is not taxable to the nonresident even if the corporation (including an S corporation) is actively engaged in a trade or business in California.

However, there are some important caveats to keep in mind:

- The sale of assets of an S corporation is taxable to a nonresident shareholder if the assets, including intangibles, are sourced (or apportioned) to California;
- The shareholder must truly be a nonresident of California and domiciled in a state other than California to avoid California tax on the sale of the stock; and
- To qualify, the sale must take place after the taxpayer establishes residency in another state. By sale, we don't mean the "close of escrow." All of the incidences of a sale must take place after the change of residence. In other words, don't negotiate the sale terms while a resident and then complete the transaction after moving. (***Comm. v. Court Holding Co.*** (1945) 324 U.S. 331) Although see the ***Bills*** case below, in which the current Board appears to be taking a more expansive view.

## Sale of a partnership interest

In the ***Bills*** case, the Board sided with the taxpayers and found that they had established residency in Washington in just one week, and so the multimillion dollar payment they received for the sale of the husband's partnership interest was not subject to California tax. (***Appeal of Bills*** (April 28, 2016) Cal. St. Bd. of Equal., Case Nos. 610028, 782397)

The FTB fought the taxpayer on two issues:

- Whether the taxpayers were residents when the sale occurred; and
- Even if they were not residents, the FTB argued that the sale was of the assets of the partnership, not the sale of an intangible — the partnership interest.

The former long-term California residents became residents of Washington state just two months before receiving an initial payment on the $40 million paid for the sale of the husband's California partnership interest. Because the sale of the husband's partnership interest was a sale of an intangible, it was sourced to their new state of residence and not taxable by California.

### The facts

Michael and Mary Bills had been California residents since the late 1990s and owned a home in Rancho Santa Fe in Southern California. Michael was the managing partner of Brandes Investment Partners, LP until his retirement at the end of 2004. In anticipation of the retirement, the taxpayers bought a completely furnished, 5,635 square foot home in Friday Harbor, Washington, for $2.8 million. Rather than selling their California home, they allowed their adult daughter to reside there.

The following summarizes the Bills' activity after the purchase of their Washington home:

| Timeline of Events | |
|---|---|
| **Date(s)** | **Activity** |
| November 2004 | The Bills purchased a home in Washington. |
| November 2004–December 2004 | The Bills set up electric and gas utility accounts for their Washington home. |
| December 31, 2004 | Michael retired from Brandes Investment, LP. |
| January 10, 2005–January 16, 2005 | The Bills stayed in their Washington home, registered to vote, Michael obtained a Washington driver's license, and the Bills received household furnishings and personal items at their Washington home. The Bills also registered three of their seven cars in Washington during this period, although all the cars remained in California. Sometime later the Bills registered four other vehicles in Washington, although none of the cars were driven up to Washington until April 2005, when one car was driven up, followed by another car in June 2005. The Bills also opened a local bank account in Washington and saw local doctors and dentists. |
| January 16, 2005–April 23, 2005 | The Bills drove back to California and stayed in their California home until February 3, 2005, when they left on a series of trips, which ended on April 23, 2005. They returned to the California home in between trips. |
| March 2005 | The Bills received the first payment for liquidation of his partnership interest ($7,553,083) from Brandes Investment, LP. This was the first of five payments paid between 2005 through 2009, which came close to $40 million in total. |
| April 23, 2005–May 2005 | The Bills drove back to their Washington home and discovered that the home's well required repairs. They returned to their California home while repairs were completed. |
| June 2005 | The Bills returned to their Washington home. |

## Residency established/no abandonment

The Board found that the evidence showed that the Bills abandoned their California domicile when they arrived at their Washington home on January 10, 2005. They had purchased a fully furnished home and undertook all the various activities that one would undertake to establish a new domicile during the one week they were in Washington. This included registering to vote, opening a bank account, visiting doctors and dentists, etc.

Once their new domicile was established in Washington in January 2005, the next question was whether their return visits to California were for other than a temporary or transitory purpose. In evaluating the Bills' contacts with California to determine whether their contacts were for more than a temporary or transitory purpose, the Board utilized the Bragg factors outlined in the Board's earlier decision in ***Appeal of Bragg***. (***Appeal of Stephen D. Bragg*** (May 28, 2003) 2003-SBE-002)

- **Registrations and filings:** This includes registering to vote, registering vehicles, etc. These were all done in Washington during the Bills' one-week stay in January, demonstrating a "strong" connection to Washington;
- **Day-to-day personal and professional contacts:** The Bills saw dentists/doctors in Washington. As Michael had retired, there were no occupational contacts in either state. These demonstrated a stronger connection to Washington; and
- **Physical location of persons and property:** The home in Washington was purchased fully furnished. Other furnishings were shipped from the Bills' California home and New York apartment. Their adult daughter resided in their California residence. The days spent in California were "brief sojourns" between trips. The Board ruled there was a closer connection to Washington.

Based on these findings, the Board ruled that the Bills became residents of Washington on January 10, 2005, and remained so thereafter.

### FTB tries to tax sale of partnership interest

The Board ruled that the sale of Michael Bill's partnership interest was the sale of an intangible sourced to the state of the Bills' residence at the time of receipt, in this case, Washington.

The FTB argued that the payments for Michael's 99% membership interest in the partnership were made in exchange for the property owned by Brandes and therefore should be treated as a sale of the partnership's property and not the sale of an intangible partnership interest. However, based on previous rulings of the Board, including the ***Appeal of Ames***, the sale of a partnership interest is considered a sale of an intangible. (***Appeal of Ames et al.*** (June 17, 1987) 87-SBE-042)

As there was no evidence that Michael had used his partnership interest in such a manner as to establish California situs, the income was not considered California-source income taxable by California.

## Appeal of Lau

The ***Bills*** case is not an isolated incident. In another surprising development in 2015, the Board appeared to be ready to rule that long-term California residents had also changed their residence right before receiving an $8 million dividend distribution. However, the FTB withdrew their Notice of Proposed Assessment against the taxpayers before the Board had a chance to issue a ruling. (***Appeal of Lau***, Cal. St. Bd. of Equal., Case No. 739838, heard March 25, 2015, dismissed May 7, 2015)

Despite the fact that the taxpayers still spent a substantial amount of time in and maintained close connections to California, it was clear that the Board members felt that the taxpayers presented sufficient evidence to support their argument that they had changed their domicile to Nevada.

## Taxpayer deemed a resident

Lest we think that the Board is completely reversing itself on residency cases, it is important to note that the Board did uphold the FTB's residency determination in a hearing earlier this year. In a fairly straightforward case, the Board ruled that a taxpayer who previously had resided in China was a California resident and domiciliary when he sold stock for a $6,731,242 gain. Therefore he was liable for $676,073 in additional tax, plus interest. (***Appeal of Hexu Zhao*** (March 29, 2016) Cal. St. Bd. of Equal., Case No. 849110)

Hexu Zhao was a California resident for approximately 11 years prior to moving to China to work as the CFO for JA Solar in July of 2006. While he was working for JA Solar, his wife and two children remained in their home in California. In April 2008, he left his employment and on May 11, 2008, returned to California to work for Legend Silicon.

On May 16, 2008, the taxpayer sold JA Solar stock, which resulted in the capital gain at issue.

The taxpayer's attorney unsuccessfully argued that while he was working for Legend Silicon in 2008, he traveled between California and Asia for both business and personal reasons and was a nonresident. For 2008, Zhao filed a California Form 540NR as married filing separately. He did not include the capital gain for the JA stock sold on May 16, 2008.

Although the FTB determined he was a nonresident for 2006 through May 11, 2008, he became a resident of California beginning on May 12, 2008, when he returned. Had he delayed his "return" home until later in the year, or better yet, until 2009, he would have had a much better chance of having the income excluded from California taxable income.

***Comment***

Although the Board has been hearing appeals all year, the BOE has not released any decisions since March of 2015, except those required under R&TC §40 (which requires a written opinion or summary within 120 days for all cases where the amount in controversy is $500,000 or more). Thus, there may be other residency cases that aren't yet available.

# TAXATION OF NONRESIDENT SELF-EMPLOYED TAXPAYERS COMPARED TO EMPLOYEES

## Self-employed taxpayers

All self-employed taxpayers who provide services to California clients must source their revenue from those services to California under the single sales factor apportionment formula and market-based sourcing rules. Self-employed taxpayers include sole proprietorships as well as partners and partnerships.

Sales from services are assigned to California to the extent the taxpayer's customer (the purchaser of the service) receives the benefit of the service in California.

***Example of self-employed taxpayer working in California***

Jeff performs tax and accounting services both in California and Nevada, but is located in Nevada. Jeff performs tax and accounting services for a California client. Those fees are sourced to California, even if Jeff performs all services for this client in Nevada. If however, the practitioner performs no services for a California client, the services are not taxable to California.

Prior to enactment of the single sales factor, Jeff computed California apportioned income based on a formula that sourced income based on Jeff's payroll, property, and sales. This computation included a percentage of profits apportioned to the state of residence and sourced revenue from services to the state where the services were performed. This no longer applies.

## Employees

California taxes nonresident employees on personal services, but only when those services are performed in California. (18 Cal. Code Regs. §17951-5) This is the case even when the individual is a shareholder/employee of their own corporation.

**Practice Pointer**

The corporation must be qualified to do business in California, and must apportion income based on the single sales factor apportionment method. This means the corporation will pay at least the $800 minimum tax to California each year.

The rules for assigning an employee's wages require a reasonable allocation of wages to California. In most cases, the employee can use a "days spent in California" method to allocate the wages.

***Example of an employee working in California***

Trudy is a shareholder/employee of her corporation. She is a Florida resident, but her clients are all California individuals or businesses. She performs 90% of her services in Florida and 10% in California. The corporation is qualified to do business in California and apportions its income to California based on the single sales factor apportionment formula and market-based sourcing rules.

Because Trudy is an employee of her corporation, her wage income is assigned to California based on the time spent working in California versus time spent working everywhere, or 10%.

Any net income from the corporation would be apportioned to California because all the services were for California clients. Thus, it benefits her to pay all her income in wages.

If Trudy operated as a sole proprietorship, all of her income would be taxable to California because all of her clients are in California.

## Enforcement

How does the FTB enforce these provisions when the nonresident performing services is working with California clients?

That would be potentially difficult. However, in the case of tax professionals, the FTB has access to PTINs. If a California return is filed, the FTB could trace the preparer. If a California return is not filed, the FTB could retrieve information from other sources, such as sales and payroll taxes, other licenses, and the IRS.

# SCHEDULE S — CREDIT FOR TAX PAID TO ANOTHER STATE

California allows individuals, estates, or trusts to claim a credit for net income taxes imposed and paid to another state only on income that has a source within the other state and is taxed by California and the other state. (R&TC §§18001–18011)

**Practice Pointer**

Business returns are not allowed a credit for tax paid in another state. Business income must be apportioned among all the states in which the business operates, and nonbusiness income is assigned to a single state.

Lately, we have seen new issues, Board decisions, and a few changes. We have also heard from several practitioners whose clients received notices disallowing the credit. So here is a review of how the credit works as well as discussions of:

- The FTB's new disallowance of credit for the Revised Texas Franchise Tax;
- Confusion with group returns;
- Double-taxed income that doesn't qualify for the credit; and
- Statute of limitations for claiming the credit.

## HOW THE OTHER STATE TAX CREDIT WORKS

Generally, you take the credit for double-taxed income on the taxpayer's resident return. However, for certain states, the credit is taken on the nonresident return. If you have income taxed by California and another state, use the following chart to determine where to take the credit.

| Other State Tax Credit: Where to Take It | | |
|---|---|---|
| **Taxpayer is:** | **Income is from:** | **Credit is taken on:** |
| California resident | Arizona, Guam, Indiana, Oregon, Virginia | Other state nonresident return |
| | Any state or U.S. possession not listed above | California resident tax return |
| **Taxpayer is:** | **Resident of:** | **Credit is taken on:** |
| California nonresident | Arizona, Guam, Indiana, Oregon, Virginia | California nonresident tax return |
| | Any state or U.S. possession not listed above | Other state resident return |
| **Note:** There are some narrow exceptions to the general rule, discussed below. | | |

## REVISED TEXAS FRANCHISE TAX

Probably the biggest current issue regarding the Other State Tax Credit (OSTC) is the FTB's new position that the Revised Texas Franchise Tax (RTFT) paid on income from a Texas LLC or S corporation is not allowed in computing the credit. The FTB is disallowing the credit without discussion as to why.

***Revised Texas Franchise Tax***

The Revised Texas Franchise Tax is a privilege tax imposed on each taxable entity formed or organized in Texas or doing business in Texas.

In January 2014, the FTB withdrew Notice 2010-2, which stated that whether a taxpayer can claim an OSTC for payment of a RTFT must be made on a case-by-case basis. Late last year, the FTB went one step further and began disallowing the OSTC for all payments of RTFT. After hearing from a number of practitioners whose clients' credits were disallowed, we asked the FTB for an answer as to why they were disallowing the credits.

In February of 2016, the FTB issued Technical Advice Memorandum 2016-01, which stated that the payment of RTFT is not eligible for the OSTC for any year because the RTFT is not a "net income tax" and that a legal ruling would be issued on the issue. At that time, we were told the FTB would issue the legal ruling "within the next couple of weeks." Most recently, we were told the advice would be coming out by the end of summer. However, at press time it still had not been released.

## FTB INCORRECTLY DISALLOWS CREDITS FROM GROUP RETURNS

The FTB has been erroneously disallowing the OSTC when a California resident claimed the credit from a group return (also commonly referred to as a composite return) for a reverse credit state on their California resident return. (A reverse credit state is one where the credit is claimed on the nonresident state; see chart "Other State Tax Credit — Where to Take It.")

For example, Virginia is typically a reverse credit state, but for a credit from a group nonresident return, the credit is taken on the California resident return. In many cases the FTB disallows the credit even though it was taken correctly. We have talked to the FTB, and they are looking into a way to fix this intermittent problem.

### Tax paid on a group return

If the tax was paid to certain states on a group nonresident return, the credit goes on the California resident tax return, even though normally the credit would go on the nonresident return of the other state. (R&TC §18535) According to the Schedule S instructions, these are the states where the taxpayer's group return income and withholding will go on the California resident return:

- Arizona;
- Guam;
- Indiana;
- Oregon; and
- Virginia.

To claim the credit for one of these states on the resident return, attach a statement to the return explaining that the income is part of a group return, the amount of the income, the tax withheld, and the state involved.

To help in correct processing of the return:

- Attach a statement for each credit claimed explaining that this is part of a group return;
- Compute each credit separately on each amount of income. Don't lump all the income and credits into one line and say "See attached"; and
- If you have a credit from more than one state, figure the credit by completing a separate Schedule S for each state. Add the credits from each state's Schedule S, and enter the total on Form 540.

Even following these guidelines, the FTB may disallow the credit. We have suggested a box to check or a separate section to list the group return states. The FTB is looking into a resolution. In the meantime, the Tax Practitioner Hotline or a secure chat is your best bet if the credit is incorrectly disallowed.

Call:

| ☎ **Telephone** |
|---|
| (916) 845-0494 |

## DOUBLE-TAXED INCOME THAT DOESN'T QUALIFY FOR THE CREDIT

R&TC §18001 defines double-taxed income for resident taxpayers claiming the credit to reflect only income that would be sourced to California to a nonresident. In other words, you cannot take the credit if the other state taxes the nonresident on the income, but California would not tax a nonresident on the same income.

***Example of double-taxed income***

Joey is a California resident. He sold property in Hawaii and is receiving principal and interest payments on the property sale. Hawaii taxes him on the principal and interest payments. Under Hawaii law, all interest on the sale of property located in Hawaii has a situs there.

California allows a credit for tax paid to the other state on the principal payments but not on the interest payments. This is because, under California law, the interest is sourced to California, not Hawaii, and a Hawaii resident is not required to pay California tax on the interest if it does not have a California situs. Thus, as a California resident, Joey will pay tax on the interest to both California and Hawaii.

## STATUTE OF LIMITATIONS

A taxpayer who pays tax to another state has one year from the date the tax is *paid* to claim an OSTC with the FTB, even if the statute of limitations has already expired. (R&TC §19311.5)

This provision will help taxpayers who do not file tax returns with a nonresident state and are notified by the other state after the California statute has expired.

***Example of statute of limitations***

Opie, a California resident, has income from an oil well in Oklahoma in 2007. He never filed Oklahoma tax returns to report the income. On December 15, 2015, the state of Oklahoma assessed $1,000 tax on $15,000 of Oklahoma income he earned in 2007, which he paid on January 15, 2016.

Even though the 2007 statute of limitations for California expired on April 15, 2012, he may claim a credit for tax paid to Oklahoma on his 2007 amended California return.

To claim the credit, he must file an amended 2007 return on or before January 14, 2017.

The reverse is not true, however. A Pennsylvania taxpayer who incorrectly filed a California resident return rather than a nonresident return was held liable for California tax. The taxpayer was not entitled to the OSTC for the increased liability because the statute of limitations to claim an OSTC had lapsed in Pennsylvania. Where a taxpayer fails to take the OSTC in another state to prevent double taxation and then the statute has run in that state, the double tax cannot be recouped under the California statute. (***Appeal of Calvin*** (November 19, 2014) Cal. St. Bd. of Equal., Case No. 728341)

# EXCEPTIONS TO THE GENERAL RULES

## Certain Oregon wages

Generally, a California resident must take a credit for tax on Oregon-source income on the Oregon nonresident return. However, for “qualifying compensation” the credit is taken on the California resident return. (FTB Information Letter 2010-3) Qualifying compensation includes wages paid by an employer to an employee for services performed in Oregon in connection with a qualifying film production. (Oregon Law 2005 Ch. 2005-559 §1)

Oregon does not allow California residents a credit against Oregon income taxes for taxes paid to California on qualifying compensation. Therefore, the FTB stated that they will generally allow a credit to California residents for income taxes paid to Oregon on qualifying compensation.

## Virginia dual residents

A Virginia dual resident is any taxpayer who is defined as a California resident under California law and a Virginia resident under Virginia law.

A dual resident of Virginia and California may claim the Other State Tax Credit on the California return for taxes paid to Virginia on Virginia-source income. Dual residents who are elected or appointed officials and staff (holders of federal elective offices, certain Presidential appointees, and congressional staff members) may claim the OSTC for taxes paid to Virginia on all income taxed by Virginia whether or not it has a source in Virginia. (R&TC §17014(b))

## Dual-resident estates or trusts

An estate or trust may claim the credit for taxes paid to another state if it is a “resident” of California and also a “resident” of another state. For this purpose, an estate or trust is considered to be a “resident” of any state that taxes all its income regardless of whether the income is derived from sources within that state. (R&TC §18005)

The credit is limited to:

- The proportion of the tax paid to the other state by the estate or trust that the double-taxed income bears to the entire income of the estate or trust; and
- The proportion of the estate’s or trust’s California tax that the double-taxed income bears to the total income taxed by California.

## What income/tax does not qualify?

The OSTC is not allowed for either preference items or alternative minimum tax paid to California or another state.

The OSTC may not be claimed for taxes paid to cities, counties, and other countries or their subdivisions, such as the Canadian provincial tax.

However, a portion of the tax paid to Maryland counties is allowed in computing the credit for Maryland. The maximum amount includable in this credit is 20% of the state tax. (***Appeal of Daniel Q. and Janice R. Callister*** (February 25, 1999) 99-SBE-003)

# MISCELLANEOUS

## COLLEGE ACCESS TAX CREDIT

For 2016, a taxpayer who makes a contribution to the California College Access Tax Credit Fund is allowed a 50% credit on amounts contributed on the 2016 California return, and a charitable contribution deduction on the federal return. (R&TC §§17039, 23036)

The credit may be used to reduce regular tax below tentative minimum tax, the AMT, and any unused portion may be carried over for six years.

To claim the credit for 2016, a taxpayer must apply for a credit allocation reservation to CEFA in the State Treasurer's Office by December 31, 2016. The contribution can be made with an ACH online payment (a web-based payment using a personal checking/savings accounts or corporate bank account), cashier's check, money order, or electronic funds transfer (EFT).

Applications (CEFA Form CATC-1) are available on CEFA's website and at CEFA's office:

**Website**
www.treasurer.ca.gov/cefa/catc/

**Address**
California Educational Facilities Authority
915 Capitol Mall, Room 590
Sacramento, CA 95814
Attn: Operations Manager

The credit will continue in 2017, and the credit remains at 50% of the contribution.

## SPOUSES DON'T NEED TO MOVE IN ORDER TO SEPARATE

In California, the community ends when the spouses separate with no intention of reuniting. This is a "facts and circumstances" test. It is not necessary to be legally separated or to have filed for separation or divorce. However, there has been debate about whether couples can separate and continue living together.

In 2015, the California Supreme Court held that the community does not end if both spouses live under the same roof. (***In re: Marriage of Sheryl Jones Davis and Keith Xavier Davis*** (July 20, 2015) 61 Cal.4th 846)

On July 25, 2016, the Governor signed SB 1255 (Ch. 16-114), which reverses the ***Davis*** case. This means taxpayers may now "separate" while continuing to live under the same roof.

### Importance of separation date

The date of separation is important for divorcing couples because it determines asset classification, spousal support calculations, and many other important issues including income splitting for income tax purposes. The date of separation is the date that the "community" ends for the married couple and community property laws no longer apply.

So this date isn't just important for battling divorce attorneys, but it affects former couples' tax returns as well. The date of separation tells us when earned income is no longer community income and is no longer split between the two spouses.

***Example of separation***

Fred and Berta had been married since 2007. On January 1, 2015, after a particularly dreary New Year's Eve, they decided to separate.

Unfortunately, the couple's finances force them to continue to live together until July 2016, when Fred moves out.

Both Fred and Berta are employed. With the enactment of SB 1255, income from wages would no longer be community property beginning January 1, 2015 — the date on which they decided to separate (so long as other facts and circumstances support that date).

## FTB SCORES BIG WIN IN *HYATT*

The FTB just gained an advantage in their battle with Gilbert Hyatt when the U.S. Supreme Court held that Mr. Hyatt can sue the FTB in a Nevada court, but his damages will be limited to $50,000. (***FTB v. Hyatt*** (April 19, 2016) U.S. Supreme Court, Case No. 14-1175) This is substantially less than the $250 million in punitive damages and $139 million in compensatory damages he was originally awarded by a Nevada court.

The case will still go back to Nevada, but the limitations the Court placed on the damages means this chapter of the saga between Mr. Hyatt and the FTB should be coming to an end shortly.

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# Chapter 13

# California Business

# CALIFORNIA BUSINESS

## REFUNDS HELD IN BUSINESS'S FINAL YEAR

### FTB LOOKS FOR ESTIMATED PAYMENTS BEFORE ISSUING REFUNDS

When a business entity tax return posts to the FTB's accounting system and creates a credit balance, the system looks to see if the corporation's estimate or LLC tax payment for the subsequent tax year has been received. If the payment has not been received and is past due, the system will move the money (up to $800) forward on behalf of the business entity to help them reduce penalties and interest on the subsequent year. At that point, the remaining credit balance would be refunded to the business entity when a return is filed or as an offset to other tax years with a billable balance due. This applies to both corporations and LLCs.

This scenario would hold true even if the recently filed return was marked "final" because if the entity does cancel or dissolve with the California Secretary of State, they continue to have a filing requirement going forward. Essentially, until they fully complete the cancellation or dissolution and the FTB receives that information from the SOS, they are still an active entity, and the $800 minimum franchise tax or $800 annual tax will continue to accrue.

***Example of refund held in final year***

Done LLC filed a timely tax return and marked the box "final." Because they had overpaid the annual fee on gross receipts, their refund was supposed to be $3,500. The FTB sent a check for $2,700 and applied the $800 to the 2016 annual tax because they had not yet cancelled their registration with the SOS.

We believe this policy was put in place because for many years, the final return could not be filed prior to dissolving with the SOS. However, that has not been the case since 2006. Entities can now file their final return and then dissolve with the SOS.

#### Avoiding the $800

The FTB will not assess the $800 minimum/annual tax for the current taxable year if an entity meets each of these three conditions:

- The entity files a timely final tax return on or before the extended due date for the preceding taxable year;
- The entity does not do business in California after the end of that year; and
- The entity files a Certificate of Dissolution, Certificate of Surrender, or Certificate of Cancellation with the SOS before the end of the 12-month period beginning with the date the final return was filed.

Due to the change in the dissolution and final return procedures many years ago, we believe the FTB should revise their procedures and not apply the $800 to the subsequent year if the final box is checked on the return.

## THE MONEY WILL ULTIMATELY BE REFUNDED

Once the FTB has received information from the SOS that the entity is indeed cancelled or dissolved, the remaining credit will be refunded, provided that the entity did not incur another year's filing and payment requirement or have some other additional balance due.

# PENALTIES

## PER SHAREHOLDER/PARTNER/MEMBER PENALTY

A taxpayer's failure to pay the $800 minimum/annual tax resulted insubstantial penalties that far exceed the tax itself. A Wisconsin S corporation was required to pay $16,200 in a late filing per shareholder penalty for failing to timely file a California franchise tax return to report and pay its $800 minimum franchise tax liability for the 2010 tax year. (***Appeal of American Orthodontics, Inc.*** (August 5, 2014), Cal. St. Bd. of Equal., Case No. 711153)

**Caution**

Under California law, in addition to the standard late payment and late filing penalties, an S corporation, partnership, or LLC that fails to timely file a return is subject to the per shareholder/partner penalty. R&TC §§19172 and 19172.5 impose a penalty against late filing partnerships/S corporations equal to $18 per partner/shareholder per month for a maximum of 12 months. As applied to American Orthodontics, with its 75 shareholders, this came to $16,200 (($18 × 75) × 12) for failure to pay the $800 minimum tax.

### Background

American Orthodontics Corporation (American) was headquartered in Wisconsin and manufactured and sold dental and orthodontic equipment around the world. At one time, American was qualified to do business in California, but surrendered this right in 1982. Since 2003, it had employees in California, and in 2010 it had six sales people in California.

Although American was required to and did pay California employment taxes on the wages paid to the sales people, American was not required to pay corporate income taxes on its California-sourced income pursuant to the federal Interstate Income Act of 1959 (P.L. 86-272).

***P.L. 86-272 and $800 minimum tax***

P.L. 86-272 provides immunity from the corporate income tax to taxpayers whose only activities involve the solicitation of sales of tangible personal property in the state. However, P.L. 86-272 protections do not extend to franchise or income taxes based on net income.

Therefore it does not apply to the minimum franchise tax or the LLC fee. Taxpayers who are "doing business" in California must pay the minimum franchise tax or LLC fee even if not required to file a corporate income tax return. (FTB Tax News, September 2013)

When American realized that it was required to file and pay the minimum franchise tax for the 2010 taxable year, it voluntarily filed a return on June 15, 2012, before it was even contacted by the FTB. On the return, it indicated that it had 75 shareholders.

### No reasonable cause

Although the per-shareholder penalty may be abated for reasonable cause, American failed to prove that reasonable cause existed. As the Board has consistently held, ignorance of the law is no excuse for failure to file a return. (***Appeal of Electrochimica Corporation*** (August 3, 1970) 70-SBE-027) Not knowing that it had a filing/payment requirement was insufficient to establish reasonable cause, and American failed to prove the "it was the accountant's fault" excuse.

## OTHER LATE-FILING PENALTIES

In addition to the per partner/shareholder penalties discussed above, below are other penalties that may be imposed for failing to timely file a return or pay tax:

| **Other Late-filing Penalties** | | |
|---|---|---|
| **Penalty** | **Amount** | **Statute** |
| Late-filing penalty | 5% per month (maximum 25%) on net income | R&TC §19131 |
| Late-payment penalty | 5% of the unpaid tax, plus 0.5% of the unpaid tax for each month, or part of the month, the tax remains unpaid (up to 40 months) 25% maximum on net income<br>Late filing penalty reduced by amount of late payment penalty in each month both apply | R&TC §19132 |
| Failure to file a return upon notice and demand when corporation or LLC is not registered and fails to file | $2,000 | R&TC §19135 |

***Example of nonfiling LLC***

Under the Table, LLC registered with the SOS in 2006 but has never filed a tax return. The LLC was suspended by the SOS in 2010. On May 1, 2016, the FTB sent Under a Demand to File for years 2011 through 2014. There were 10 members, and there was no gross receipts fee due.

If Under fails to file returns, the FTB will assess the $800 annual tax plus the $2,000 penalty for 2011 through 2014. Because Under was suspended and failed to file a return, the FTB will assess the 25% (maximum) late payment penalty for 2011 through 2014, and will also assess the $18-per-member-per-month penalty (with a maximum of 12 months) for failure to timely file Schedules K-1.

The total tax and penalties will be:

| | | |
|---|---|---|
| Annual tax | $800 × 4 years | $ 3,200 |
| Per-member penalty | $216 × 10 × 4 years | $ 8,640 |
| Late-filing/payment penalties | $200 × 4 years | $ 800 |
| Failure to file on demand | $2,000 × 4 years | $ 8,000 |
| Total tax and penalty due | (not including interest) | $20,640 |

If Under files the late returns when requested by the FTB, the $2,000 per-year penalty will not apply, but the other penalties will apply.

If Under does not file the 2006–2010 returns, the FTB may in the future send a Demand to File for those years too.

# CREDITS

## LOW-INCOME HOUSING CREDIT

Legislative changes to the Low-Income Housing Credit allow taxpayers to:

- Sell the credit;
- Extend a partnership's authority to allocate the credit based on a partnership agreement; and
- Authorize the California Tax Credit Allocation Committee (CTCAC) to impose fines against a credit awardee who violates the terms and conditions of the credit.
(SB 837 (Ch. 16-32))

***Low-Income Housing Credit***

This program provides a tax credit for investors for a portion of the costs of investing in low-income rental housing projects. The amount of the credit is determined by the California Tax Credit Allocation Committee, which reviews program applications and allocates credits based on certain previously established legislative priorities. (R&TC §§17058, 23610.5)

### Selling the credit

A taxpayer awarded a Low-Income Housing Credit may make an irrevocable election to sell all or a portion of the credit not already claimed on their return to one or more unrelated parties for not less than 80% of the credit amount, and the purchaser is allowed a one-time resale of the credit as well. The authorization to sell the credits is available to projects that receive a preliminary reservation on or after January 1, 2016, and before January 1, 2020. (R&TC §§12206(o), 17058(q), 23610.5(q))

Purchasers may use the purchased credits in the same manner in which the taxpayer that originally received the credit could use them. This means a taxpayer who purchases a portion of a credit that was originally assigned four years ago must use the computation method applicable to the fourth year of the credit, rather than the initial computation method applicable to the first three years of the credit.

## Partnership allocation

SB 837 also reinstates until January 1, 2020, a partnership's ability to allocate Low-Income Housing Credits based on the partnership agreement, regardless of how the federal Low-Income Housing Credit is allocated to the partners, or whether the allocation of the credit under the terms of the agreement has substantial economic effect. (R&TC §§12206(b)(1)(C), 17058(b)91)(C), 23610.5(b)(1)(C))

This allows a low-income housing partnership to distribute the state Low-Income Housing Credit to partners without economic interest in the housing project. This ability to allocate the credit is available to projects that receive a preliminary reservation beginning on or after January 1, 2009, and before January 1, 2020. Prior to the enactment of the bill, this provision was scheduled to expire on January 1, 2016.

# CALIFORNIA COMPETES TAX CREDIT

SB 836 (Ch. 16-31) enacts additional factors that the Governor's Office of Business and Economic Development (GO-Biz) may consider when evaluating applications for the California Competes Tax Credit (CCTC; aka the "GO-Biz" Credit).

The CCTC is a nonrefundable credit against corporate franchise and personal income taxes that is available to new and growing California businesses or businesses that are considering terminating or leaving California. Each fiscal year, a specified dollar amount is available for the credit ($200 million each year for the 2015–16 and 2017–18 fiscal years), which is awarded on a competitive basis. (R&TC §§17059.2, 23689) Twenty-five percent of the allocated amount must be awarded to small businesses.

The taxpayer applies in advance for the credits, and the actual credit terms are negotiated in a credit agreement with GO-Biz. The agreement is then approved or rejected by the CCTC Committee. (R&TC §§17059.2(c), 23689(c))

Taxpayers are not required to be located in any specific geographic zone to qualify for the credit.

## Evaluation criteria

Previously, GO-Biz evaluated each application that made it past the initial screening phase based on a series of qualitative factors, such as unemployment/poverty rates in the proposed project area, other incentives available, economic impact on California, compensation (including benefits) paid, and more. A full list of factors is contained in 10 Cal. Code Regs. §8030(g).

Applicable to taxable years beginning on or after January 1, 2016, SB 836 adds the following factors to the list of items that GO-Biz may consider:

- The taxpayer's financial solvency and ability to finance its proposed expansion;
- The taxpayer's current and prior compliance with federal and state laws;
- Current and prior litigation involving the taxpayer;

- The reasonableness of the fee arrangement between the taxpayer and any third party providing any services related to the credit; and
- Any other factors GO-Biz deems necessary to ensure that the administration of the credit "is a model of accountability and transparency and that the effective use of the limited amount of credit available is maximized."

***Charging a contingency fee is now OK***

In January 2016, a California superior court ruled that the GO-Biz regulation limiting contingency fees charged by tax consultants assisting taxpayers applying for the California Competes Credit to an amount equivalent to what would be charged using a "reasonable hourly rate" exceeded GO-Biz's authority. According to the court, there was nothing in the statute that would ban or limit tax consultants assisting taxpayers applying for the credit from charging a contingency fee. (***Ryan U.S. Tax Services, LLC v. State of California*** (January 7, 2016) Sacramento County Superior Court, Case No. 34-2014-00167988)

Clearly the changes listed above were enacted in response to the court's ruling.

# NEW MOTION PICTURE CREDIT

A new income tax credit for qualified expenditures for the production of qualified motion pictures in California went into effect for taxable years beginning on or after January 1, 2016. (AB 1839 (Ch. 14-431); R&TC §§17053.95, 23695) The credit differs from the Original Motion Picture Credit that was in effect for pre-2016 tax years as follows:

- The total amount that may be allocated is increased from $100 million to $330 million per fiscal year;
- Big budget films, one hour TV series, and TV pilots are eligible for the credit;
- The increased credit available to independent films is no longer limited to independent films with budgets of less than $10 million;
- Credits are awarded on a competitive basis among similar types of productions based on a jobs ratio rather than awarded on a lottery basis;
- Penalties are imposed for taxpayers who overstate the jobs ratio without reasonable cause; and
- Taxpayers eligible for the 20% credit may claim an additional maximum 5% credit if the production is filmed within California but outside the Los Angeles zone and for visual effects and music scoring/recording performed in California.

## Application period

Applications will be taken by the California Film Commission for the new Film and Television Tax Credits against personal and corporation franchise and income taxes during the period January 2–13, 2017.

Applications will be accepted for:

- Transferable credits for independent films with a minimum $1 million budget for up to the first $10 million of qualified expenditures; and
- Nontransferable credits for nonindependent feature films with a minimum budget of $1 million for up to the first $100 million in qualified expenditures.

Projects that rank in the top 200% will be notified to submit Phase II documents by January 17, 2017. Credit allocation letters will be issued on February 13, 2017.

 

| Comparison of Original and New Motion Picture Credits | | |
|---|---|---|
| | **Original Motion Picture Credit** | **New Motion Picture Credit (Provisions in bold are changes from the Original Motion Picture Credit)** |
| **Credit amounts/ eligibility** | A 20% credit is available for production expenses for the following productions:<br>(1) A feature with a budget of at least $1 million, but not exceeding $75 million;<br>(2) A movie of the week or miniseries with a maximum production budget of $500,000; or<br>(3) A new television series produced in California with a minimum production budget of $1 million that is licensed for original distribution on basic cable | A 20% credit for production expenses is available to the following productions:<br>(1) **No maximum budget cap, but maximum base credit is limited to $20 million**;<br>(2) A movie of the week or miniseries with a $500,000 **minimum** budget;<br>(3) A new television series produced in California, with a minimum production budget of $1 million per episode, **for any distribution outlet**); or<br>**(4) A television pilot with a $1 million minimum budget** |
| | | **An additional 5% maximum credit may be added to the 20% credit for the following expenditures incurred in California:**<br>**(1) Filming outside of the "Los Angeles Zone";**<br>**(2) Music scoring and music track recording by musicians; and**<br>**(3) Visual effects (VFX): VFX work must represent at least 75% of the VFX budget or a minimum of $10 million in qualified VFX expenditures incurred in California** |
| | A 25% credit for production expenses may be claimed for the following productions:<br>(1) An independent film, with a budget of $1 million to $10 million, which is produced by a company that is not publicly owned (and not more than 25% of the company is held directly or indirectly by a public company); or<br>(2) A television series that relocates to California | A 25% credit for production expenses may be claimed for the following productions:<br>(1) **No maximum budget, but maximum credit is capped at $2.5 million**, which is produced by a company that is not publicly owned (and not more than 25% of the company is held directly or indirectly by a public company); or<br>(2) Television series relocating to California: **$1 million minimum budget. No minimum episode length. Credit reduced to 20% for subsequent seasons after the first season filmed in California** |

## AGRICULTURAL PRODUCTS DONATION CREDIT

The credit for donations of fresh fruit and vegetables to California food banks, which was scheduled to expire beginning with the 2017 taxable year, has been increased from 10% to 15% of the food's inventory cost and was extended through the 2021 tax year. (SB 837 (Ch. 16-32; R&TC §§17053.88.5, 23688.5)

# LLC ISSUES

## CALCULATING THE LLC FEE FOR REAL ESTATE DEALERS

In FTB Legal Ruling 2016-01, the FTB stated that for purposes of the LLC fee if property is held for investment purposes, the property's adjusted basis is not included in the taxpayer's gross income. However, if the property is sold in the taxpayer's ordinary course of business, the adjusted basis must be added back to the taxpayer's gross income for purposes of calculating the taxpayer's LLC fee.

This means that real estate dealers would be required to include the selling price of their property in their LLC fee calculation.

The FTB acknowledged that their Form 568, Limited Liability Company Return of Income, Schedule IW instructions were confusing and stated that they will be revised.

The 2015 and prior years Form 568 Schedule IW instructions erroneously told taxpayers the cost of goods sold did not include the adjusted basis of real property held for sale to customers in the ordinary course of business. This language has now been removed

Just as importantly, the FTB has stated that they will not be auditing prior year returns related to this issue. Taxpayers who previously relied on these instructions to their detriment may be eligible for penalty abatement and should contact the Taxpayers' Rights Advocate's office to see if they qualify. (FTB Tax News, August 2016)

### Fee calculation

R&TC §17942 imposes a fee on LLCs based on "total income from all sources derived from or attributable to this state." Total income for purposes of calculating the LLC fee is defined in R&TC §17942 as "gross income … plus the cost of goods sold that are paid or incurred in connection with the trade or business of the taxpayer."

The example below compares how the LLC fee should be calculated for both real estate dealers and investors under FTB Legal Ruling 2016-1.

 

***Example of calculating the fee***

Flipper, LLC, a real estate dealer, purchases a California residence for $300,000 and makes $150,000 in improvements. When the improvements were complete, the LLC sold the home for $700,000.

Flipper owes a gross receipts fee of $2,500 computed as:

| | |
|---|---|
| Schedule B, line 1, gross receipts | $700,000 |
| Schedule B, line 2, COGS | ( 450,000) |
| Schedule B, line 3, gross profit | 250,000 |
| Schedule IW, line 1b, add back COGS | 450,000 |
| Income for gross receipts fee | $700,000 |
| Fee | $2,500 |

On the other hand, Skip, who is not a real estate dealer, uses his single–member LLC to invest in a piece of real estate at a cost of $500,000. He makes $100,000 in improvements before he sells the property for $800,000.

Skip reports the transaction as a capital gain on Schedule D and for purposes of the LLC fee, only $200,000 is includable as gross income. Assuming the LLC has no other income, there is no fee because the LLC's total income is below $250,000.

## Federal law

This ruling is consistent with federal cases and rulings where the courts found that a taxpayer in the trade or business of buying and selling property, such as a house flipper, must treat the property as inventory. (***Sutton v. Comm.***, TCS 2013-6; ***Flood v. Comm.***, TCM 2012-243; ***Garrison v. Comm.***, TCM 2010-261)

The ***Sutton*** court cited the following factors in determining whether property is held primarily for sale to customers in the ordinary course of business:

- The taxpayer's purpose in acquiring the property;
- The purpose for which the property was subsequently held;
- The taxpayer's everyday business and the relationship of the income from the property to the taxpayer's total income;
- The frequency, continuity, and substantiality of sales of property;
- The extent of developing and improving the property to increase the sales revenue;
- The extent to which the taxpayer used advertising, promotion, or other activities to increase sales;
- The use of a business office for the sale of property;
- The character and degree of supervision or control the taxpayer exercised over any representative selling the property; and
- The time and effort the taxpayer habitually devoted to the sales.

# CALCULATING THE LLC FEE FOR SMLLCs

Single-member limited liability companies (SMLLCs) are required to include §1231 gains and capital gains in computing their LLC fees, even though the California Form 568, Schedule IW instructions may appear to indicate otherwise.

SMLLCs who do not meet the filing requirements to complete Form 568 Schedule B or Schedule K should prepare the Schedule IW, Limited Liability Company Income Worksheet, by entering the California amounts attributable to the SMLLC from the member's federal Schedule B, C, D, E, F (Form 1040), or additional schedules associated with other activities.

***Completing Form 568 for SMLLCs***

A single-member LLC is required to complete Form 568 Side 1, Side 2, and Side 6 (Schedule IW), and pay the annual tax and LLC fee (if applicable).

However, if either of the following two thresholds is met, Schedule B or Schedule K must be included:

- The income or loss amount reported on Schedule B, line 1 or line 3 through line 11, is $3 million or more; or
- The "Total distributive income/payment items," Schedule K, line 21a, is greater than or equal to $3 million OR less than or equal to -$3 million.

Single-member LLCs do not complete Schedule K-1.

Confusion has arisen because the instructions on the actual Schedule IW refer only to the Schedule B or Schedule K. For example, Line 14 reads: "California 1231 gains. Enter the amount of total gains (not losses) from Form 568, Schedule K, line 10a." However those SMLLCs not required to file a Schedule K (568) would get that information from the schedule containing that information, such as a Schedule D-1 and enter that amount on Line 14.

Disregarded entities that do not meet the filing requirements to complete Schedule B or Schedule K should prepare Schedule IW by entering the California amounts attributable to the disregarded entity from the member's federal schedule or any additional schedules associated with other activities.

***Comment***

We've asked the FTB to either:

- Revise their form to include references to the other schedules that might be involved such as Schedule D or Schedule D-1; or
- Develop a separate schedule for SMLLCs.

We'll let you know if this happens.

# SMLLCs OWNED BY TAX-EXEMPT ENTITIES

## SMLLC conducting business in California

In Chief Counsel Ruling 2016-04, the FTB found that a SMLLC doing business in California but owned by an out-of-state credit union is required to file a Form 568 and pay the $800 minimum tax and the annual fee on California-source income.

So long as the credit union obtains (and subsequently maintains) an exemption from California franchise and income tax as a credit union, it will annually file Form 199. In addition, in any year that the SMLLC generates unrelated business taxable income (UBTI) for California franchise or income tax purposes, the credit union should also file Form 109 to report and pay tax on the UBTI.

 

### SMLLC only held raw land

In Chief Counsel Ruling 2015-02, the FTB stated that a SMLLC owned by an out-of-state exempt entity was required to file a Form 568 and pay the $800 minimum tax. However, as long as the SMLLC was not producing any UBTI for the owner, the owner was not required to file a Form FTB 3500, Exemption Application, or a Form FTB 199, Exempt Organization Annual Information Return.

The SMLLC, a disregarded entity for federal and state tax purposes, owns raw land (homesites) and vineyards in California. The SMLLC is organized in California, but it had not been selling grapes for some time. The SMLLC's owner is a single-employer pension and retirement fund for police officers and firefighters employed by the city of Dallas, Texas.

## MIDYEAR CONVERSIONS

### The basics

Under the default rules, single-member LLCs are treated as "disregarded entities," and multi-member LLCs are treated as partnerships. Either may elect to be treated as a corporation by filing federal Form 8832, Entity Classification Election. They may also elect out of corporate taxation in a later year.

Separate elections are not allowed for California. (R&TC §23038(b)(2)(B)) The electing entity must attach a copy of Form 8832 to its California return for the year in which the election is effective.

### Filing multiple returns for one year

If the election becomes effective midyear, the LLC must:

- File separate short-period returns for the pre- and post-reclassification parts of the taxable year; and
- Pay the $800 annual/minimum tax twice.

**Practice Pointer**

Clearly midyear conversions are expensive, costing your clients at least an additional $800 in tax. So if at all possible, try to have your clients make the conversion at the end of the tax year.

However, as the LLC fee may be reduced for the two LLCs dividing the income, it could be less expensive tax-wise to file two returns.

#### Filing requirements for midyear conversion of a partnership to an LLC

Different filing requirements apply for federal and state purposes when a partnership converts to an LLC midyear (without a change in proportionate ownership). Under Revenue Ruling 95-37, only one return for the year is required for federal purposes.

For California purposes, whether the partnership is a general partnership or a limited partnership, you must file the Form 565, Partnership Return, for the short year prior to converting the partnership to an LLC. Then file the Form 568, Limited Liability Company Return, for the short year from the time the entity converted to an LLC. You must pay the annual $800 tax with the Form 565 if the partnership was a limited partnership and a second $800 annual tax with Form 568 and possibly the LLC fee, depending on the LLC's California income for that period. (Instructions to Form 568)

### Two returns: SMLLC to multimember LLC

An LLC that converts midyear from a SMLLC to a multimember LLC or vice versa must file two returns and pay the $800 annual tax twice. In filing the two returns, the LLC will divide the income between the two returns for purposes of the gross receipts fee.

If the LLC checks the box and elects to be taxed as a corporation in the middle of the year, file an LLC return and pay the $800 and gross receipts fee for the short period the entity was taxed as an LLC, and file a corporate return and pay the $800 minimum tax or tax on net income but no gross receipts fee for the second part of the year.

## California corporation numbers for LLCs taxed as corporations

When an LLC elects to be taxed as a corporation, the IRS handles the transition smoothly because the taxpayer must file federal Form 8832, Entity Classification Election. This alerts the IRS that the LLC will now be filing a corporate return. For federal purposes, the entity uses the same taxpayer identification number before and after the election.

However, because the Secretary of State does not get a copy of the Form 8832 and LLCs do not have a SOS corporation number, two problems may arise:

- Estimated tax payments may not be properly posted; or
- When the taxpayer files the first corporate return, the FTB may send nonfiling notices when they can't find the LLC return.

The FTB is aware of the problem and has implemented a few internal procedures that may help some taxpayers.

**✎ Practice Pointer**

The FTB assigns and mails a corporation number immediately after the entity makes its first estimated tax payment or files its first corporate return. Until that number is issued, use the federal ID number for returns and estimates. Also, use a corporate estimated tax voucher to pay corporate estimated tax for an LLC taxable as a corporation.

If there are problems, contact the Tax Practitioner Hotline for resolution.

**☎ Telephone**
(916) 845-7057

Once your client receives the corporation number, enter this number in the box labeled "California corporation number" on all estimated tax vouchers and tax returns.

**Caution**

A corporation in its first year is not subject to the minimum franchise tax. (R&TC §23153(f)(1)) This also applies to an LLC that elects corporate tax treatment in its first year. If a taxpayer made the $800 estimated payment and qualifies for the first-year-free rule, file Form 100 or Form 100S and apply the payment against any tax liability based on the corporate tax on net income.

An LLC that elects corporate treatment after its first year of business is still subject to the $800 minimum franchise tax in the year it elects corporate treatment.

***California checklist for LLC electing corporate taxation***

Use this checklist to help process returns and payments for an LLC that has elected corporate tax treatment. The same procedures will apply to the entity that elected to be taxed as a corporation and also made a valid S corporation election:

- Make estimated tax payments with the federal ID number;
- Advise clients to forward to you the new identification number provided by the FTB as soon as they receive it;
- Contact the FTB if the estimated tax payment and any prior payments are not transferred to the new account;
- Enter the identification number in the box labeled "California corporation number"; and
- If the election to be taxed as a corporation is made in the first year of the entity's registration or organization, the corporation is not subject to the $800 minimum franchise tax but is subject to tax on net income (8.84% for C corporations and 1.5% for S corporations).

Alert your clients that they may receive notices from the FTB requesting the LLC return and/or asking for money if payments were not properly transferred because the new identification number is not used.

# FREQUENTLY ASKED LLC QUESTIONS

We all know that LLCs are kind of a hybrid between corporations, partnerships, and disregarded entities and that many of our clients and their attorneys feel that LLCs are the best thing since sliced bread. Unfortunately for tax preparers, LLCs can be a bit of a nightmare … especially when preparing California returns.

Although we frequently cover LLC issues in articles, webinars, and seminars, the questions keep coming in. Below are this year's most frequently raised questions from our Message Board. We hope this provides a quick overview of some of the most common issues that arise when filing an LLC return or deciding if an LLC or its member(s) even have a California filing requirement.

## Filing requirements for nonresident members

**Q:** Is a nonresident member of an LLC doing business in California required to file a California return?

**A:** It depends. The FTB has taken the position that all LLC members, whether they are managing or nonmanaging members, are considered to be doing business in California if the LLC is doing business in California. (FTB Legal Ruling 2014-01) However, in ***Swart Enterprises, Inc. v. FTB***, a California superior court held that a nonresident member who was a passive investor and held only a 0.02% interest in a California LLC was not required to file a California return. (***Swart Enterprises, Inc. v. FTB*** (November 14, 2014), Fresno Superior Court, Case No. 13CECG02171, Order on Cross Motions From Summary Judgment) The FTB has appealed this decision.

**Caution**

***Swart*** is still pending, and it is possible that the court could overturn the Fresno Superior Court's decision or narrowly draw the decision to effectively only allow exemption from filing if the LLC investment is really an investment in nature.

**Practice Pointer**

For nonresident passive LLC members, to file or not to file is a huge question that practitioners and their clients must weigh. The FTB has not backed down on its position that out-of-state passive LLC members must file. For members that are corporations, LLCs, or limited partnerships, this will mean they will be required to at least pay an $800 minimum/annual tax in addition to filing the return.

If they do not file/pay, they could be subject to the $2,000 failure-to-file penalty (if the FTB issues a demand to file). They may also be subject to hefty per-partner penalties (discussed on page 13-2) if there are numerous partners in the case of an LLC treated as a partnership or an LLC treated as an S corporation.

The safest approach might be to file the return and then file a claim for refund.

***Example of limited partner vs. nonmanaging member filing requirements***

Corporation X, which has its commercial domicile in Texas, is a limited partner in a California partnership that runs a winery in California. The partnership invested in a brand new multimillion dollar winery operation in Paso Robles.

Corp. X has no role in the management or governance of the partnership. Corp. X would not have a corporation franchise tax filing requirement, but might have a corporate income tax filing requirement if the partnership distributes California-source income.

Corp. X is also a nonmanaging member of a California LLC that holds title to ranch land in the Central Valley. Corp X has a 3% ownership interest in the LLC. Under the LLC's operating agreement, all management decisions are made by the managing LLC member, and nonmanaging members have no control over the leadership or management of the LLC.

According to the FTB, Corp. X is considered "doing business" in California because of its LLC membership interest. Therefore it would be required to file a corporate return and pay the $800 minimum tax. However, Corp. X might want to file a protective refund claim pending resolution of the ***Swart*** case.

**Q:** Does an out-of-state LLC with two managing members in California need to file a Form 568, Limited Liability Company Return, even if it has no California-source income?

**A:** Yes, because it has managing members in California, it is considered to be doing business in California and must file a Form 568 and pay the annual $800 tax. However, because it has no income attributable to California, it would not be required to pay the LLC fee. And the Board has upheld the FTB's decision. (***Appeal of Mockingbird Partners, LLC*** (May 17, 2006) Cal. St. Bd. of Equal., Case No. 306061)

## S corporation member's filing/registration requirements

**Q:** Would an out-of-state corporation (or LLC) that is filing a return solely because it's a member of a California LLC be required to register with the Secretary of State as well?

**A:** The LLC or corporation would only be required to register with the SOS if it is actually "transacting intrastate business" in California, which is a different standard than the tax nexus "doing business" standard. R&TC §17708.02 defines transacting intrastate business as entering "into repeated and successive transactions of business in this state, other than in interstate or foreign commerce." In many cases entities that are doing business in California are not actually transacting business here.

## Due date of annual tax for newly formed LLC

**Q:** What is the due date for the annual $800 tax for a newly formed LLC?

**A:** Domestic LLCs have until the 15th day of the fourth month after they file their Articles of Organization with the SOS to pay the first-year annual tax. If filed mid-month, the clock starts on the first day of that month. For example, an LLC that files its Articles of Organization on June 19 must pay the annual tax by September 15. (FTB 3556 LLE MEO, Limited Liability Company Filing Information)

## Identification number used by foreign LLC filing first California return

**Q:** What identification number should a foreign (non-California) SMLLC with a California member use when filing a Form 568? Does the SMLLC need to register in California?

**A:** The SMLLC would use the LLC's FEIN to file the first return. The FTB will assign a number to the LLC if there is no SOS registration number. (***Appeal of K&T Properties General Partnership*** (November 19, 2014) Cal. St. Bd. of Equal., Case No. 733449) The LLC would only be required to register if it is "transacting business" in California pursuant to Corp. Code §17708.03.

**Q**: Can a foreign LLC e-file if it hasn't received a California identification number?

**A:** A foreign LLC that has not received a California identification number may e-file a return. The LLC should simply provide an explanation in lieu of a number, such as "Applied for" or "Foreign Non-U.S." Contact your tax preparation software provider if you receive a diagnostic message preventing you from e-filing the return. The FTB will assign a foreign LLC that has not registered with the SOS a California ID number after it files an initial return. To find out if a number has been assigned, contact the FTB at:

☎ **Telephone**
(800) 852-5711
(916) 845-6500 (outside the U.S.)

## Apportionment of income

**Q:** What income is subject to the LLC fee for an LLC that provides services to customers in various states? What about an LLC that sells tangible personal property to customers inside/outside California?

**A:** To determine the LLC's California-source income subject to the LLC fee, the LLC must use the apportionment rules applicable to corporations, including the market-based sourcing rules. (18 Cal. Code Regs. §17942(d)) So the income received from services provided to California customers would be subject to the LLC fee. Only sales of tangible personal property delivered to customers in California or thrown back to California if the LLC is not subject to tax in the other state are subject to the LLC fee. These rules apply to all LLCs operating in multiple states regardless of where the entity was formed.

**Note:** For California apportionment purposes, sales of a unitary group include sales of the group that are not subject to apportionment in any other state (known as the "throwback" rule). (R&TC §25135)

### Nonresident consent form requirements

**Q:** Do nonresident LLC members need to sign and attach the Form 3832, Limited Liability Company Nonresident Members' Consent, to the Form 568 every year?

**A:** No, the Form 3832 is only required to be filed in the first taxable year the LLC has a nonresident member or a new nonresident member. (Instructions to Form 3832) For example, it must be signed and attached to the Form 568:

- During the year of formation if it has nonresident members;
- In the year a resident member moves out of state;
- In a year a new nonresident member joins the LLC; and/or
- If there is liability for annual tax in the year of dissolution.

# BUSINESSES OPERATING IN MULTIPLE STATES

## 2016 ECONOMIC THRESHOLD AMOUNTS

For the 2016 tax year, a corporation is considered to be doing business in California during the year if it actively engages in any transaction for the purpose of financial or pecuniary gain or profit in California (as discussed above), or if, for the 2016 taxable year, it satisfies one of these economic nexus threshold tests:

- The corporation is organized or commercially domiciled in California;
- The corporation's California sales, including sales by an agent or independent contractor, exceed the lesser of $547,711 ($536,446 for 2015) or 25% of the corporation's total sales. "Sales" includes sales by agents and independent contractors, and is the same "sales" determined under the sales factor rules using market-based sourcing;
- The corporation's California real property and tangible personal property (valued at their original costs) exceed the lesser of $54,771 ($53,644 for 2015) or 25% of the corporation's total real property and tangible personal property; or
- The amount paid in California by the corporation for compensation exceeds the lesser of $54,771 ($53,644 for 2015) or 25% of the total compensation paid by the taxpayer. (R&TC §23101) Compensation is determined by using the rules for assigning payroll under R&TC §25133, as modified by 18 Cal. Code Regs. §25137.

### Gross receipts aggregated

For purposes of determining whether a taxpayer has met the economic nexus threshold, its receipts from California sales of tangible personal property (TPP) are aggregated with its California-sourced royalties received from licensing its trademarks. (Chief Counsel Ruling 2016-03)

## APPORTIONMENT ISSUES

### *Gillette*

The U.S. Supreme Court has denied Gillette's petition to review the California Supreme Court's decision in ***Gillette Co. v. FTB. (Gillette Co. v. FTB*** (December 31, 2015) California Supreme Court, No. S206587; petition for writ of *certiorari* denied (October 11, 2016) U.S. Supreme Court, No. 15-1442).

This means that taxpayers do not have a right to elect to use the Multistate Tax Compact's equally weighted three-factor apportionment formula rather than use California's statutory apportionment formula (currently a single sales factor apportionment formula). Taxpayers who made the MTC election on their original returns may be subject to significant penalties, including the 20% large corporate understatement penalty. The FTB has stated that it will be issuing guidance shortly for any potentially affected taxpayers.

## COD income and reduction of tax attributes

When reducing tax attributes under IRC §108, post-apportioned COD income is applied rather than pre-apportioned COD income. (FTB Technical Advice Memorandum 2015-02) IRC §108 requires taxpayers to reduce certain tax attributes such as net operating loss carryovers, certain tax credits, capital loss carryovers, and property basis, to the extent COD income is excluded.

## Marketing services and nonmarketing services

A question arose as to how taxpayers should determine where the benefit of a service is received if the taxpayer's customers' clients are the ones that actually receive the benefit of a taxpayer's service and not the taxpayer's customer.

Although the governing statute and regulations do not differentiate between marketing services and nonmarketing services, the FTB issued a Chief Counsel Ruling that requires taxpayers to apply different sourcing rules depending on whether the service is a marketing or a nonmarketing service. (FTB Chief Counsel Ruling 2015-03)

According to the FTB, sales of services where the taxpayer's services do not market a product, service, or other item are properly considered nonmarketing services and should be assigned to the location of the taxpayer's customers and not to the location of the taxpayer's customers' clients. The FTB relied on analogous rules applied to sourcing receipts from sales of intangibles to make this distinction.

***Example of marketing/nonmarketing services***

Financial Resources, Inc. is a service provider engaged in the business of providing integrated financial information and analytical applications to business entity customers located in California and Nevada. The taxpayer's services were used by both its customers and its customers' clients. Financial Resources, Inc. is not in the business of marketing a product or service, so therefore its revenues are from nonmarketing services and would be sourced to California and Nevada where its customers are located.

Mortgage Marketing Corporation is a marketing company that specializes in advertising for mortgage brokers. Although its broker clients are located in California and Oregon, the brokers have customers throughout the Western States. Because Mortgage Marketing Corp. is engaged in marketing services, it must assign its revenues across the western states where its customers' clients are located, likely based on population figures or home ownership figures.

**Caution**

There is still a lot of confusion as to how to source service revenues for various tax purposes. The nonresident withholding regulations and publication (18 Cal. Code Regs. Sec. 18662-5(a)(2); Publication 1017, question 17), as well as the instructions for the Schedule S, Other State Tax Credit, still indicate that service revenues are sourced to the state where the service is performed, whereas the apportionment statute and regulations require that the income be sourced to where the benefit is received. We've asked the FTB for clarification on these issues and have been informed that they will be issuing rulings on these issues.

## MISCELLANEOUS CASES, RULINGS, AND LEGISLATION

### Business trusts not subject to minimum franchise tax

The FTB issued two separate Chief Counsel Rulings holding that regulated investment companies organized as business trusts (a Massachusetts business trust, and a Delaware business trust) were not "corporations" for purposes of the minimum franchise tax and were therefore not liable for the tax. (Chief Counsel Ruling 2016-01; Chief Counsel Ruling 2016-02)

### Water's-edge elections

FTB Notice 2016-02 addresses how the FTB will treat an otherwise valid water's-edge election when a unitary foreign affiliate of a water's-edge combined reporting group becomes a taxpayer because it is now considered to be doing business in California.

To be valid, a water's-edge election must include all members of the combined reporting group that are subject to California tax. (R&TC §25113(b)) However, with the enactment of the economic nexus standards in 2011, foreign affiliates who had not previously been considered California taxpayers are now subject to California tax under R&TC §23101(b). This left in limbo many unitary groups that had made valid water's-edge elections prior to the enactment of the new standards.

 

Chapter 14

# California Miscellaneous

# CALIFORNIA MISCELLANEOUS

## DISASTERS

## §165(i) THROWBACK ELECTION

Disaster victims often benefit from the ability to throw back any disaster loss under IRC §165(i) to the prior year and receive an immediate refund.

California conforms to IRC §165(i). In addition, California law allows the throwback election for any loss attributable to a disaster for which only the Governor has declared a state of emergency. (R&TC §§17207.14, 24347.14)

Taxpayers may claim an IRC §165(i) throwback election on the California return for any disaster loss that was:

1. Declared by the President (current law); or
2. Declared by the Governor for any city, county, or city and county that is proclaimed by the Governor to be in a state of emergency.

### When to make the election

California has always allowed the election to be made on or before the extended due date for the year of the loss.

The IRS recently issued temporary and proposed regulations that extend the due date for making the IRC §165(i) election. The regulations are applicable to elections made after October 12, 2016.

The temporary regulations generally provide that the due date for making the IRC §165(i) election is six months after the due date for filing the taxpayer's federal income tax return for the disaster year (determined without regard to any extension of time to file). (Temp. Treas. Regs. §1.165-11T(f)) Previously the election had to be made on or before the original due date, not including extensions.

### Four years of "instant" benefits

A big benefit to California's tax treatment is that for any loss declared by either the President or the Governor, a taxpayer may be able to obtain four years of immediate tax benefit: the current year, throwback to the immediate prior year for the disaster loss and, if an NOL is created or increased, an additional two years of carryback attributable to the NOL. Plus, any remaining loss can also be carried forward.

*Example of disaster*

Joe's crops in Kern County were destroyed in the 2016 fires for which the Governor declared a state of emergency. His crop was not insured, and his casualty loss was $300,000. Because the President did not declare the fires a disaster, he has no disaster loss for federal purposes. However, for California he has a disaster loss, and under IRC §165(i), he may claim the loss on either his 2016 or 2015 return.

Joe's income is approximately $60,000 per year, and the unused loss will create an NOL.

If he elects to claim the loss on his 2015 return, he can carry back 100% of the unused loss to 2013 and 2014. If there is a loss remaining, he may carry the loss forward to the 2016 year.

If he does not make the throwback election, he will claim the loss on the 2016 return and may carry 100% of the NOL back to 2014 and 2015. But he won't be able to claim the disaster loss until he files the 2016 return in 2017.

In any event, he may carry any unused loss forward for 20 years from the year the loss is claimed.

**2016 California Losses that Qualify for Disaster Loss Treatment**

| "State of emergency" declaration date | Type of disaster | Declaration source | Counties/cities impacted |
|---|---|---|---|
| January 2016 | Gas leak | Governor | Los Angeles |
| April 2016 | Rainstorms | Governor | Alameda, Contra Costa, Del Norte, Humboldt, Mendocino, Napa, San Mateo, Santa Clara, Santa Cruz, Sonoma, and Trinity counties |
| June 2016 | Wildfires | Governor | Kern County |
| June 2016 | Rainstorms | Governor | San Diego (City of Del Mar) |
| July 2016 | Wildfires | Governor | Los Angeles and Monterey counties |
| August 2016 | Wildfires | Governor | San Luis Obispo |
| August 2016 | Wildfires | Governor | Lake |
| August 2016 | Wildfires | Governor | San Bernardino |

## PROPERTY TAX RELIEF

R&TC §69 allows an individual to transfer the base-year value of the original property that has been substantially damaged or destroyed (more than 50% of FMV) by a Governor-declared disaster to a comparable replacement property. The replacement property must be purchased within five years after the disaster, and the assessed value of the replaced property in excess of 120% of the damaged property's assessed value will be assessed at FMV.

For disaster victims who acquire a new property in the same county, base-year value transfers are available for all property types. However, the original property and the replacement property must be of the same property type: residential, commercial, agricultural, or industrial. All California counties, except for Fresno County, have adopted an ordinance for disaster relief.

For more information, go to the BOE website at:

**Website**
www.boe.ca.gov/Assessors/pdf/disaster_general.pdf

R&TC §69.3 provides similar disaster base-year value transfer relief, but §69.3 is limited to principal residences purchased in a county different from the county in which the displaced property is located. In addition, it only applies to homes purchased in counties where the board of supervisors has adopted an ordinance making this benefit available.

These counties allow base-year value transfers for displaced homeowners who previously lived in another county: Contra Costa, Los Angeles, Modoc, Orange, San Francisco, Santa Clara, Solano, Sonoma, Sutter, and Ventura.

## DISASTER EXTENSIONS FOR BOE-ADMINISTERED TAXES

The BOE may, in the case of a disaster, extend for up to three months the time for a tax or fee payer to file a tax return or report, or to pay the tax. The extension applies to sales and use taxes and all other taxes and fees administered by the BOE. (AB 1559 (Ch. 16-257))

Under prior law, extensions could only be granted for up to one month. Now, the extension may be granted at any time so long as the request for relief is filed with the BOE within or before the period at issue.

**Note:** This bill does not automatically relieve a taxpayer of accrued interest, only a potential 10% late-filing penalty. However, existing law already provides a taxpayer relief of interest if the BOE finds that a person's failure to make a timely return or payment was due to a disaster, and occurred notwithstanding the exercise of ordinary care and the absence of willful neglect. (R&TC §6593) A person seeking interest relief must file a claim with the BOE.

# FTB

## TOP FIVE AUDIT PROGRAMS

The Franchise Tax Board has an active audit program. The top five issues are:

1. **Capital gains and losses:** Audits check whether gains and losses were reported correctly for a variety of audit issues, including sales of stock, business property, casualty losses, and amounts flowing through from passthrough entities;
2. **Like kind exchanges:** Issues include erroneous boot calculations, improper property identifications, and failure to meet other deferral requirements;
3. **Head of household filing status:** Common errors include the qualifying individual's income exceeding the gross income test, and taxpayers who do not meet the requirements to be considered unmarried or considered not an RDP;
4. **Employee business expenses:** The FTB may ask taxpayers claiming unreimbursed employee business expenses to provide documentation to substantiate their employer's reimbursement policy to determine whether their expense is allowable; and
5. **Shareholder/partner/owner's basis in a passthrough entity:** Audits check the correct reporting of flow-through items and amounts reported on the sales of interests in passthrough entities.

There are a number of other programs, including residency. We are also aware of taxpayers who receive correspondence/audit notices about other issues, such as other state tax credits, apportionment, and tax credits, to name a few.

## FTB residency audits are not fun

The FTB has an active nonfiler program that finds nonresidents who should be filing returns. However, in that net, the FTB also catches many taxpayers who are legitimate nonresidents with no California-source income.

### Auditor's arsenal

When a nonresident taxpayer comes into the FTB's sights, even before the taxpayer knows an audit is happening, the auditor will have pulled numerous documents and built the residency case. The auditor will likely know:

1. If returns were filed in other states;
2. What business entities and partnership/LLC investments are owned by the taxpayer both inside and outside California;
3. Where bank accounts are located;
4. When the taxpayer obtained a new driver's license;
5. What property is owned in California and other states;
6. If and when property was purchased or sold in California and another state; and
7. Where the taxpayer claimed a homeowner's exemption.

It is also possible that the auditor will have visited Facebook, LinkedIn, Instagram, and generally searched the web for information about the taxpayer. Remember, we all love digging for dirt about people on the web, and the FTB is looking for tax pay dirt. They will likely also have credit information and information available on paid websites like Spokeo.

### Contacting the taxpayer

As a part of the residency audit, the FTB will request:

1. Credit card statements/receipts;
2. Bank statements, including ATM and debit transactions;
3. Utility bills; and
4. Information on investments and other businesses to add to or verify what they have already discovered.

The FTB will also request calendar information and verify with credit card statements how much time the taxpayer spent in California.

From this information, the auditor will build a case that the taxpayer was a resident for the year involved or on the date that a large capital gain or other income not taxable to a nonresident was received.

***Example of a taxpayer leaving California***

Tony had been a California resident for 20 years when he moved to his family hometown in New Hampshire. Tony sold stock that resulted in a capital gain of $1 million.

| **Timeline of Events** | |
|---|---|
| **Date** | **Activity** |
| January 10 | Tony purchases a new home in New Hampshire |
| March 1 | Tony puts his California house on the market and, on the advice of his Realtor, he leaves his furnishings in the house so it will show better |
| April 1 | Tony goes to New Hampshire and stays with his sister while painting and preparing his new home |
| May 1 | Tony's California house sells |
| May 15 | Tony "moves into" his New Hampshire home, with clothes and a new bed purchased to sleep in |
| June 1 | Tony sells his stock |
| June 10 | Tony returns to California to sign escrow papers and begins preparing to move all of his possessions to New Hampshire |
| June 15 | Escrow closes on the California house |
| June 16 | Movers pick up Tony's furnishings and move them to New Hampshire |
| June 20 | The furniture arrives, and Tony is all moved in |

The question is: When did Tony become a New Hampshire resident?

The FTB will assert that Tony did not abandon his California domicile and become a resident of New Hampshire until June 20, when he completely moved into his New Hampshire home. It will be up to you to argue that he made the move on May 15, but it may be difficult as he was still somewhat in transition. And we believe you may have a difficult time prevailing.

✎ **Practice Pointer**

Remember the ***Bills*** case on page 12-3? The Bills were able to convince the Board they were nonresidents very early on with a worse fact pattern.

## The FTB will always fight for residency

In the example above, the FTB will argue that the taxpayer remained a resident. However, if Tony were moving from New Hampshire to California, the FTB would argue he became a California resident earlier.

## Nonfilers and occupational license information

The FTB uses occupational license information sources to identify nonfilers. If the individual has a California address and a license, such as a contractor's license, real estate license, cosmetology license, etc., and does not file a return, the FTB sends a nonfiler notice.

Although the FTB has stated they don't send these notices to taxpayers without a California address, we often hear about the FTB contacting long-term nonresidents, such as retirees, who have maintained the license and have no California address.

Generally, a call to the Tax Practitioner Hotline and a copy of the federal return with the non-California address will end the process, assuming the FTB does not have W-2 or 1099 information with California-source income.

If the individual fails to respond by filing a return, or fails to provide an explanation of why a return is not required, the FTB will assess tax based on an "average" amount of gross income earned by someone with that license.

The FTB also sends filing enforcement notices to individuals who:

- File a federal return with a California address; or
- Have income reported on W-2s, 1099s, and K-1s — if reported as California-source income or with a California address.

## Taxpayer win could affect future sale-of-property audits

The State Board of Equalization recently allowed actor Rob Lowe and his wife, Sheryl Berkoff, to include millions of dollars of improvement costs in the basis of their home, even though the Lowes conceded they had no records to substantiate the costs. (***Appeal of Lowe and Berkoff*** (August 25, 2015) Cal. St. Bd. of Equal., Case No. 571973)

### They did report $10 million in gain

The Lowes sold their home in Montecito, California, in 2005 for $25,000,000 and reported a gain of just over $10 million. However, the FTB examined the Lowes' 2005 return and determined that they had underreported their gain by approximately $9 million. The taxpayers are obviously not in dire financial straits here, but that sort of gap results in a large tax assessment by anyone's standards.

The Lowes argued that they were unable to present documents to support their basis numbers because their former business manager had lost them (apparently his computer had crashed). They did, however, present testimony from their business managers, appraisers, and contractors and professionals who had worked on the property.

The Lowes asked the Board to apply the ***Cohan*** rule (***Cohan v. Comm.*** (1930) 39 F.2d 540) and allow an estimate of their construction and improvement costs.

### The FTB wouldn't budge

The FTB argued that the Board should only allow a little over $4 million in basis for construction of the property because that was all the taxpayers could document, and the FTB's appraiser supported that number.

During the hearing, multiple Board members expressed their skepticism that an 11,000 square foot property could be built for that amount. It was also noted that the property was quite exceptional and had been featured in Architectural Digest and other prestigious publications. But the FTB maintained their position that the taxpayers could not prove a higher basis.

Continuing what has been a taxpayer-friendly trend in recent Board decisions, the Board ruled in favor of the taxpayers by following the ***Cohan*** rule and allowing them to adopt a basis of $12,167,208.

To view the recording of the November 17, 2015, Board meeting in which this case was heard (and the Lowes testified), go to:

**Website**
www.youtube.com/watch?v=UHI3GghAPYo

The case is heard about 38 minutes in.

### Future audits

It will be interesting to see if this case has any effect on future sale-of-residence audits. We have heard from a number of practitioners that the FTB is firm about only allowing basis if the taxpayers can document it. Applying the ***Cohan*** rule to these situations would be very beneficial to taxpayers who have lost track of records from years ago but can demonstrate a reasonable estimate of what it would cost to build or remodel their property.

# NONRESIDENT WITHHOLDING

## What is California-source income?

An inquiry from our Message Board highlighted what is likely a source of confusion for many tax practitioners and taxpayers when it comes to what "California-source income" actually means. The confusion arises because the use of California-source income for apportionment purposes is different than California-source income for withholding-at-source purposes.

For apportionment purposes, service revenues of a trade or business are sourced according to where the benefit is received under 18 Cal. Code Regs. §25136-2.

However for withholding-at-source for nonresidents, the focus is on where revenues for personal services performed by an individual should be sourced. Under 18 Cal. Code Regs. §17951-5, personal service revenues are sourced where the service is performed. So if a nonresident performs personal services in California for a business, then the business must withhold 7% from the payments made to the nonresident for those services performed in California.

***Example of service revenue***

MySource, Inc. provides online, personalized meditation services for tax practitioners over the Internet. From its billing records, it is able to tell where its customers receive the benefit of its services. Let's say for 2016, 400 out of 2,000 customers are in California. For California apportionment purposes, MySource, Inc. would source 20% of its revenues to California.

MySource, Inc. hired Sally Nirvana, a Hawaii resident, as an independent contractor to perform some of these meditations and to train other meditation leaders. In April, she came to MySource, Inc.'s headquarters in Santa Cruz, California, to conduct a seminar. She was paid $10,000 for the personal services she performed in Santa Cruz and $5,000 for work she performed in Hawaii, putting together the reports and doing telephone follow-ups for MySource.

Under the current instructions to Form 592, MySource must withhold $700 from the $10,000 payment ($10,000 × 7%). She is not subject to withholding on the services she performed in Hawaii.

We have requested clarification from the FTB. It is an issue that we will bring up at the December 2016 Taxpayer Bill of Rights hearing.

## Reporting withholding for a nonresident with no TIN

Sometimes payments for services are made to an individual, such as a musician, from a foreign country who has no SSN, ITIN, or FEIN.

In these cases the Form 592 is filed without a Tax Identification Number (TIN). Then the payor or the payee must follow-up with the FTB later to provide the TIN, so the payee will get credit for the withholding. However, this also means the payments are subject to the backup withholding rules. Let's review the withholding requirements, and what payees must do in this situation.

### Filing the Form 592

You must send Form 592 and Form 592-V, Payment Voucher for Resident and Nonresident Withholding, by the April 18, 2017, due date even if the payee has not provided a TIN. File the 592 leaving the TIN blank.

Give the payee Form FTB 590, Withholding Exemption Certificate, or a W-9 to collect a TIN, which you should do before making a payment.

If the withholding agent receives a TIN after the due date, then the withholding agent may call the FTB for assistance to determine if an amended form is required (this is according to the form instructions).

Call the FTB at:

| ☎ **Telephone** |
|---|
| (888) 792-4900 |

The withholding agent is required to give the payee Form 592-B, Resident and Nonresident Withholding Tax Statement, before the due date. The payee will file the Form 592-B with their tax return.

The payee will not get credit for the withholding until a TIN has been obtained (the recipient is required to file a tax return).

After the TIN has been obtained, if the withholding agent does not contact the FTB (or amend the 592 to include the TIN) the payee must contact the FTB before they file a return to claim the withholding.

### No TIN

If the payee does not contact the FTB and provide a valid TIN, the withholding credit will be denied.

Under R&TC §19307, no refund or credit of tax withheld or estimated tax paid or tax withheld can be allowed unless and until a taxpayer has filed a valid return for the year.

Taxpayers can obtain a TIN at:

| 💻 **Website** |
|---|
| www.irs.gov/individuals/international-taxpayers/taxpayer-identification-numbers-tin |

 

Keep in mind that the timeframe for obtaining a TIN, such as an ITIN in the case of the taxpayer we discussed previously, can take up to seven weeks.

### Who is subject to withholding?

Withholding at source is required from payments made to:

- Nonresident individuals;
- Nonresident estates and trusts;
- Any trust without a resident grantor, beneficiary, or trustee, or estates where the decedent was not a California resident;
- Non-California business entities, including corporations, partnerships, and LLCs that do not have a permanent place of business in California or are not qualified through the California Secretary of State;
- Individuals and entities that fail or refuse to provide identifying information, generally where backup withholding is required under IRC §3406, et seq.;
- Suspended or forfeited corporations (if the payee has knowledge of, or has reason to know of, the suspension or forfeiture); and
- Resident and nonresident individuals and non-California businesses for sales of California real estate.

With respect to non-U.S. partners and LLC members, California conforms to IRC §1446 regarding withholding on allocable shares of California–source income effectively connected to a California trade or business. (R&TC §18666; see Treas. Regs. §1.1446-0, et seq.; IRS Publication 515)

There is no nonresident withholding requirement if the payment or distribution is made to:

- A tax-exempt entity;
- An individual that meets the requirements of the Military Spouse Residency Relief Act (MSRRA); or
- An insurance company, IRA, or a qualified pension/profit sharing plan.

***Backup withholding***

If you pay California-source income to a California nonresident, generally, you must withhold 7% on all payments that exceed $1,500 in a calendar year. However, for payments to California residents and nonresidents who do not provide a TIN, or do not certify exemption from backup withholding when required, payees must withhold on all payments.

Payers must withhold and remit 7% of reportable payments to California. For purposes of backup withholding, "reportable payment" is defined by reference to IRC §3406(b) and only includes payments of income from:

- Rents, profits, or other gains (Form 1099-MISC);
- Commissions, fees, or other payments to independent contractors (Form 1099-MISC);
- Payments to brokers (Form 1099-B);
- Certain payments to fishing boat operators (Form 1099-MISC);
- Royalty payments (Form 1099-MISC); and
- Certain gambling winnings (Form 1099-MISC).
(R&TC §18664)

The law specifically excludes from California's backup withholding rules:

- Interest and dividends; and
- Any release of loan funds made by a financial institution in the normal course of business.

### Limitations period applies to refunds of failure-to-withhold liability

The standard four-year limitations period for refunds of corporate franchise and personal income taxes applies to refunds of overpayments of the failure-to-withhold liability imposed against withholding agents. (FTB Technical Advice Memorandum 2016-02 (February 24, 2016))

Frequently, a payor who fails to file a return and pay the withholding will be held liable for the amount of withholding that should have been withheld. (R&TC §18668(a); 18 Cal. Code Regs. §18662-8(d)(2)(C))

After paying the liability, the taxpayer from whom the amount should have been originally withheld will then file a return and pay the tax due. In such situations, the payor may then file for a refund as long as it files within four years from the original due date of the payor's return (FTB Form 592, Resident and Nonresident Withholding Statement, or FTB Form 593, Real Estate Withholding Statement), not the ultimate taxpayer's return.

## MISCELLANEOUS FTB

### Taxpayer couldn't challenge his Top 500 tax debtors listing

Ernest Franceschi, a California attorney, was barred from bringing a privacy action in state court challenging the FTB's authority to include him on its Top 500 Delinquent Taxpayer list. (***Franceschi v. Franchise Tax Board*** (July 8, 2016) California Court of Appeal, Second Appellate District, Case No. BS154331). He was also subject to the $5,000 frivolous claim penalty under R&TC §19714.

### Walk-through revivor appointments available at field offices

Following a pilot program at the San Diego FTB field office, business entities now have the option to schedule an appointment for a walk-through revivor at any of the FTB's field offices. (FTB Public Service Bulletin 16-26, June 30, 2016)

Previously, assistance was provided on a first-come-first-served basis; this option will continue to be available for business entity customers who do not wish to schedule an appointment.

Appointments are scheduled as part of the revivor process, during which the FTB employee will provide the information to the business entity to contact the appropriate field office.

For information on reviving a business entity, go to:

**Website**
www.ftb.ca.gov/businesses/faq/742.shtml

Or call:

☎ **Telephone**
(916) 845-7033

 

# EDD

## SDI RATE

| | SDI rate | Maximum wage base | Maximum payment |
|---|---|---|---|
| 2017 | 0.9% | $110,902 | $998.12 |
| 2016 | 0.9% | $106,742 | $960.68 |

# BOE

## SALES AND USE TAX MAY APPLY TO CROWDFUNDING ACTIVITIES

With the IRS issuing recent guidance on the income tax consequences of crowdfunding campaigns (IRS Information Letter 2016-0036), we thought it might be a good idea to address the sales and use tax implications as well.

The typical nonequity-raising, noncharitable type campaign that could involve a sales tax liability involves a campaign creator who wants to develop and market a new product.

The creator starts a campaign on a host platform such as Kickstarter or Indiegogo to attract campaign donors to contribute money toward the product's development. In exchange for the contribution, a campaign creator will frequently offer some type of "reward" whereby the donor will usually receive an advance release of the product free or at a discounted rate. Some campaigns simply offer a thank you note or inclusion on a donor list.

These latter types of rewards obviously do not create any type of sales or use tax liability, but the offering of tangible personal property or, in some states, intangible property or services may create sales or use tax liabilities.

### Nexus

In California, as is true in most states, a taxpayer has nexus and registration/reporting requirements for sales and use tax purposes if the taxpayer has some form of physical presence in the state. (***Quill Corp. v. North Dakota*** (May 26, 1992) 504 U.S. 298)

Clearly if your client is operating their business out of California, even if the manufacturing is done in another state, they must register with the BOE and pay sales tax on all California sales. (R&TC §6066) If your client is collaborating with people in other states, such as partners in the endeavor or manufacturers, they may have nexus in those states as well, so it is important to review those other states' "doing business" or vendor registration standards to determine if sales tax must be paid for purchases made in those states.

### Click-through nexus

Where it gets really tricky, however, is in determining whether the client has use tax collection nexus in those states in which the crowdfunding host has nexus. According to several commentators, nexus may be established via the crowdfunding host in those states that have adopted click-through nexus statutes (aka Amazon laws), such as New York where Kickstarter has offices. If click-through nexus is established, your client must pay and report use taxes collected on behalf of purchasers in those states if certain sales thresholds are met. For example, in New York, an out-of-state seller of tangible personal property (TPP) or services may be required to collect use tax on taxable purchases shipped to New York consumers if the seller:

- Enters into an agreement under which a New York person is paid for referring purchasers to the out-of-state seller; and
- Receives more than $10,000 in cumulative gross receipts from the referral in the previous four quarter periods.
  (New York Tax Law §1101(b)(8)(vi))

The referral can be done through an Internet-based link, a website, or otherwise, which would seem to encompass a crowdfunding host's website.

Fifteen states, including California, currently have some form of click-through nexus statute.

***Example of a Kickstarter campaign***

Dennis, who lives in California, launches a campaign on Kickstarter to raise money to develop and sell a baseball hat with a built-in glove so baseball fans sitting in the stadium are always ready to catch the foul ball coming their way. Dennis' campaign is a huge hit, and New York donor contributions alone reach $15,000. Because that exceeds the $10,000 threshold, Dennis is required to collect and remit use taxes to New York on the sales made to New York purchasers. Failure to do so can result in New York imposing penalties for nonfiling and nonpayment.

To see a list of states and their statutes, go to:

**Website**
www.caltax.com/spidellweb/public/editorial/CAT/1016-nexuslaws.pdf

## Agency nexus

Other commentators have taken the position that use tax nexus can also be established via some type of agency nexus theory. Under this theory, the crowdfunding host (e.g., Kickstarter) is acting as the seller's agent or representative, and therefore the host's presence in a state would establish nexus in that state for the campaign creator. If the agency nexus theory applies, there would be no minimum threshold to meet before nexus is established. However, sales in the states where the agent-host has nexus would need to be more than *de minimis* in order to establish use tax liability on behalf of the campaign creator.

## Application of tax

For California, the sales and use tax applies to all sales of tangible personal property but would not apply to sales of intangibles or most sales of services. For example, sales of software, electronic data, e-books, and digital images sold on their own and delivered electronically are generally not taxable. (BOE Publication 109, Internet Sales)

However, some states might subject sales of services or intangibles to tax (or classify sales of software as tangible personal property or taxable services), so it's important to review each state's laws to determine the taxability of different product offerings.

## Tax base

Another issue that must be examined is what is the tax base of the reward? Is it the minimum contribution amount listed in order to receive the reward? That is the position taken by the Washington State Department of Revenue in its recently released guidance on crowdfunding. (Washington State Department of Revenue Crowdfunding webpage www.dor.wa.gov/content/getaformorpublication/publicationbysubject/taxtopics/Crowdfunding.aspx)

**Note:** To date, Washington is the only state that has issued official guidance on crowdfunding.

So in this case, if a campaign is offering a product to donors of $50 or more and someone donates $75, the $50 would be subject to the Washington state sales tax, and the remaining $25 would be considered a nontaxable donation.

California has not yet provided any guidance in this area, but it seems that under California's laws and regulations a similar interpretation would apply. (R&TC §§6011, 6012)

It is also important for the creator of the fund to indicate whether the sales tax is included in the price. Let's say your client asks for a minimum contribution of $25 for the "reward." Assuming an 8% sales tax rate, either:

- Contributors are charged a total of $27, and $2 is remitted to the state; or
- The minimum contribution can be listed as $25, "sales tax included," which means the price is actually $23.18, and $1.82 must be remitted to the BOE.

## Timing

Many commentators have also raised the question as to when the use tax is due for crowdfunding campaigns, especially in terms of fixed-funding campaigns. In a fixed-funding campaign, a crowdfunding host will only release the funds to the campaign creator if a specified funding goal is met by a specified deadline. The amount and deadline is set by the campaign creator. If the campaign does not meet the goal by its deadline, all contributions are refunded back to the contributors. California has not addressed when crowdfunding rewards become taxable sales. In its guidance, Washington state has indicated that the tax is not due until the campaign is fully funded. So if the goals are not timely met, no sales or use tax would be due. It would seem California would take a similar position in that a purchase is not completed until a transfer of title or possession for consideration occurs. (R&TC §6010)

***Checklist for crowdfunding creators and their tax preparers***

Use the checklist below to help keep track of a campaign creator's potential sales and use tax liabilities:

- Which states have these click-through nexus laws (see note below)?
- What are the minimum sales thresholds for the click-through nexus states (see note below)?
- Where do the crowdfunding hosts have nexus (or at least where is the click-through coming from), so you can see if any click-through nexus laws might apply to those transactions?
- Does the state in which the crowdfunding host is located have agency nexus provisions?
- Does the state tax the sales of some forms of intangibles (e.g., software, digital products, etc.)?
- Does the state tax sales of services?
- What state exemptions apply to sales of TPP?
- What are the tax rates and filing requirements for the states in which use tax collection is required?
- Are out-of-state sellers required to collect district taxes as well?

It can be beyond some practitioners' capabilities to do this type of search for all 50 states. Should you have a client who hits the crowdfunding "jackpot," referring your clients to firms that specialize in multistate businesses or at least firms that specialize in multistate sales and use tax practices might be advisable.

**Note:** For a list of the states with typical click-through nexus statutes similar to New York's click-through nexus provisions, go to:

**Website**
www.caltax.com/spidellweb/public/editorial/CAT/1016-nexuslaws.pdf

## SINGLE CLAIM OF REFUND FOR INSTALLMENT OVERPAYMENTS

Taxpayers making installment payments on outstanding sales and use taxes and any other tax or fees administered by the BOE may file a single claim for refund to cover all subsequent installment payments. (AB 1856 (Ch. 16-98)) The single refund claim is applicable to all claims for refund made on or after January 1, 2017.

## LIMITED *LUCENT*-TYPE SALES AND USE TAX REFUNDS TO BE ISSUED

The Board has directed BOE staff to begin issuing sales and use tax refunds involving sales of software under a technology transfer agreement (TTA) to taxpayers with near identical fact patterns to those involved in ***Lucent Technologies, Inc. v. State Board of Equalization***. (***Lucent Technologies, Inc. v. State Board of Equalization*** (2015) 241 Cal.App.4th 19) To qualify as an exempt TTA under the ***Lucent*** case, the agreement must:

- Assign or license the right to reproduce or copy noncustom software, subject to the exclusive holder-retailer's copyright or patent interest; and
- Be transmitted on wholly collateral storage media.

The BOE is sending questionnaires to taxpayers that filed Lucent-related protective refund claims to help BOE staff identify qualifying claims. (***Lucent*** Court Case: Lucent's Charges for Software on Storage Media as Part of Technology Transfer Agreement are Not Subject to Tax, BOE Special Notice, August 24, 2016)

***Filing refund claims***

A claim for refund for all open periods (under the three-year statute) should be filed for all software products that meet the ***Lucent*** criteria and on which California use tax was paid. If the purchase was from a California vendor with sales tax added, contact the vendor to file a claim for refund on your behalf.

BOE staff is holding interested parties meetings in 2016 and 2017 to address the issues of how to treat canned and embedded software. Additional information is available in BOE Special Notice L-468 at:

**Website**
www.boe.ca.gov/pdf/L468.pdf

## 2016 USE TAX LOOKUP TABLE

For taxpayers who choose to pay their use tax liability using the use tax table on their FTB return, the amounts in the use tax table have increased for 2016.

| **2016 Use Tax Lookup Table** | |
|---|---|
| **AGI range** | **Use tax liability** |
| Less than $10,000 | $2 |
| $10,000–$19,999 | $6 |
| $20,000–$29,999 | $10 |
| $30,000–$39,999 | $14 |
| $40,000–$49,999 | $17 |
| $50,000–$59,999 | $21 |
| $60,000–$69,999 | $25 |
| $70,000–$79,999 | $29 |
| $80,000–$89,999 | $33 |
| $90,000–$99,999 | $37 |
| $100,000–$124,999 | $44 |
| $125,000–$149,999 | $53 |
| $150,000–$174,999 | $63 |
| $175,000–$199,999 | $73 |
| More than $199,999 | 0.039% of AGI<br>(AGI × 0.00039) |

The table provides a safe harbor for a taxpayer who:

- Reports use tax on an FTB return; and
- Does not have a single purchase of $1,000 or more. Taxpayers with one or more purchases greater than $1,000 may calculate their actual use tax owed on those purchases, and use the table to report use tax on all other purchases. The safe harbor will apply to the purchases of $1,000 or less, but the BOE may assess additional tax on the purchases over $1,000.

# SECRETARY OF STATE

## LLC STATEMENT OF INFORMATION FILING REQUIREMENTS CHANGED

LLCs that do not have any changes in the information reported to the Secretary of State (SOS) on the biennial Statement of Information will now submit a Form LLC-12NC, LLC Statement of No Change. Previously, such LLCs checked a box on the LLC Statement of Information (LLC-12) indicating that no changes had occurred since the last complete Statement of Information was filed.

The LLC-12 must be filed with the SOS within 90 days after filing Form LLC-5, Application to Register, and when any specified changes occur.

Mail the LLC-12 and LLC-12NC to:

**Address**
Secretary of State
Statement of Information Unit
P.O. Box 944230
Sacramento, CA 94244-2300

# PROPERTY TAXES

## AIRBNB-TYPE HOSTS SUBJECT TO PERSONAL PROPERTY TAXES

The San Francisco assessor's office requires Airbnb/VRBO-type short-term rental hosts to file a business personal property tax statement (Form 571-R) and pay the 1.182% personal property tax on the property reported.

The assessor's office has contacted all of the short-term rental owners who have registered as a business with the city and county of San Francisco or other short-term lessors the assessor is aware of to inform them of their reporting/payment requirements.

This is a fairly aggressive position, as under R&TC §441(a), business owners with personal property of less than $100,000 in value are only required to file a business property statement upon the assessor's request. All businesses with property valued at $100,000 and up must file the annual statement.

We are unaware of any other California county making such requests of Airbnb-type hosts.

 

For more information, go to: "Short-Term Rental Business Personal Property Taxation Frequently Asked Questions," San Francisco Office of the Assessor-Recorder, available at:

**Website**
www.sfassessor.org/sites/default/files/notice/
2016.8.9__STR%20FAQ%20--%20ASR%20Header%20and%20Footer.pdf

Taxpayers must report the cost and acquisition year of all physical assets used in the rental activity (regardless of when purchased), "including kitchen appliances, laundry machines, entertainment units, linens, dishes, utensils, artwork, and any other property that you provide to your renters as part of the rental activity." And don't forget the "cleaning supplies, computer equipment, and office equipment such as desks, chairs, and file cabinets."

***Comment***

According to recent reports, San Francisco brought in a whopping $120,000 from this so called "furniture tax." The average personal property tax bill came to $60.

## MORE VETERANS QUALIFY FOR PROPERTY TAX RELIEF

Veterans with 100% disability with Other Than Honorable (OTH) or Bad Conduct military discharges may qualify for the Disabled Veterans' Exemption but only if the U.S. Department of Veteran's Affairs determines they are eligible for federal health and medical benefits. (SB 1458 (Ch. 16-871); R&TC §205.5) Previously only vets with an honorable discharge were eligible for the exemption. The change is applicable commencing with the lien date for the 2017–18 year.

The bill also extends the use of roll corrections to process disabled veteran related refunds to eight years. (R&TC §§4831.1, 5097, 5097.3)

**Note:** The honorable discharge standard is particularly an issue for veterans suffering from post-traumatic stress disorder (PTSD). These veterans are more likely to have been discharged under OTH or Bad Conduct because of actions related to their PTSD. However the Veteran's Department frequently authorizes federal benefits after its investigation.

## COUNTIES WITH BASE-YEAR VALUE TRANSFER PROVISIONS

For California property tax purposes, 11 California counties have ordinances implementing the intercounty base-year value transfer provisions for persons age 55 and over and severely and permanently disabled persons, effective June 5, 2016. (Letter to County Assessors, No. 2016/022 (June 14, 2016))

The 11 counties are:

- Alameda;
- El Dorado;
- Los Angeles;
- Orange;
- Riverside;
- San Bernardino;
- San Diego;
- San Mateo;
- Santa Clara;
- Tuolumne; and
- Ventura.

## SPECIAL NEEDS TRUST BENEFICIARY ELIGIBLE FOR PROPERTY TAX POSTPONEMENT

A beneficiary of a special needs trust that holds title in real property is an eligible claimant for the Senior Citizens' and Disabled Citizens' Property Tax Postponement (PTP) program, effective January 1, 2017. (SB 909 (Ch. 16-425); R&TC 20583)

## PROPOSITION 64 — MARIJUANA

On November 8, 2016, California voters approved Proposition 64, which legalizes recreational marijuana for use by adults age 21 or older. The proposition will also allow non-medical retail sales of marijuana and impose new taxes on marijuana sales, though those changes will not go into effect immediately.

Note the following:

- Effective immediately, if you are 21 or older, you can possess an ounce of marijuana, and grow up to six plants in your home legally;
- It is still illegal to smoke marijuana in public, or to drive while impaired by marijuana;
- An excise tax of 15% will be imposed on retail sales of marijuana, and cultivation taxes of $9.25 per ounce of flower and $2.75 per ounce of leaves will be imposed on marijuana growers. These new taxes will be imposed beginning January 1, 2018. Medical marijuana will be exempt from some taxation;
- Non-medical marijuana can only be sold by state-licensed businesses, and the state has until January 1, 2018, to begin issuing licenses for recreational retailers. So, for now, it is not legal to sell marijuana for recreational purposes; and
- Local authorities will have the authority to impose additional restrictions and taxes on marijuana sales.

Although the proposition legalizes the recreational use of marijuana for California purposes, it is important to note that marijuana is still an illegal substance for federal purposes. This means that supplying marijuana is considered drug trafficking for federal and state purposes. (***Californians Helping to Alleviate Medical Problems, Inc. v. Comm.*** (May 15, 2007) 128 TC 173)

It also means that your clients who chose to operate marijuana businesses are faced with interesting issues concerning taxation.

### TAXATION

Under IRC §280E, marijuana businesses are prohibited from claiming any deductions other than cost of goods sold (COGS). IRC §280E prohibits taxpayers from deducting expenses incurred in trafficking of controlled substances, even where marijuana is sold through a legal marijuana dispensary.

California personal income tax law conforms to the IRC §280E prohibition, so individuals, sole proprietors, partnerships, and LLCs taxed as partnerships may only deduct COGS.

California's corporation tax law does not conform to IRC §280E. This means that a corporate taxpayer (including an LLC taxed as a corporation) may be allowed full deductions for COGS and business expenses.

However, no deduction is allowed for COGS by either personal income or corporate taxpayers if the taxpayer was determined to be engaged in criminal profiteering or related activities enumerated in R&TC §§17282 and 24436.1. These activities include drug trafficking. For this limitation to apply, a taxpayer must be found to be engaged in these activities through a final determination in a criminal proceeding, or a proceeding in which the state, county, city and county, city, or other political subdivision was a party. If such a determination is made, the taxpayer is prohibited from claiming all business expenses, including COGS.

## Computing COGS for marijuana dispensaries

The IRS has issued guidance on which expenses a marijuana dispensary business may deduct, regardless of whether the dispensary sells recreational or medical marijuana. (CCA 201504011) The Chief Counsel Advice (CCA) says that marijuana businesses can write off COGS, such as direct material costs and indirect production costs, but must compute COGS using the rules under IRC §471, General Rules for Inventories, rather than under IRC §263A, Capitalization and Inclusion in Inventory Costs of Certain Expenses. IRC §263A increased the types of costs that are inventoriable, compared to the rules under IRC §471.

**Note:** IRC §263A is a timing provision. It does not change the character of any expense from "nondeductible" to "deductible," or vice versa.

A cash-basis facility would therefore have more taxable income than its accrual-basis counterpart. The CCA states that when auditing a cash-basis marijuana dispensary, the IRS has the authority to permit the taxpayer to deduct from gross income its costs that would have been inventoriable if the taxpayer used the accrual method.

***Example of sole proprietor dispensary***

Mary Juana operated a medical marijuana dispensary in Marytown. She had gross receipts of $100,000, COGS of $25,000, and business expenses of $70,000.

For federal and California purposes, she must report gross income of $100,000 and a deduction of $25,000 for COGS on her Schedule C. She may not deduct business expenses, so her net income subject to federal and California tax is $75,000.

Assume, however, it is determined that Mary was not selling medical marijuana legally under California law but was using her establishment to sell to individuals without prescriptions. She was convicted in a California state court of drug trafficking.

In this case, she may still deduct the COGS on the federal return, but for California purposes, she is not allowed any deductions for COGS, or other expenses, and the full $100,000 gross sales is subject to California tax.

***Example of corporate dispensary***

The Joint, Inc. is a licensed medicinal marijuana dispensary. Joint's gross sales are $200,000. Joint's COGS is $75,000, and expenses are $115,000.

For federal purposes, Joint reports $200,000 in sales, COGS of $75,000, and $125,000 of taxable income.

For California purposes, because Joint is a corporation, COGS and all expenses are allowed, and Joint's taxable income is $10,000.

Assume, however, it is determined that Joint was not selling medicinal marijuana legally under California law. Joint was convicted of drug trafficking in a California state court.

In this case, Joint may still deduct the COGS on the federal return, but for California purposes, Joint is not allowed any deductions for COGS or other expenses and the $200,000 gross sales is subject to California tax.

## Sales and use taxes

Prior to Proposition 64, all medical marijuana sales were subject to sales and use tax. Effective November 9, 2016, certain sales of medical marijuana are exempt from sales and use tax.

The sales and use tax exemption only applies to the retail sales of medical cannabis, medical cannabis concentrate, edible medical cannabis products, or topical cannabis as those terms are defined in the Business and Professions Code §19300.5. To obtain the exemption, qualified patients or their primary caregiver must provide their valid Medical Marijuana Identification Card issued by the California Department of Public Health and a valid government-issued identification card at the time of purchase.

Medical marijuana retailers will claim the exemption on their sales and use tax return and must retain supporting documentation to substantiate exempt transactions. Recreational marijuana sales will also be subject to sales and use tax.

## Incentives

Marijuana businesses may qualify for the New Employment Credit, and cultivators may also qualify for the Research Credit, the manufacturer's partial exemption of sales and use tax, and agricultural exemptions and credits.

## Business licenses/fees

Localities either ban dispensaries or require dispensaries to obtain business licenses and pay local taxes/fees. Failure to comply with these requirements will transform a dispensary into an "illegal" activity.

# PRACTITIONER CONCERNS

Practitioners are concerned that preparing returns for marijuana growers and retailers could lead to legal trouble and will be considered unethical or in violation of Circular 230. Practitioners are pushing the IRS to issue guidance clarifying that a tax professional will not be considered unethical, targeted for audit, or considered in violation of Circular 230 solely for preparing a return for a legal dispensary.

 

The 2014 Office of Professional Responsibility Report contains the following Internal Revenue Service Advisory Council (IRSAC) recommendation:

*"IRSAC members believe that as a matter of substantive tax law either section 280E or the controlled substance schedules incorporated by reference into section 280E (or both) need clarification in light of these state law developments. Regardless of any such substantive changes, however, tax professionals need reassurance regarding their own roles in giving tax advice to and preparing tax returns for such businesses.*

***Recommendation from IRSAC***

*Published guidance should promptly clarify that a tax professional will not be considered unethical, will not be targeted for audit, and will not be in violation of Treasury Circular 230 solely for representing or preparing a return for a business that is illegal under federal law but legal at the state level under state law."*

Although it was anticipated that the OPR would have guidance in early 2015, that has not yet happened.

## Board of Accountancy

At this time, the Board has no specific position regarding the marijuana industry. According to Arturo Ramudo, CPA, CISA, who presents ethics, regulatory review, and accounting and auditing courses for Spidell, as long as the tax return is prepared accurately, the Board generally should not have a problem. Even if a CPA were to prepare a tax return for a drug dealer (illegal trade), the Board's only concern would be that the return was prepared accurately based on the information provided or based on the information the CPA should have known (i.e., recognize 100% of the illegal income and none of the nondeductible related expenses).

As far as the AICPA's Code of Professional Conduct is concerned, there is no specific standard regarding the marijuana industry. As long as the business is legitimate, the AICPA would not have an ethical problem. If it involves illegal sales, the Code does not prohibit the CPA from preparing the return, but it does require that the CPA consider the moral character of the individual and consider possible disengagement.

## Other suggestions

Because tax professionals, with the exception of attorneys, do not have privilege, a tax professional should be aware that the attorney–client privilege is not available. In the case of an audit, you should work under an attorney's shield.

Tax professionals should consult with their malpractice carrier for additional guidance.

For a discussion of risk management and suggestions for dealing with clients in the marijuana industry, go to the CAMICO insurance website:

**Website**
www.camico.com/blog/Marijuana_Business_Clients_Smokin_Hot_Issues_for_CPAs

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Chapter 15

# Practitioner Aids

# PRACTITIONER AIDS

## 1040 ENGAGEMENT LETTER

*This letter is provided for information purposes, only. Spidell Publishing, Inc.® assumes no responsibility for its use. Consult with legal counsel. Engagement letters should always be modified to fit each engagement.*

Dear [CLIENT NAME]:

Thank you for selecting [YOUR FIRM NAME] to assist you in preparing your personal income tax returns. This letter confirms the terms of our engagement and the nature, timing, and limitations of the services we will provide.

We will prepare your 2016 federal and state personal income tax returns from information you furnish us. We will not audit or otherwise verify the data you submit, although it may be necessary to request clarification and/or documentation of some of the information. Generally, we will rely on your representation that you have maintained the documentation required by law to support the information you provide, including expenses for meals, entertainment, travel, gifts, vehicle use, charitable contributions, etc. If you are not clear regarding what documentation is needed for any given item of income or deduction, we'd be happy to discuss it with you. **Note that you have the final responsibility for the income tax returns and, therefore, you should carefully review them before you sign and file them.**

We have provided an organizer for your use. While we don't require its use, it may serve as a useful "tickler" to remind you of items to provide to us. Nonetheless, provide us with originals or copies of originals of all government tax documents including W-2s, 1099s, 1098s, and property tax statements.

We will use professional judgment in resolving issues when the tax law is unclear or when there is conflict among the authorities.

The filing deadline for the tax returns is April 18, 2017. In order to meet this filing deadline, we must receive your information in substantially complete form by April 1.

If an extension of time to file is required, we will use the information available to us at the time to prepare the extension. To prepare a valid, accurate extension, we need as much information as is available. We also need your express approval to file the extension on your behalf. **An extension, however, only provides you with an extension to file, not an extension to pay. Taxes paid after April 18 will result in penalties and interest.**

Under both federal and California law, we are required to electronically file your returns. However, you may opt out of electronically filing without explanation. If you would rather not e-file, please let us know and we will provide you with the government opt-out forms you must sign and return to us.

If a joint return is prepared, tax returns and copies of all supporting documentation will be made available to either spouse without the consent or notification of the other spouse.

You are responsible for reporting foreign activities. By signing this letter you acknowledge that you will inform us if you have income from foreign sources or if you have signatory authority over any foreign account. If you are unsure whether income or an account is foreign, we will review it. **Note that the penalties for failure to report foreign activities are severe.**

By signing this agreement, you authorize [YOUR FIRM NAME] to execute the Online Account View Access Authorization on the Franchise Tax Board's website. You understand [YOUR FIRM NAME] will have view-only access to all the tax year information available on the FTB's website that is associated with you. This authorization remains in effect until you revoke it in writing.

Your tax returns may be selected for review by the taxing authorities. If the government selects your return for examination, we will be available to assist you. At our discretion, there may be additional fees for this service.

We generally retain, for seven years, the final work product generated for our clients. After the retention period, the documents are destroyed. We do not keep original documents — they are returned to you after completion of the returns. It is your responsibility to retain your records for possible future use, including possible examination by the taxing authorities.

Our fees for tax preparation services are based on the amount of time required at our standard billing rates plus out-of-pocket expenses. All invoices are due and payable upon presentation. Tax returns will not be filed electronically until fees are paid.

If the foregoing fairly sets forth your understanding, please sign the enclosed copy of this letter and return it to our office. Work cannot commence until a signed copy of this document is returned. If this is a joint return, both spouses must sign.

Yours truly,

[YOUR FIRM NAME]

Acknowledged:

Signature:___________________________

Print name:___________________________

Signature:___________________________

Print name:___________________________

**Website**
To download a copy of this client letter, go to:
www.caltax.com/spidellweb/public/editorial/Letter1040.doc

Additional engagement letters for Forms 1120, 1120S, and 1065 are also available online at:

**Website**
**Form 1120:** www.caltax.com/spidellweb/public/editorial/Letter1120.doc
**Form 1120S:** www.caltax.com/spidellweb/public/editorial/Letter1120S.doc
**Form 1065:** www.caltax.com/spidellweb/public/editorial/Letter1065.doc

# CLIENT LETTER (MAY BE ORGANIZER LETTER)

Dear [CLIENT NAME]:

We hope that 2016 has been a happy and prosperous year for you and your family. Enclosed is your annual organizer for your 2016 taxes. It's been an interesting year with a few important tax changes that will impact you. Here are some of the changes and issues you need to know about.

**Tax return due date changes:** Beginning with the 2017 filing season, for federal and California tax purposes, the due dates for partnership and C corporation returns have changed. Be aware that partnership returns are now due a month earlier.

The due dates for returns are as follows:

- Partnerships must file returns by the 15th day of the third month following the close of the taxable year (March 15 for calendar-year taxpayers). Previously, these were due by the 15th day of the fourth month following the close of the taxable year;
- C corporation returns are generally due by the 15th day of the fourth month following the close of the taxable year (April 15 for calendar-year taxpayers). Previously, these were due by the 15th day of the third month of the taxable year;
- S corporation returns will remain due by the 15th day of the third month of the taxable year (March 15 for calendar-year taxpayers); and
- W-2s and 1099s must be filed by January 31, 2017, for the 2016 year. This is one month earlier than in the past. There are penalties for filing these forms late.

The April 15 due date for 2016 returns will be extended to April 18, 2017, because of a holiday celebrated in Washington DC.

**Identity theft:** Tax refund fraud and identity theft are an increasing problem. Thieves are coming up with new ways to steal your identity, your refund, and your money. Here are a couple of recent tricks used to steal from you.

- **The threatening phone call:** Scammers call and tell you they are the IRS and that if you don't make a payment, you will be sued, subject to a lien or even be convicted of a criminal offence. The IRS DOES NOT call you about collection or balances due. In fact, the IRS will generally only call if you are working with an employee on an audit or other issue. If you get one of these calls, hang up immediately; and
- **The letter with a bill:** You receive an official looking bill for a small amount — maybe $200 or so. You decide it's easier to just pay the bill than to contact our office about it. Please let us know any time you receive correspondence from the IRS or the State of California. In the most recent fraudulent letters, you are told to make out a check to "I.R.S." rather than to "United States Treasury;" and the return address does not match the processing center address posted on the IRS website.

**Property transactions:** Did you sell any real estate this year? Be sure to provide copies of escrow statements, as well as the Loan Estimate form, the Closing Disclosure form, and California Form 593, Real Estate Withholding Tax Statement. We need these documents to properly prepare your return. If you can get them to us as early as possible, we can make sure we have everything we need, and that any state withholding documentation is correct.

**1099s and K-1s:** If you received 1099s or K-1s from investments in 2016, we may extend your return in case these documents are corrected after the original filing deadline. We are seeing increasing numbers of corrected information returns, which require taxpayers to amend their original tax returns to reflect the corrected amounts. In some cases, the amounts are vastly different and can create additional costs in amending the tax returns and potential penalty problems.

**Foreign accounts:** Beginning this year, we must report overseas assets owned by businesses as well as individuals. So, the reporting requirements are increasing and the penalties for failure to report continue to be harsh. Not all foreign holdings must be reported. If, for example, you hold stock in a foreign company through a U.S. broker, those holdings do not have to be separately reported. However, if you hold any other types of foreign assets, including bank accounts and securities accounts, please let us know. If you have any doubt as to whether any of your assets are foreign, please discuss those assets with us. Again, this year we will need information on a business' foreign holdings as well.

Please take extra care in preparing your organizer and documentation so we can do the best possible job to find new tax benefits that are hidden in the law and protect you from more aggressive audit programs and larger penalties.

Yours truly,

Your tax professional

P.S. Let's try to file your return as early as possible so you can get your refund quickly!

**Website**
To download a copy of this client letter, go to:
www.caltax.com/spidellweb/public/editorial/Organizerletter.doc

## LENDER LETTER

Many of our subscribers have told us that they are again receiving lender letters asking for verification of tax information contained on borrowers' tax returns. We suggest that when asked for verification, you use the following sample lender letter we have created with the help of CAMICO, a major insurance carrier for CPAs in California.

To Whom It May Concern:

I prepared individual income tax returns that have included Schedules C for [INSERT NAME HERE] for [INSERT WHICH YEARS] years based upon information given to me by [INSERT NAME HERE]. My services to [INSERT NAME HERE] were and remain limited to the preparation of individual federal and state income tax returns from information provided to me by my client. I have not reviewed, audited, or otherwise attempted to verify any of the information given to me by [INSERT NAME HERE]. Consequently, I cannot affirm its accuracy or completeness.

Sincerely,

[YOUR NAME]

**Website**
To download a copy of this client letter, go to:
www.caltax.com/spidellweb/public/editorial/LetterLender.doc

 

## SOLAR CLIENT LETTER

Dear Client:

Solar energy is growing, and California is leading the way. More and more Californians each year are having solar panels put on their roofs, and the energy cost savings can be substantial.

There can also be substantial tax savings as you may get a tax credit of up to 30% of the cost of buying and installing the panels.

If you are considering putting solar panels on your home, beware that there are many aggressive salespeople who are misrepresenting the tax savings that you may be entitled to. Note the following:

- If you choose to lease panels, that may be the most economical way to go; however, if you lease, you do not get the tax credits;
- If you must install a new roof in connection with installing solar panels, you may not get a tax credit for all or part of the cost of the roof; and
- If you finance the purchase of the solar panels through any of the programs that allow you to make your finance payments through your property taxes, that portion of your property taxes is not deductible as property tax.

There are other tax and nontax considerations regarding whether you should lease or buy your panels or whether you should go with solar at all. Please contact us to discuss.

Sincerely,

Your tax professional

**Website**
To download a copy of this client letter, go to:
www.caltax.com/spidellweb/public/editorial/solarletter.doc

## SAMPLE CAPITALIZATION POLICY

**Purpose:** This accounting policy establishes the minimum cost (capitalization amount) that shall be used to determine the capital assets to be recorded in [BUSINESS ENTITY]'s books and financial statements.

**Capital asset definition and thresholds:** A "Capital Asset" is a unit of property with a useful life exceeding one year and a per-unit acquisition cost exceeding [SPECIFY AMOUNT]. Capital assets will be capitalized and depreciated over their useful lives. [BUSINESS ENTITY] will expense the full acquisition cost of tangible personal property below these thresholds in the year purchased.

**Capitalization method and procedure:** All Capital Assets are recorded at historical cost as of the date acquired.

Tangible assets costing below the aforementioned threshold amount are recorded as an expense for [BUSINESS ENTITY]'s annual financial statements (or books). In addition, assets with an economic useful life of 12 months or less must be expensed for both book and financial reporting purposes.

**Documentation:** Invoices substantiating the acquisition cost of each unit of property are to be retained for a minimum of 10 years.

**Tax capitalization threshold:** The permissible ceiling for deducting otherwise capitalizable expenditures is $5,000 when our business has applicable financial statements. The threshold is limited to $2,500 in the absence of applicable financial statements.

**Website**
To download a copy of this capitalization policy, go to:
www.caltax.com/spidellweb/public/editorial/samplecap.doc

## AUTHORIZATION TO CONTACT FAMILY OF A CLIENT WITH DEMENTIA

Dear Client,

Many of my clients would like me to contact a family member or friend if I cannot reach them, they have not filed a return, or if I have a concern about their financial decisions. If you would like to provide me with permission to release your tax information to a family member or friend, please sign below. You may revoke this permission at any time.

I, CLIENT NAME authorize TAX PROFESSIONAL NAME to contact NAME OF CONTACT at E-MAIL ADDRESS or PHONE NUMBER if TAX PROFESSIONAL NAME is unable to reach me, if I have not filed a tax return, or if TAX PROFESSIONAL NAME has a concern about my financial decisions.

I understand that I may revoke this permission in writing at any time.

Signed,

________________________ _______________
Name Date

**Website**
To download a copy of this client letter, go to:
www.caltax.com/spidellweb/public/editorial/contactfamily.doc

## GENERAL DISENGAGEMENT/TERMINATION LETTER

[DATE]

[CLIENT NAME]

[CLIENT ADDRESS]

Dear [CLIENT NAME],

Thank you for entrusting me to act as your tax professional. [I/WE] have enjoyed having you as a client. However, due to [INSERT REASON FOR TERMINATION], [I/WE] will no longer be able to provide you with professional services.

This letter is to inform you that effective [DATE], [I/FIRM NAME] resign(s) from all engagements with [CLIENT NAME/ENTITY NAME].

[CLIENT NAME/ENTITY NAME] previously engaged [ME/FIRM NAME] to provide [LIST SERVICES].

[I/WE] recommend that you engage a new tax professional as soon as possible. Here are the services and due dates that you will need assistance with in the coming months:

- [LIST SERVICES]

[IF AN OUTSTANDING BALANCE IS OWED, REQUEST PAYMENT BY A SPECIFIED DATE]

[I/WE] will work with your new tax professional to make this transition as smooth as possible. Please contact [ME/US] with any questions you may have

Sincerely,

Your tax professional

**Website**
To download a copy of this client letter, go to:
www.caltax.com/spidellweb/public/editorial/disengagementletter.doc

## CONFLICT OF INTEREST DISENGAGEMENT LETTER

[DATE]

[CLIENT NAME]

[CLIENT ADDRESS]

Dear [CLIENT NAME],

This letter is to inform you that effective [DATE], [I/FIRM NAME] resign(s) from all engagements with [CLIENT NAME/ENTITY NAME] due to a potential conflict of interest.

[CLIENT NAME/ENTITY NAME] previously engaged [ME/FIRM NAME] to provide [LIST SERVICES].

[I/WE] have enjoyed working with you. However, because of [DESCRIBE CONFLICT OF INTEREST SITUATION] the above referenced services will no longer be provided.

[I/WE] recommend that you engage a new tax professional as soon as possible. Here are the services and due dates that you will need assistance with in the coming months:

- [LIST SERVICES]

[IF AN OUTSTANDING BALANCE IS OWED, REQUEST PAYMENT BY A SPECIFIED DATE]

[I/WE] will work with your new tax professional to make this transition as smooth as possible. Please contact [ME/US] with any questions you may have

Sincerely,

Your tax professional

**Website**
To download a copy of this client letter, go to:
www.caltax.com/spidellweb/public/editorial/conflictletter.doc

## CONSENT TO SHARING 1041 TAX RETURN INFORMATION

[DATE]

[FORMER CLIENT NAME]

[FORMER CLIENT ADDRESS]

Dear [FORMER CLIENT NAME],

You have requested that [I/WE] provide information from your tax returns to [NEW TAX PROFESSIONAL]. In order for [ME/US] to release the requested information, you must complete the written authorization below.

Federal law requires this consent form be provided to you. Unless authorized by law, we cannot disclose, without your consent, your tax return information to third parties for purposes other than the preparation and filing of your tax return. If you consent to the disclosure of your tax return information, Federal law may not protect your tax return information from further use or distribution.

You are not required to complete this form. If we obtain your signature on this form by conditioning our services on your consent, your consent will not be valid. If you agree to the disclosure of your tax return information, your consent is valid for the amount of time that you specify. If you do not specify the duration of your consent, your consent is valid for one year.

**Authorization**

I, ________________________, authorize [YOUR NAME/FIRM NAME] to disclose to ________________________ my tax return information for the following tax year(s) _______________.

Purpose for disclosing information:

________________________________________________________________________________

Name and address to which the information is being disclosed:

________________________________________________________________________________

Duration of consent: ___________________________

Signature: ___________________________ Date: ___________________________

If you believe your tax return information has been disclosed or used improperly in a manner unauthorized by law or without your permission, you may contact the Treasury Inspector General for Tax Administration (TIGTA) by telephone at 1-800- 366-4484, or by email at complaints@tigta.treas.gov.

**Caution**

A consent furnished to the taxpayer on paper must be provided on one or more sheets of 8½ inch by 11 inch or larger paper. All of the text on each sheet of paper must pertain solely to the disclosure or use the consent authorizes. All of the text on each sheet of paper must also be in at least 12-point type (no more than 12 characters per inch).

**Website**

To download a copy of this client letter, go to:
www.caltax.com/spidellweb/public/editorial/consentletter.doc

## SELLING PRACTICE: TRANSFERRING CLIENTS TO NEW OWNER

[DATE]

Dear [CLIENT NAME],

After much consideration, I have decided to end my practice effective [DATE]. At this time, I have made arrangements for [NEW OWNER] to take over my practice and to provide for continued service to my clients.

You will be contacted by [NEW OWNER] in the near future to discuss your acceptance of this new relationship. At that time [NEW OWNER] will review with you the specific services you require, the applicable deadlines for these services, and other relevant items as determined by you and [NEW OWNER]. With your permission, I will then turn over your records to [NEW OWNER]. To assist them in the transition, I will be working with them during [TIME FRAME] for consultations, special projects, and other services deemed appropriate.

If you choose not to accept [NEW OWNER] as your accountants, you will need to make arrangements with another professional as soon as possible to ensure that all of your applicable filing deadlines are met timely. I will work with your subsequent accountant as appropriate.

I have enjoyed working with you in the past and wish you success in your future endeavors. If you have any questions, or would like to discuss this further please call me.

Sincerely,

Your tax professional

**Consent**

Federal law requires this consent form be provided to you. Unless authorized by law, we cannot disclose, without your consent, your tax return information to third parties for purposes other than the preparation and filing of your tax return. If you consent to the disclosure of your tax return information, Federal law may not protect your tax return information from further use or distribution.

You are not required to complete this form. If we obtain your signature on this form by conditioning our services on your consent, your consent will not be valid. If you agree to the disclosure of your tax return information, your consent is valid for the amount of time that you specify. If you do not specify the duration of your consent, your consent is valid for one year.

**Authorization**

I, ________________________, authorize [YOUR NAME/FIRM NAME] to disclose to ________________________ my tax return information for the following tax year(s) _______________.

Purpose for disclosing information:

__________________________________________________________________________________

Name and address to which the information is being disclosed:

__________________________________________________________________________________

Duration of consent: ___________________________

Signature: ___________________________ Date: ___________________________

If you believe your tax return information has been disclosed or used improperly in a manner unauthorized by law or without your permission, you may contact the Treasury Inspector General for Tax Administration (TIGTA) by telephone at 1-800- 366-4484, or by email at complaints@tigta.treas.gov.

**Caution**

A consent furnished to the taxpayer on paper must be provided on one or more sheets of 8½ inch by 11 inch or larger paper. All of the text on each sheet of paper must pertain solely to the disclosure or use the consent authorizes. All of the text on each sheet of paper must also be in at least 12-point type (no more than 12 characters per inch).

**Website**

To download a copy of this client letter, go to:
www.caltax.com/spidellweb/public/editorial/transferletter.doc

# myRA CLIENT LETTER

Dear [CLIENT NAME],

If you don't have access to an employer-sponsored retirement savings plan or are looking to supplement a current plan, a myRA ("My Retirement Account") could be a prudent option. Available on the Department of Treasury website, a myRA is a retirement savings account for individuals that is simple and affordable, where your account balance will never go down, and account maintenance fees are nonexistent.

A myRA can be opened with no start-up costs and no minimum contribution requirement. Thereafter, through automatic payroll deductions, you can contribute as little as a few dollars per month, up to $5,500 per year. myRAs are Roth IRAs and are available to anyone who has adjusted gross income of less than $129,000 a year for individuals and $191,000 for married couples filing jointly. But myRAs have the advantage over conventional Roth IRAs of no fees and a government guarantee of principal.

Currently, you can only fund a myRA from your paycheck if your employer offers direct deposit and can direct funds into your retirement savings account. However, your myRA belongs to you, so you can continue to use the same account even if you change jobs. If you're interested in a myRA and your employer does not offer direct deposit, you'll have to wait until the Treasury offers other contribution options.

Setting up a myRA is easily done. Visit myRA Online at https://myra.treasury.gov/. The application takes under 10 minutes to complete. You'll need your:

- Social Security number;
- Driver's license, state ID, passport, or military ID;
- Home address;
- E-mail; and
- Beneficiary's (or beneficiaries') name and birthdate.

After completing the application, you'll receive an account number to use on the direct deposit paperwork, which you will submit to your employer. Thereafter, you can manage your account through myRA Online.

If you have any questions or would like more information on myRAs, please give me a call.

Sincerely,

Your tax professional

**Website**

To download a copy of this client letter, go to:
www.caltax.com/spidellweb/public/editorial/myRAletter.doc

# IRA/UBI CLIENT LETTER

Dear [CLIENT NAME],

When funds within a taxpayer's IRA are invested in a limited partnership, the partnership reports the IRA's portion of the partnership's income and expense activity on a Form 1065 and Schedule K-1, as well as that of all other partners. (The term IRA in this situation includes traditional IRAs, SEP-IRAs, SIMPLE IRAs, and Roth IRAs.)

We are sending you this letter as we see that you have a retirement account that is invested in one or more such partnerships. This income is not reportable on your Form 1040 because it is inside the IRA. However, the income in these investment vehicles is often considered under the Internal Revenue Code to be "unrelated business income," or UBI, to a qualified retirement plan.

When cumulative UBI in a given tax year exceeds $1,000 for a particular retirement plan, a Form 990-T is required to be filed, which reports the UBI and calculates the tax. Even if UBI nets to a loss, Form 990-T should be filed, as the loss can be carried back and/or forward, much like a net operating loss.

Tax rates for UBI are the same as those used for trusts (fiduciaries), with the highest bracket being 39.6%. In addition, any resulting tax must be paid directly from IRA assets to avoid the risk of a prohibited transaction, resulting in a disqualification, with the worst-case scenario of the entire balance of your IRA being deemed distributed in one lump sum and therefore fully taxable.

IRA trustees are required to prepare Form 990-T, but in the event they do not fulfill their obligation, it's important that the form be prepared by someone, as the IRA could potentially be disqualified. To avoid complications, we strongly suggest that you contact your IRA trustee immediately to discuss the Form 990-T requirement and coordinate its preparation and filing, if applicable. Because we are not your IRA trustee, we do not prepare Form 990-T, and the IRA Schedule K-1 is not part of your individual income tax return.

If the trustee of your IRA does not prepare the form as required and provide you with a copy, we advise you to seek legal counsel to protect your IRA investment.

If you have any questions, please give us a call.

Sincerely,

Your tax professional

**Website**
To download a copy of this client letter, go to:
www.caltax.com/spidellweb/public/editorial/IRAUBIletter.doc

 

# ROTH CONVERSION CHECKLIST

| Roth Conversion Checklist | | |
|---|---|---|
| Does the taxpayer qualify? | Virtually all taxpayers qualify because the income limitations have been repealed. | ☐ |
| Has the taxpayer decided to do a conversion? | The deadline is December 31 of the year of the conversion. The taxpayer does not get until April 15 of the following year, as is the case with contributions. | ☐ |
| Did the taxpayer take a distribution? | If so, the conversion must be completed within 60 days of the distribution by depositing the funds in a Roth account. The taxpayer gets 60 days regardless of the time of year. The conversion is deemed to take place on the day of distribution, not on the day the funds are deposited in the Roth. | ☐ |
| Does the taxpayer have RMD? | RMD must be taken first. If the taxpayer has an RMD requirement in the tax year, that amount cannot be converted. Essentially, the taxpayer must take RMD before doing the conversion or leave an amount in the traditional IRA sufficient to make his RMD. | ☐ |
| New beneficiary forms: | New Roth accounts need new beneficiary forms. | ☐ |
| 60-day rollover: | If the taxpayer takes a distribution, the funds must be deposited in the Roth account within 60 days. Failure to do so results in the distribution being taxable. If possible, use a trustee-to-trustee transfer to avoid the possibility of failing the 60-day rule. | ☐ |
| Does the taxpayer have basis in his or her IRA? | The taxpayer should have a Form 8606 showing the basis and will have to determine the tax-free amount of the conversion at the end of the year of the conversion. | ☐ |
| Does the taxpayer understand the five-year rule? | Distributions from Roth IRAs are generally tax-free. However, the distributions of earnings from a Roth are taxable if distributed within five years of the taxpayer first establishing a Roth. | ☐ |
| Is the conversion coming from a SIMPLE IRA? | An amount distributed from a SIMPLE IRA during the two-year period that begins on the date that the individual first participated in a SIMPLE maintained by the individual's employer cannot be converted to a Roth. | ☐ |
| Is the taxpayer's income unusually low? | The taxpayer may want to consider a conversion to use excess deductions or, at the very least, to take IRA distribution into income at low tax brackets. | ☐ |
| Does the taxpayer expect income to be unusually low in 2015 and/or 2016? | The taxpayer may want to consider a conversion to use excess deductions or, at the very least, to take IRA distribution into income at low tax brackets. | ☐ |
| Does the taxpayer have an NOL carryover? | The taxpayer may want to do a conversion to offset the NOL. | ☐ |
| | | *(continued)* |

| Roth Conversion Checklist (continued) | | |
|---|---|---|
| Does the taxpayer have a contributions carryover or wish to make sizable contributions during the year? | The taxpayer may want to do a conversion to offset the contributions or may want to make contributions during this year to offset a conversion. | ☐ |
| Does the taxpayer expect RMD to push him or her above the active participation threshold for passive losses? | The taxpayer may want to "take the hit" all at once and do a conversion in the current year. Without RMD, the taxpayer may be able to take up to a $25,000 deduction for active participation losses in future taxable years. | ☐ |
| Does the taxpayer expect RMD to push his or her income up to levels where Social Security becomes taxable? | The taxpayer may want to "take the hit" all at once and do a conversion in the current year. Without RMD, the taxpayer's Social Security may be tax-free. | ☐ |
| Does the taxpayer have an existing Roth? | Roll the conversion into a new Roth account. This will prevent having to sort earnings from the existing funds from earnings on the converted funds should the taxpayer decide to recharacterize. | ☐ |
| Will the taxpayer roll the converted funds into one or more Roth IRA accounts? | Consider rolling into multiple Roths. The taxpayer can pick and choose which to recharacterize back to a traditional IRA. | ☐ |
| After converting, did the value of the account drop substantially? | Consider recharacterizing. The account can then be reconverted at a lower value (i.e., a lower tax cost). | ☐ |
| After converting, did the taxpayer's income rise unexpectedly? | Consider recharacterizing. The taxpayer may convert in a later year when in a lower tax bracket. | ☐ |
| Is the taxpayer considering a recharacterization? | The deadline for recharacterizing is the extended deadline for the tax year of the conversion (i.e., October 15). This is true even if the taxpayer didn't extend. If the taxpayer has already filed, do the recharacterization and then file an amended return. | ☐ |
| Does the taxpayer have cash outside of the IRA to pay tax? | A conversion is not feasible if the taxpayer can't pay taxes caused by the conversion. | ☐ |
| Can income past 2015 be predicted with any reasonable certainty? | If the taxpayer is going to be in lower tax brackets in future years, it might not make sense to do a conversion now (in higher brackets). | ☐ |
| Does the taxpayer trust Congress not to change the law on Roth distributions in the future? | For a long time, it was commonly believed that Social Security benefits would never be taxable. Is it possible Congress might someday make Roth distributions taxable at least to the extent of earnings? | ☐ |

**Website**

To download a copy of this checklist, go to:
www.caltax.com/spidellweb/public/editorial/RothConversionChecklist.pdf

 

# ALLOWABLE ROLLOVERS

**Comparison Chart of Allowable Rollovers**

| Rollover From | Rollover To: IRA | SEP-IRA | SIMPLE IRA | Roth IRA | 457(b) | 403(b) | Qualified Plan | Designated Roth Account |
|---|---|---|---|---|---|---|---|---|
| **IRA** | Yes | Yes | Yes | Yes, must include in income | Yes, must have separate accounts | Yes | Yes | No |
| **SEP-IRA** | Yes | Yes | Yes | Yes, must include in income | Yes, must have separate accounts | Yes | Yes | No |
| **SIMPLE IRA** | Yes, after two years | Yes, after two years | Yes | Yes, after two years. Must include in income | Yes, after two years. Must have separate accounts | Yes, after two years | Yes, after two years | No |
| **Roth IRA** | No | No | No | Yes | No | No | No | No |
| **457(b)** | Yes | Yes | Yes | Yes, after December 31, 1997. Must include in income | Yes | Yes | Yes | Yes |
| **403(b)** | Yes | Yes | Yes | Yes, after December 31, 1997. Must include in income | Yes, must have separate accounts | Yes | Yes | Yes |
| **Qualified Plan** | Yes | Yes | Yes | Yes, after December 31, 1997. Must include in income | Yes, must have separate accounts | Yes | Yes | Yes (401(k) plans) |
| **Designated Roth Account** | No | No | No | Yes | No | No | No | Yes, if a direct trustee-to-trustee transfer |

**Warning:** The comparison chart shows general information that may not be applicable to all plans. Now all accounts allow rollover contributions. (Treas. Regs. §1.402(a)(31)-1, Q&A 13) Check with your pension administrator for additional requirements. A trustee-to-trustee transfer is required in some instances. A 60-day rollover rule may apply. (www.irs.gov/ep)

**Website**

To download a copy of this chart, go to:
www.caltax.com/spidellweb/public/editorial/AllowableRollovers.pdf

# SPIDELL'S REFUND GRABBER CHECKLIST

"I do a thorough review of the federal return and my tax program makes the California adjustments for me." How often have we said this? But we all know the computer does what we tell it to do. So, if someone doesn't tell the computer there is a California difference, it goes unnoticed and the taxpayer usually pays more tax. Or, sometimes we think we told the computer something and we actually didn't. Here is a list of common errors made on tax returns where you might find lost money for your clients.

- [ ] **NOL — Carry back.**

  For the 2015 and 2016 year, was 100% of the California NOL carried back? Or was the election made to carry the loss forward?

- [ ] **Railroad retirement — May be included in pension income.**

  California does not tax railroad retirement. For federal purposes, Part A is treated as Social Security and Part B is fully taxable and reported on the pension line of the federal return. Be sure both are excluded for California purposes.

- [ ] **IRA, Keogh, and SEP distributions — Basis?**

  Taxpayers who contributed to these accounts between 1982 and 1986 probably have a California basis. Contributions in 1987–1995 may have a higher California basis if income was different. Verify that the basis has been excluded from income.

- [ ] **HSA — Basis?**

  California does not conform to any of the HSA provisions. Since the taxpayer does not get a California deduction for contributions and must report earnings currently, the taxpayer gets basis for California purposes. Be sure to track California basis. The expenses paid with HSA funds are a deductible medical expense.

- [ ] **Depreciation — Basis differences from IRC §179 and bonus.**

  California has had different depreciation methods and different §179 expensing amounts in many prior years. Be sure that the basis and method are correct for California purposes. For an older asset, the California depreciation may be greater because of a longer life or higher basis.

- [ ] **Suspended passive losses — Did they carry over?**

  Make sure that suspended passive losses were not accidentally dropped in a prior year.

- [ ] **AMT passive losses — Were suspended losses carried over?**

  Suspended passive losses for AMT purposes are often different. Also, when inputting client information into a new computer program, you must make separate entries for AMT items and regular tax items.

- [ ] **AMT — Check depreciation.**

  Make sure that AMT depreciation has been carried forward properly, otherwise, when the asset is sold, the AMT gain may be too high.

- [ ] **AMT Credit — Don't forget.**

  If the taxpayer suffers or has ever suffered from AMT, see if there is a credit for prior-year AMT and carry it forward to reduce current-year regular tax.

- [ ] **AMT NOL — Correctly computed?**

  If the taxpayer has California AMT, make sure that any California AMT NOL is correctly computed so it carries over to next year.

- [ ] **Capital loss carryover for new clients, including AMT.**

  Particularly when setting up a new client, make sure to enter capital loss carryforwards, including the AMT capital loss carryover, even if the same as for regular tax. Most software requires both entries.

- [ ] **Mortgage Interest Credit — Larger itemized deduction.**

  If the taxpayer has a federal mortgage interest credit, the Schedule A interest expense is reduced. For California purposes, the taxpayer may deduct the full amount of the mortgage interest.

- [ ] **Carryover credits — Don't lose them.**

  Most of California's credits can be carried over for many years or indefinitely. Make sure that any carryover credits were not accidentally lost from one year to the next.

- [ ] **Federal credits — Larger deductions and basis.**

  If the taxpayer claimed federal business credits, there is often a basis or expense deduction lost on the federal return. Be sure that the basis is increased or the deduction increased for California purposes.

- [ ] **Credit for taxes paid to another state — Calculate it properly.**

  If the taxpayer has income taxed by both California and another state, be sure there is a credit on the California or the other state return. Make sure it is on the correct state return.

- [ ] **Interest income: Nonresident — May not be California-source.**

  A nonresident is not taxed on interest income from California sources unless the income has a situs in California. Generally, interest on the note collateralizing the sale of property or business assets in California is not taxable unless the note is used as collateral on another California business or property.

- [ ] **Renter's Credit — Don't forget it.**

  Single renters with California AGI of $39,062 or less may qualify for a $60 credit. The Renter's Credit is $120 for MFJ and head of household renters with California AGI of $78,125 or less.

- [ ] **Excess SDI — More than one employer.**

  If a taxpayer had two or more jobs during the taxable year, make sure the return gives credit for any excess SDI. Include VPDI in this calculation.

- ❑ **Mental health surtax — File MFS when taxable income exceeds $1 million.**

  The surtax applies to taxable income in excess of $1 million, regardless of filing status. So, married taxpayers benefit from filing separate, saving up to $10,000 in tax. **Caution:** If you file separate for California, you must generally also file separate for federal.

- ❑ **Credits on S corporation return.**

  When an S corporation is entitled to a tax credit, the S corporation is allowed one-third of the credit and the shareholders are entitled to 100% of the same credit. Be sure the credit was computed for both the entity and the shareholders.

- ❑ **State tax paid on group return.**

  When a member/partner/shareholder is a nonresident included on the entity's group return, include tax paid as state tax deduction on federal Schedule A. Verify that California's Schedule S was included to claim the credit for tax paid to the other state.

- ❑ **State tax withheld.**

  Check 1099s, partnership, LLC, or S corporation K-1s (or Form 592, Resident and Nonresident Withholding Statement, attachment or separate letter) for state tax withheld. Also, check for withholding on real property reported on the closing statement or Form 593, Withholding on the Sale of California Real Estate

**Website**
To download a copy of this checklist, go to:
www.caltax.com/spidellweb/public/editorial/refundgrabber.pdf

 

# CHECKLIST FOR A TROUBLE-FREE TAX RETURN

For trouble-free processing of your client's California scannable or e-filed return, we suggest you incorporate the following items into your normal processing procedures.

| e-file | Scannable | |
|---|---|---|
| ❑ | ❑ | Is the client's name, address, and Social Security number correct? |
| ❑ | ❑ | If the client had an estimated tax or balance due payment of more than $20,000, or a tax liability of more than $80,000 for the first time in the 2016 taxable year, did you advise the client of the mandatory EFT payment requirement? |
| ❑ | ❑ | Ask the client if he or she would like to pay electronically or schedule quarterly payments electronically. |
| ❑ | ❑ | If using a different filing status from federal, is the box checked? (**Note:** Different filing statuses may be used only in very limited circumstances) |
| ❑ | ❑ | If claiming the Child and Dependent Care Expenses Credit on Form FTB 3506, did you enter the child's year of birth and the child care provider's address, telephone number, and Social Security number? |
| ❑ | ❑ | If the client is using the head of household filing status, have you verified that the client qualifies for 2016, and that the Form 3532, Head of Household Filing Status Schedule is completed? |
| ❑ | ❑ | Is the Direct Deposit of Refund bank account information correct? The routing number must have nine digits (starting with 01-12 or 21-32), and verify the account number. (See FTB Publication 1095D) |
| ❑ | ❑ | Did you verify estimated payments claimed? (You can do this using MyFTB.) |
| ❑ | ❑ | Is your client entitled to a refund of excess SDI? Did the taxpayer (or spouse) work for more than one California employer and have more than $106,742 in income? |
| ❑ | ❑ | If claiming a credit for withholding on real property, did the escrow company use the taxpayer's correct Social Security number? |
| ❑ | ❑ | Have you included withholding from K-1s, real estate withholding, back-up withholding and nonresident withholding? |
| ❑ | ❑ | Is the third-party designee box checked? Checking this box allows a preparer to discuss with the FTB information needed to process the return, inquire about the status of a refund or payments made, and respond to FTB notices about math errors, offsets and return preparation. |
| | ❑ | Is the client's address properly designated as a new address or the same address? |
| | | *(continued)* |

| Checklist for a Trouble-Free Tax Return (continued) | | |
|---|---|---|
| **e-file** | **Scannable** | |
| ❑ | ❑ | If the client has a private mailbox, enter PMB next to the box number (e.g., 1200 Hollow Way, PMB 123). |
| | ❑ | Mailing envelopes to the FTB should be white and use sans serif fonts, and contain the correct address including ZIP + 4 extension. |
| | ❑ | Is the federal return attached? Do not attach a federal return unless the client is filing Form 540 with any federal schedules other than Schedule A or Schedule B, Long or Short Form 540NR, or a return for an RDP couple. **Note:** For e-file, your software should transmit the federal return, when it is required, with the state return. |
| | ❑ | Do not staple anything to the scannable forms, including the check or W-2s, and do not staple page 1 to the rest of the return. |
| | ❑ | Is Schedule W-2, Wage and Withholding Summary, attached directly behind Side 5 of the return? If your software does not populate Schedule W-2, include the "state" copy of federal Form(s) W-2, W-2G, and any Form(s) 592-B, 593, and federal Form(s) 1099 showing California tax withheld to it. |
| | ❑ | Did you sign the return as preparer and enter your PTIN? Remember, you and your clients only need to sign the California return itself. You do not need to sign copies of any attached federal returns or other forms or schedules requesting signatures. |
| | ❑ | If a Form FTB 5805 is required, did you check the box indicating it is attached, and is it attached to the back of the return? |
| ❑ | ❑ | Is the mailing envelope addressed to the correct FTB address? |
| | ❑ | Did you give your client the option to include use tax paid on the return (unless the client is a qualified purchaser)? |
| ❑ | ❑ | If filing a joint RDP return, is the California RDP Adjustments Worksheet attached or are copies of the federal single returns attached? |
| ❑ | ❑ | For taxpayers who filed Form 8938, is a copy of the form attached to the California return? |
| ❑ | ❑ | For any credits, be certain to include the appropriate form(s). For example, when filing a return that claims the Other State Tax Credit, be certain to include a Schedule S for each state. |

**Website**
To download a copy of this checklist, go to:
www.caltax.com/spidellweb/public/editorial/troublefree.pdf

# CHECKLIST TO PREPARE YOUR OFFICE FOR TAX SEASON

In addition to worrying about our clients, look at things you can do prior to the end of 2016 to prepare for the upcoming tax season.

1. Check your tax software:
   a. Install;
   b. Check proforma'd clients if converting from another software company. Be sure to verify that California carryover amounts are correct. Often the federal amounts are carried over but not the California amounts, or the federal numbers are repeated for California purposes;
   c. Test.
2. Complete CPE:
   a. For CPAs and attorneys, if your license renewal will happen during tax season;
   b. For Enrolled Agents, hours, including ethics, must be completed prior to December 31.
3. Renew your PTIN. Monitor you PTIN on the IRS's website throughout tax season to check for possible fraudulent use.
4. Perform MyFTB maintenance:
   a. You will need a new password for your MyFTB account 13 months from completing the process last year;
   b. Set up clients you may want to access (to check estimated tax payments or for other reasons) into your MyFTB account now so you won't be delayed during filing season while the FTB sends the 10-business-day notification;
   c. Refresh tax preparer clients in your account prior to the 13-month period so you don't need to start over or wait for another 10-business-day hold during the filing season.
5. Obtain powers of attorney from clients in preparation for the upcoming filing season. Some practitioners get POAs on all clients, some get them only on clients who make estimated tax payments, and some don't obtain POAs unless needed for a specific purpose.
6. Alert payroll clients that due dates to send W-2s to the Social Security Administration and 1099s to the IRS is January 31, 2017 — not February 28, 2017.
7. Write your client letters, and prepare to send organizers, appointment cards/e-mails, etc.
8. Alert any clients who exchanged California property for out-of-state property of their requirement to file California's Form 3840. In the event the client goes to a different preparer who is unaware of the requirement, the penalty is onerous, and it is good customer service to remind the client.
9. Get copies of escrow statements for sales of property, and check to see if the real estate withholding has been credited to the taxpayer's account.
10. Verify software security. Preparers' client data was stolen last year.
11. Train office staff. Hire them if you haven't already.
12. Order supplies, and verify that supplies are at least enough to last through tax season.

**Website**
To download a copy of this checklist, go to:
www.caltax.com/spidellweb/public/editorial/taxseason.pdf

# NONRESIDENT WITHHOLDING PROCESS

| Nonresident Withholding Process | | |
|---|---|---|
| **Phase** | **Forms to use** | **Phase Tasks** |
| Before withholding agent makes payment to nonresident payee | FTB Form 590, Withholding Exemption Certificate | Payee who is a California resident or a business with resident status can use Form 590 to certify exemption from nonresident withholding. No withholding required with a valid withholding exemption certificate.<br>Withholding agent keeps a copy of Form 590 in records. |
| | FTB Form 588, Nonresident Withholding Waiver Request | Nonresident payee who qualifies can use Form 588 to get a waiver from withholding based generally on California tax filing history. Form 588 must be submitted at least 21 business days before payment is made.<br>Withholding agent keeps a copy of the waiver certificate in records. No withholding required with a waiver certificate. |
| | FTB Form 589, Nonresident Reduced Withholding Request | Nonresident payee can use Form 589 to itemize expenses against the California source income. Form 589 must be submitted at least 21 business days before payment is made. FTB provides withholding agent a letter stating the reduced withholding amount. |
| At the time withholding agent makes payment to nonresident payee | (There are no FTB forms to use, but withholding agents will develop their own internal processes for withholding.) | Withholding agent withholds 7% of all California source payments to a nonresident payee that exceed $1,500 in a calendar year, unless payee qualifies for reduced or waived withholding. |
| After withholding agent makes payment to nonresident payee | FTB Form 592, Resident and Nonresident Withholding Statement | After making a payment to a nonresident payee, withholding agent sends FTB a timely Form 592, either electronically or by mail. The 592 contains a list of all payees withheld upon during the filing period. FTB posts the withholding to the payees' accounts. |
| | FTB Form 592-V, Payment Voucher for Resident and Nonresident Withholding | Withholding agent remits Form 592-V with payment when submitting a completed Form 592 to FTB. |
| | FTB Form 592-B, Resident and Nonresident Withholding Tax Statement | By January 31 following the end of the calendar year, withholding agent sends each payee a completed 592-B and keeps a copy for records.<br>A payee claims the withholding by attaching a copy of the 592-B when filing the required California tax return. The 592-B is proof of California source income and withholding credit. |

**Website**
To download a copy of this chart, go to:
www.caltax.com/spidellweb/public/editorial/NRwithholding.pdf

 

# CALIFORNIA TAXATION OF NONRESIDENT INCOME

**California Taxation of Nonresident Income**

| Type of Income | Taxability |
|---|---|
| Income from business activities conducted solely in California | Taxable |
| Income from business activities outside California by a California business | Apportionable[1] |
| Income from business activities conducted both inside and outside of California | Apportionable[1] |
| Real property located in California | Taxable |
| Real property located outside California | Not taxable |
| Income from tangible personal property located in California | Taxable |
| Income from tangible personal property located outside California | Not taxable |
| Gain on the sale of real property or tangible personal property located in California | Taxable |
| Interest and dividends | Not taxable[2] |
| Payment for services performed in California* | Taxable |
| Payment for services performed outside California for a California business, trade, or profession* | Not taxable |
| Pensions accrued during California residency from services performed in California | Not Taxable |
| Income from a stock option exercised after taxpayer becomes a nonresident but where services between grant date and exercise date were performed while taxpayer was a resident | Taxable[3] |
| Income from California S corporation | Taxable |
| Gain on sale of partnership interest or closely held stock in a California corporation | Not taxable[4] |
| Income from royalties and for the privilege of using patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, etc., that have a business situs in California | Taxable |

[1] If the income is an integral part of a unitary business, it would be taxable, and you would need to use the unitary formula to determine the portion allocable to California (R&TC §17951-4(c))

[2] Interest and dividend income would not be taxable unless it had a business or taxable situs in California (R&TC §17952) or unless the intangible income is from an installment sale that occurred while the taxpayer was a resident

[3] 18 Cal. Code Regs. §17952

[4] ***Appeal of Amyas Ames, et al.*** (June 17, 1987) 87-SBE-042

* This is true if services performed were reported on a Form W-2. If however, services were in connection with a trade or business, they must be apportioned to California using market-based sourcing rules

**Website**

To download a copy of this chart, go to:
www.caltax.com/spidellweb/public/editorial/CAtaxofNR.pdf

# WALKING AWAY FROM A CORPORATION/LLC QUALIFIER

Use this checklist to see if the FTB can hold the shareholder or LLC member liable for unpaid income and franchise taxes.

## PART I

1. Compensation taken from corporation/LLC:
   - A. Cash .................................................. $________
   - B. Fair market value of tangible personal property .................. ________
   - C. Fair market value of real estate .................. ________
   - D. Fair market value of inventory .................. ________
   - E. Fair market value of accounts/notes payable .................. ________
   - F. Face value of loans to shareholder/member .................. ________
   - G. Fair market value of goodwill .................. ________
   - H. Fair market value of other intangibles .................. ________
   - I. Other compensation taken .................. ________
   - J. Total compensation received by shareholder/member (Add lines A – I) $________
2. Consideration given by shareholder/member:
   - A. Wages or other compensation paid .................. $________
   - B. Loans from shareholder/member to corporation/LLC .................. ________
   - C. Liabilities assumed by shareholder/member .................. ________
   - D. Corporate/LLC expenses paid by shareholder/member .................. ________
   - E. Other consideration .................. ________
   - F. Capital stock at shareholder's cost (corporation) .................. ________
   - G. Member contributions (LLC) .................. ________
   - H. Total consideration given by shareholder/member (Add lines A – G) $________

## PART II

If the answers to ALL of the following questions are YES, the FTB may hold the shareholder/member liable for income or franchise taxes:

| | | Yes | No |
|---|---|---|---|
| 1. | Is the total on Part I, line 1J greater than the amount in Part I, line 2G?.................. | ☐ | ☐ |
| 2. | At the time of the transfer and at the time the shareholder/member liability was asserted, was the corporation/LLC liable for the tax?.................. | ☐ | ☐ |
| 3. | Was the transfer made after liability for the tax was accrued, whether or not the tax was actually assessed at the time of the transfer? .................. | ☐ | ☐ |
| 4. | Was the corporation/LLC insolvent at the time of the transfer or did the transfer leave the corporation/LLC insolvent?.................. | ☐ | ☐ |
| 5. | Had the FTB exhausted all reasonable remedies against the corporation/LLC?..... | ☐ | ☐ |

**Website**

To download a copy of this worksheet, go to:
www.caltax.com/spidellweb/public/editorial/WalkingAwayQualifier.pdf

 

# LETTER FOR CLIENTS CONSIDERING LLCs

Dear [CLIENT NAME]:

RE: You may want to think twice before forming an LLC

Many people feel they need to form an LLC to protect themselves and their assets. But often, these concerns can be more easily addressed with insurance. You should be aware that the liability protection provided by an LLC is limited, and there are annual taxes and fees that must be considered. Also note that the FTB's has been aggressively pursuing nonresident LLC members, which may deter out-of-state investors.

## Limited liability protection

Generally, members of an LLC are not personally liable for the debts of the LLC. A member's acts may bind the LLC, but they generally do not subject individual members to personal liability. However, like the corporate shareholder, the LLC member is personally responsible for his or her tortuous or malpractice acts.

An LLC member's non-LLC assets may be attached if:

- The member caused the event;
- The member was negligent in hiring the person who caused the problem (e.g., the member knew that the employee prepared fictitious Schedules C); or
- The member was responsible for supervising the activity (e.g., a project manager overseeing a job).

## What about insurance?

For LLCs that hold property, all lenders will require the owner of the property to carry insurance on the property. Depending on your needs, you may be able to purchase an additional $1 million of insurance for in the neighborhood of $250. Cost of insurance is based on a number of factors, including who the carrier is and what other coverage the carrier provides.

In short, here's the choice: Pay the $800 LLC annual tax plus the cost to prepare the return, or pay $250 for $1 million of additional coverage.

## The annual tax and fee

Be aware that, at a minimum, the LLC is liable for an $800 annual tax, and that obligation is indefinite until the LLC formally dissolves. LLCs that have gross receipts attributable to California of $250,000 or more must also pay an LLC fee.

While LLCs are an excellent structure for many businesses, they aren't the right choice for everyone. If you are considering forming an LLC, contact me so we can address the issues above and help you decide if an LLC is a good fit for you.

Yours truly,

Your tax professional

**Website**
To download a copy of this client letter, go to:
www.caltax.com/spidellweb/public/editorial/ConsideringLLCsLetter.doc

## AUDIT-PROOFING DISASTER/CASUALTY LOSSES

| | |
|---|---|
| ❑ | Include the loss on the original tax return. When filing the tax return for the year of the loss, try to include the loss, or an estimate, on the originally filed return. Filing an amended tax return with a large refund due to the loss could result in an audit. If the taxpayer cannot determine the exact amount of the loss in time to include it in the tax return, file the return with an estimate of the amount of the loss, insurance proceeds, and deductible loss. When all the insurance proceeds are received and the replacement property is acquired, file an amended return to account for the exact gain or loss on the casualty/disaster. |
| ❑ | If the taxpayer will have a gain from the casualty/disaster, do not file an extension without paying at least as much, if not more, of the expected tax liability. California has an automatic extension of time to file tax returns. If the taxpayer takes advantage of the automatic extension, he or she will have late-payment penalties and interest due when the return is filed. If the return is filed and the gain is reported on the extended tax return, the taxpayer will be assessed interest and late-payment penalties. If the taxpayer files the return and underestimates the amount of tax due on the gain for the extension and later files an amended return paying the full amount of tax on the recognized gain, there will be interest due, but no late-payment penalties. |
| ❑ | Have the property appraised immediately after the event. If local appraisers are busy, use a real estate broker to do a curbside appraisal for your estimate. Later, have a licensed appraiser prepare an appraisal. If this amount differs from the broker's values, amend the tax return to adjust the difference. Because the loss is based on the decline in FMV, the taxpayer must have an appraisal done to show the FMV immediately before and immediately after the disaster. An appraisal done at the time of the audit (years after the event) will hurt your taxpayer's case during the audit. |
| ❑ | The taxpayer does not need to reduce the cost of real property by the land value when the property was the taxpayer's principal residence. (Treas. Regs. §1.165-2(b)(2)(ii)) |
| ❑ | Have the taxpayer take photographs or videos of the damage. Keep a copy in their file of tax records. |
| ❑ | Gather photos taken prior to the casualty to establish the pre-disaster condition of the property. |
| ❑ | Get testimony of neighbors as to the condition of the property prior to and immediately after the disaster. |
| ❑ | Keep copies of newspaper clippings showing the extent of the disaster. |
| ❑ | Make a complete, written inventory of items damaged or destroyed. Include, if available, brand names, year of purchase, any available receipts of purchase, and estimated values from thrift shops, second-hand stores, or catalogs. |
| ❑ | File an insurance claim. Taxpayers should still file a claim with their homeowner's insurance company even if they do not have the appropriate insurance (e.g., earthquake insurance). Keep the denial of the claim with the tax files. This document will be required during the audit. |
| ❑ | If the taxpayer has received an SBA loan, include the following information on SBA's policy. According to the SBA Standard Operating Procedures, loan proceeds must be used to "repair," "replace," and "repaint," not for improvement of the home. Although not conclusive, a copy of the SBA report can be helpful in determining the loss. |

**Website**
To download a copy of this checklist, go to:
www.caltax.com/spidellweb/public/editorial/disastercasualty.pdf

 

# ITEMS YOUR CLIENT SHOULD BRING TO A TAX INTERVIEW

1. 1099-Ks for merchant charges. Reconcile amounts on 1099s to amounts reported by the client for Schedules C or E (or business entity return).
2. 1099-Bs for sales of stock or securities. Reconcile amounts on 1099s to amounts shown on client reports, if any.
3. Property tax statements: Look at property tax bills and estimate of value of real property in California to verify that the county has properly computed tax based on reduced property values.
4. Property tax statements: Look for items that are not deductible as property taxes, such as HERO or PACE payments.
5. Review government documents (W-2s, 1099s) for federal/California differences.
6. Paycheck stubs to review 2016 withholding and to provide to the FTB if withholding amount is reduced.
7. Statements and instructions from mutual fund companies breaking down U.S. government and state tax-exempt income information.
8. All tax information broken out separately for both members of a registered domestic partnership.
9. Notices, bills, etc., from the IRS or California.
10. New clients should bring the past four years' returns.
11. For the Child and Dependent Care Expenses Credit:
    - Nontaxable funds received, including child support and public assistance;
    - Percentage of time the qualifying dependent lives in the California home of the taxpayer;
    - Address, telephone number, and Social Security number or Employer Identification Number of the care providers;
    - Expenses paid to California providers; and
    - Nonresident military spouse's military income.
12. California K-1 and accompanying correspondence (check for California differences and possible state tax paid by S corporation, partnership, trust, or LLC).
13. Withholding paid through escrow on sales of property reported on FTB Form 593-B and closing statements. Keep a copy of the escrow closing statement and Form 593-B.
14. Withholding for residents and nonresidents reported on FTB Form 592-B.
15. Invoices from purchases made over the Internet, by mail, or by phone order where no California sales or use tax was paid (or, if the use tax table amount is used, only individual purchases of more than $1,000.
16. Any activity pertaining to a Health Savings Account, including contributions to, earnings or losses from, distributions from, and rollovers to that account.
17. Rollover or distribution amounts from Medical Savings Accounts, FSAs, HRAs, and Roth IRA conversions.
18. Did the taxpayer form a business entity this year, does the taxpayer own an inactive business, or does he or she plan to terminate a business this year?
19. Payroll records for 2015 if number of employees increased in 2016 (for businesses operating in designated geographic areas (DGAs)).
20. Change of ownership of business entity.
21. Title change information for property that changed hands due to gift or death of an owner.
22. For employers with no more than 25 full-time equivalent employees, review for possible federal Health Insurance Credit. If credit is taken, there will be a federal/California difference in the expense amount for employee health insurance.
23. For Schedule C and other business returns, alert the taxpayer of the requirement for a city business license.
24. Identity Protection PIN (IP PIN): If you received a CP101A Notice from the IRS in December, your IP PIN is located in the left column. Please provide a copy of this letter.
25. For all documents, please provide a scan, photocopy, or fax. Do not send photos taken with a cell phone.

**Website**

To download a copy of this checklist, go to:
www.caltax.com/spidellweb/public/editorial/taxinterview.pdf

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# Index

# Index

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SPIDELL

Tax • Analysis • Education

# Index of Addresses

# Index of Addresses, Telephone Numbers, Fax Numbers, Websites, and E-mail Addresses

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| Request a waiver for the EDD's e-pay mandate | EDD | 10-5 | 💻 |
| Get information on EDD's e-pay mandate | EDD | 11-2 | 💻 |
| Confirm the contact information on a bill or notice received from the FTB | FTB | 5-7, 11-18 | 💻 |
| Contact the FTB's e-Programs Customer Service to verify enrollment in e-file | FTB | 5-22 | ☎ |
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| Access the BSA E-Filing System for filing FBARs | Other | 2-2 | |
| Get information about scams targeting taxpayers | Other | 5-5 | |
| Report identity theft to the FTC | Other | 5-6 | |
| See which forms of federal identification are compliant | Other | 5-16 | |
| Get information on financial elder abuse and other senior issues | Other | 5-25 | |
| Collect Social Security benefits based on an ex-spouse's earnings | Other | 6-36 | |
| Apply for College Access Tax Credit allocation reservation | Other | 9-5, 12-12 | |
| View the full text of enacted legislation | Other | 10-4 | |

| Purpose | Agency | Page | Contact via |
|---|---|---|---|
| Get information on the California Secure Choice Retirement Savings Program | Other | 10-7 | |
| Mail LLC Statements of Information to the SOS | Other | 14-16 | |
| Get more information on Airbnb rentals | Other | 14-17 | |
| Get information for dealing with clients in the marijuana industry | Other | 14-21 | |
| Download a client letter on myRA accounts | Spidell | 6-21 | |
| Download a client letter on UBI | Spidell | 10-9 | |
| Download a client disengagement letter | Spidell | 5-28 | |
| Download a conflict of interest client letter | Spidell | 5-29 | |
| Download a client letter on consent to sharing 1041 information | Spidell | 5-31 | |
| Download a client letter on transferring the client to the new business owner | Spidell | 5-32 | |
| See a list of states and their click-through nexus statutes | Spidell | 14-12, 14-14 | |

**Address** **Telephone** **Fax** **Website** **E-mail**