Solutions for Federal Tax Research 11th Edition by Sawyers

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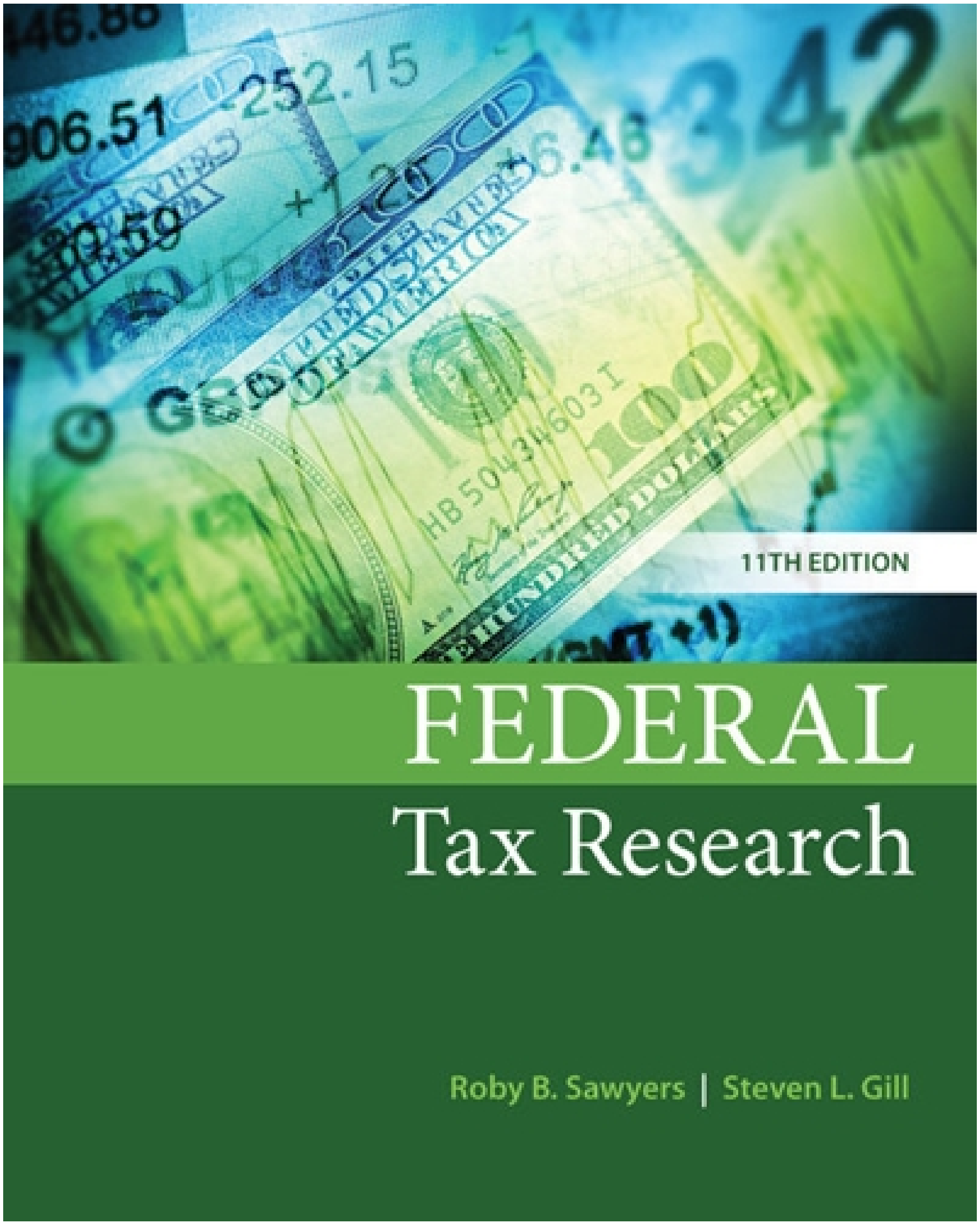

Solutions

Chapter 2-Tax Research Methodology

TAX RESEARCH PROCESS

1. **Establish** the Facts
   - **a.** Get all the relevant facts.
   - **b.** Facts that appear irrelevant initially may prove to be relevant later on.
2. **Identify** the Issues
   - **a.** Fact issues are concerned with information having an objective reality.
   - **b.** Law issues arise when it is not clear which portion of the law applies to the factual issues.
   - **c.** Seemingly simple situations often generate many tax research issues.
   - **d.** New issues may result from attempts to solve the original problem.
3. **Locate** Authority
   - **a.** Primary authority comes from statutory, administrative, and judicial sources. The Internal Revenue Code is the basis for tax law; administrative and judicial authorities interpret and explain applications of the Code.
   - **b.** Secondary authority consists of unofficial sources of tax information, such as journals, treatises, and newsletters.
     - Annotated services
     - Topical services
     - Court reporters
4. **Evaluate** Authority
   - **a.** Different authorities may suggest different treatments.
   - **b.** Different authorities have different precedential values.
5. **Develop** Conclusions and Recommendations
   - **a.** No single best answer may be available; alternatives must be considered.
   - **b.** Recommendations should include alternative courses of actions.
6. **Communicate** the Recommendations
   - **a.** Memorandum to the file.
   - **b.** Letter to the client.

CONDUCTING TAX RESEARCH USING ONLINE SERVICES

1. In order to efficiently do tax research in today's environment , tax professionals must use online tax research databases.

2. Most tax research today use a subscription tax service. See Exhibit 2-4. Limited tax research can be done on free non-subscription internet sites. See Exhibit 2-2

3. Online tax services allow tax professionals to search large amounts of data very quickly by using a search query.

4. Another benefit of online tax services is that they are current, many of them being updated in real time.

USING AN ONLINE TAX SERVICE TO CONDUCT TAX RESEARCH

Step 1 - State the Issue as a Question

Step 2 - Identify the Keywords

Step 3 - Construct a Computer Research Query

Step 4 - Select a Database and Execute the Search

Step 5 - Interpret and Refine the Search

TAX RESEARCH PRACTICAL CONSIDERATIONS

When a tax researcher undertakes an engagement, there are several practical factors to consider. These factors can influence the research project on several levels.

a. Engagement Time Cost

b. Potential Tax Liability Involved

c. Accuracy Threshold

d. Ethics

RESEARCH AND TAX ON THE CPA EXAM

The CPA exam is prepared by the American Institute of CPAs.

a. Recent changes include an increased emphasis on critical thinking and analysis

b. The Regulation (REG) section of the exam includes significant coverage of federal taxation issues including ethics and professional and legal responsibilities requiring candidates to be familiar with Circular 230, the AICPA Statements on Standards for Tax Services and relevant IRC sections and related regulations. Topics covered also include filing and payment due dates, the IRS audit and appeals process, statute of limitations and the judicial process. In this section, candidates are also expected to conduct research of tax issues, formulate conclusions and prepare documentation to support those conclusions.

SUMMARY

Tax research is a complex process. However, it can be structured to make the process logical and efficient to produce satisfactory results at a reasonable cost.

CHAPTER 2
TAX RESEARCH METHODOLOGY

DISCUSSION QUESTIONS

2-1. The primary purpose of tax research is to aid in finding solutions to tax problems.

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2-2. The basic steps in conducting tax research include the following:

Establish the Facts. This step involves the gathering of facts, including tax and nontax considerations.

Identify the Issues. The tax researcher must identify both issues of fact and issues of law. In so doing, the researcher must rely on a combination of education, training, and experience.

Locate the Appropriate Authority. The researcher must locate authority relevant to the client's situation. Authority may include both primary and secondary authority.

Evaluate the Authority. This step in the tax research process requires the researcher to analyze the authority, including the current status of the authority and the precedential value of the authority.

Develop Conclusions and Recommendations. The researcher must arrive at his or her conclusions based on the first four steps of the tax research process.

Communicate the Recommendations. The final step in the research process is to communicate to the client the facts, assumptions, issues, sources of authority, and conclusions and recommendations.

Pages 47-56

2-3. First, the researcher must understand the mechanical techniques that are used to identify and locate the tax authorities that relate to solving a problem. Second, the researcher must be creative and explore all of the relevant relationships among the facts and the problems at hand.

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2-4. Significant tax facts that a tax practitioner might want to obtain could include any of the following:

The client’s tax entity(ies).
The client's family status and stability.
The client's past, present, and projected marginal tax rates.
The client's legal domicile and citizenship.
The client's motivation for the transaction.
Relationships among the client and other parties involved in the transaction.
Whether special tax rules apply.
Whether the transaction is proposed or completed.

Pages 47-48

2-5. The researcher should be aware of the following pitfalls:

1. The researcher may attempt to research a problem before fully understanding the facts and circumstances relevant to the client's situation.

2. Often the researcher may have a tendency to ignore new questions that arise as the research task progresses.

3. The client may fail to provide all of the information that is vital to an accurate solution.

4. The tax researcher may approach a tax problem without considering other constraints on the solution to the problem, such as economic factors or personal preferences of the client.

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2-6. a. T (lower tax liability).

b. NT (economic constraints).

c. NT (personal preference).

d. NT (personal preference).

e. NT (personal preference).

2-7. a. NT (personal preference). Might also be classified as T, since the taxpayer's motivation for a potential transaction is known.

b. NT (personal preference)

c. NT (family preference)

d. T (lower tax liability)

e. T (lower tax liability)

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2-8. Research issues can be divided into two major categories, namely, fact issues and law issues. Fact issues are concerned with problems such as the dates of the transactions, the amounts involved in an exchange, reasonableness, intent, and purpose. Law issues arise when the facts are well established, but it is not clear which portion of the tax law applies.

Page 48

2-9. The legal concept of *collateral estoppel* bars relitigation on the same facts or the same issues. Therefore, the tax practitioner must be certain that his or her case is researched fully and no issues have been overlooked. If an issue is not addressed in the original case, it may be lost forever.

Page 49

2-10. Tax research may be spread over a lengthy period of time. The researcher must be aware of changes that occur during this period which might affect the outcome of the research. Applicable law or facts might be subject to changes which will cause the researcher to arrive at different conclusions and recommendations, even concerning completed research activities.

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2-11. All tax authority does not carry the same precedential value. The tax researcher must consider the source of the authority, including whether the source of authority is a primary or secondary source, and the force of the authority. Primary authority comes from statutory, administrative, and judicial sources. In fact, statutory authority is the basis for all tax provisions.

Secondary authority consists of unofficial sources of tax information, such as tax journal articles, textbooks, and newsletters. The researcher should be cautious in relying upon secondary authority which does not have precedential value, but which may be of assistance in clarifying or explaining the primary authority. In addition, the researcher must take into account new issues that have developed since the date of the authority.

Pages 51-52

2-12. Statutory sources include the Constitution, tax treaties, and tax laws that have been passed by Congress. Administrative authority includes the various rulings of the Treasury Department and the IRS. Judicial authority consists of the collected rulings of the various courts on Federal tax matters.

Pages 52-53

2-13.
a. P
b. P
c. S
d. P
e. P

Pages 51-52

2-14.
a. P
b. P
c. P
d. S
e. S

Pages 51-52

2-15.
a. S
b. S
c. P
d. P
e. S

Pages 51-52

2-16. A citator is a reference source that enables the researcher to follow the judicial history of court cases.

Page 54

2-17. A tax service is a coordinated set of reference materials that organizes the tax authority into a useable format, making the Internal Revenue Code more accessible.

Page 58

2-18. a. *TAXES* - General tax practitioners

b. *Journal of Taxation* - Sophisticated tax practitioners

c. *Practical Tax Strategies* – General tax practitioners

d. *The Tax Adviser* - Members of the AICPA and other tax practitioners

e. *The ATA Journal of Legal Tax Research – Tax academics and practitioners.*

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2-19. All tax authority does not carry the same precedential value. In the process of evaluating the tax authority for the issue under consideration, it is possible that new issues, not previously considered, may become known. In this case, the researcher may be required to gather additional facts, find more pertinent authority, and evaluate the new issues.

Pages 51-52

2-20. If a clear solution to a tax research problem has not been obtained, the practitioner must use professional judgment as to the proper conveyance of the research results to the client. In addition, the client might be informed of the alternative possible outcomes of the disputed transaction and give the best acceptable recommendation.

Page 55

2-21. Include the following items in both the memorandum to the client file and the client letter:

1. A restatement of the pertinent facts from the researcher's perspective.

2. A summary of any assumptions that the researcher made in the course of his or her research.

3. A summary of the issues addressed in the research process.

4. The applicable authority used to arrive at the researcher's conclusions and recommendations.

5. The researcher's conclusions and recommendations.

Generally, the memorandum to the client file will contain significantly more details than the letter to the client.

Pages 56-57

2-22. Yes. In many research situations, a fact generates an issue that in turn may lead to an answer or the need for more facts. Similarly, once an answer is found to an issue, it may also cause a new issue to appear or the need to gather more information. The same situation occurs in evaluating authority. Frequently, there will be ambiguity between items of authority that will require the researcher to use his or her critical thinking skills. This may result in new issues becoming known. The researcher would then be required to gather additional facts, find additional pertinent authority, and evaluate the new issues.

Page 50

2-23. Substantial Authority under Reg. §1.6662-4(d)(3)(iii) includes:

a. The Internal Revenue Code and other statutory provisions,

b. Proposed, Temporary, and Final Regulations,

c. Revenue Rulings and Procedures,

d. Tax Treaties and regulations there under,

e. Court Cases,

f. Congressional Committee Reports,

g. The Blue Book,

h. Private Letter Rulings issued after 10/31/76,

i. Technical Advice Memoranda issued after 10/31/76,

j. General Counsel Memoranda issued after 3/31/81, and

k. IRS Information and Press Releases.

It is important to be familiar with the above sources because any position documented based on these authorities will prevent accuracy-related penalties associated with the item or return under review.

Page 52

2-24. Online tax research systems provide a fast, cheap method for tax practitioners to access tax information that he or she could not afford to buy before the use of computers. Today’s online systems allow the distribution of tax research information and entire tax services to multiple tax staff in both small and large CPA firms. They are accessible through the Internet and several public telecommunications networks. The materials that are available with these services are contained in databases that are stored at centralized computer locations. These databases may be accessed from remote locations with the use of a variety of compatible video devices and keyboards. Usually, they can be accessed via compatible handheld devices and computers that the user already owns.

Advantages of such a system over a standard printed service are the ability on the part of the user to index any significant item by using it as a search item in a query, and the ability for the user to tailor his or her query to fit the requirements of a specific tax problem, which can result in the research process being conducted with greater speed and thoroughness; that online services are updated much faster than printed tax services; that they are particularly useful in researching case law, since every word contained in a case is included in the database, which in turn enables the user to save time by directly accessing only those cases that contain the key terms of his or her search, that certain documents may be obtained only from the central computer library, and that it can be used to obtain regularly published documents to which the researcher does not have access.

Pages 58-59

2-25. Any of the following could be examples of web addresses of three free online Internet sites where someone could find information on various aspects of taxation:

- http://taxsites.com
- www.irs.gov
- http://thomas.loc.gov

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2-26. Citations not only document a preparer's research and provide a trail for reviewers to follow but also to support that the preparer has met the substantial authority standard. Citations in a memo immediately signal to a reader the types of documents and level of authority a researcher is relying upon.

Page 56

2-27. a. Thomson Reuters Checkpoint--A Web-based tax research service that contains research material on federal, state, local, and international taxation. Checkpoint contains analytical material such as the Tax Coordinator 2d and the United States Tax Reporter.

b. CCH IntelliConnect--A Web-based tax research service that contains CCH's tax services (Tax Research Consultant and Federal Income Tax Reporter) and other federal, state, local, and international legal and tax information.

c. LexisAdvance Tax--Besides containing all federal and state tax research material, LexisNexis provides access to expert analytical materials from CCH, Tax Analysts, and BNA. In addition, LexisNexis has extensive libraries of newspapers, magazines, journals, and patent records and medical, economic, and accounting databases.

d. Westlaw and WestlawNext contain all federal, state, local, and international legal sources, including court cases, administrative releases, and statutory information. All government documents (e.g., IRS publications, court cases) are also available on this system.

2-28. The disadvantages of using a computerized tax service include the high cost of conducting a search and the broad nature of the database.

The database includes all of the pertinent documents needed to conduct a thorough tax research. However, a computerized tax service does not normally include any type of indices; therefore, the researcher must determine the key words to utilize in his or her search request. If the request is not properly structured, the researcher will not locate the pertinent documents.

Pages 62-63

2-29. Developing an effective search request requires that the researcher:

1. State the Issue in the Form of a Question

2. Identify the Keywords

3. Construct a Computer Research Query

4. Select Database and Execute Search

5. Interpret and Refine the Search

Pages 59-60

2-30. To reduce the number of retrieved documents to a reasonable number, the researcher should modify his or her request, usually by editing the last request transmitted to one that is narrower in scope and utilize more unique key words.

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2-31. The Checkpoint search connectors discussed in the text are:

- and – finds documents with both chosen keywords in them
- or – finds documents with either chosen keywords in them
- /n - finds documents where the first chosen term is within ‘n’ words of the second chosen term
- not – finds documents with the term that precedes the connector, but not the term following the connector

Page 61

2-32 (1) Primary
(2) Primary
(3) Primary
(4) Secondary

Page 61

2-33. “Engagement Time Cost” could impact an engagement by making the research to costly for the client.

Page 62

2-34. The “Potential Tax Liability” in a situation by making the research cost exceeds the tax savings.

Page 63

2-35. The “Accuracy Threshold” could impact how much time is spent on the project. As a general rule, the more accuracy needed by the client, the more research that needs to be done to reach a higher level of client comfort.

Page 63

2-36. “Professional Ethics” could impact a tax engagement by requiring the researcher to achieve an appropriate comfort level for the research conclusion.

Page 63

2-37. The four parts of the Uniform CPA Exam are:

1. Auditing and Attestation (AUD)

2. Business Environment and Concepts (BEC)

3. Financial Accounting and Reporting (FAR)

4. Regulation (REG)

The tax issues covered in the REG section of the Uniform CPA Exam include processes, procedures, accounting, and planning as well as federal taxation of property transactions, individuals, and entities. Ethics and professional and legal responsibilities are key components of the section, requiring that candidates be familiar with Treasury Department Circular 230, the AICPA Statements on Standards for Tax Services, and relevant IRS Code sections and regulations.

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EXERCISES

2-38. All can be found online (however, a researcher may have to pay a subscription fee for access to them). For the second part of the question, the answer will vary by individual school campus library.

2-39. All responses and answers will vary with the availability of tax research services available for student use on your campus. Information regarding how students can gain access to the system for research projects in your classes should be obtained by the instructor. If the tax research service is not available on your campus, the student will state so.

2-40. Form 3903 and its instructions deal with moving expenses. IRS forms and publications can be accessed at: https://www.irs.gov/forms-pubs.

2-41. IRS Publication 3 is the Armed Forces' Tax Guide. IRS forms and publications can be accessed at: https://www.irs.gov/forms-pubs.

2-42. IRS Publication 575 deals with Pension and Annuity Income. IRS forms and publications can be accessed at: https://www.irs.gov/forms-pubs.

2-43. Form 1040-PR can be found at: https://www.irs.gov/forms-pubs.

2-44. Publication 1542 is no longer updated by the IRS. Instead, the IRS updates per diem rates in annual (or more frequent) IRS Notices. At the time of the book's printing, the most recent IRS Notice was Notice 2016-58.

2-45. Answers will vary over time.

2-46. Issues that may be relevant in determining the tax consequences of these transactions include the following:

1. Does the condemnation of the land constitute an involuntary conversion of §1231 property?
2. If gain is realized, how is it computed?
3. If gain is recognized, is it ordinary income or capital gain?
4. Can any of the gain be deferred?
5. How is the award for damages treated?

2-47. Issues that may be relevant in determining the tax consequences of these transactions include the following:

1. Did the accident result from a "willful act" by Joey (i.e., his not setting the brake)?
2. Does the accident qualify for the casualty loss deduction for Joey?
3. How are the damages to the car and other property measured?
4. Are any payments for Nick's injuries deductible by Joey?
5. Is the damage to Nick's house deductible by Joey?

2-48. Issues that may be relevant in determining the tax consequences of these transactions include the following:

1. Who has the liability for the tax on the $75,000, John, Marsha, or both?
2. Could John and Marsha's other income have any impact on the taxability of the $75,000?
3. Did John receive any benefit from the income and how might that affect any income tax liability?
4. Do John and Marsha live in a community property or common law state and what impact would that have on any tax liability?
5. If John reimburses the bank for the $75,000, is it deductible to him?

2-49. Issues that may be relevant in determining the tax consequences of these transactions include the following:

1. Is the receipt of the restricted stock compensation to Dave?
2. Is there any gain realized on the receipt of the stock? If so, how is the gain computed?
3. If gain is recognized on the receipt of the stock, is it ordinary income or capital gain?
4. Can any of the gain be deferred? If so, how?
5. What is Dave's basis in the restricted stock?
6. If Dave sells the stock after seven years, how will any gain or loss be taxed?

2-50. Issues that may be relevant in determining the tax consequences of these transactions include the following.

1. What are the tax consequences of rents received in advance?
2. Is Ericka a cash or accrual basis taxpayer?
3. If she is a cash basis taxpayer, how is the rent treated?
4. If she is an accrual basis taxpayer, how is the rent treated?
5. How are any expenses (e.g., depreciation and real estate taxes) associated with the rental income treated?

2-51. The query should include several of the following key words:

redemption
call
proceeds
tax-exempt
bonds
municipal

2-52. The query should include several of the following key words:

treaty
Germany
fellowship income
fellowship grant
internship

Examples of queries include the following:

"treaty Germany" /10 & fellowship or internship (CheckPoint)

treaty w/10 Germany and fellowship or internship (Lexis)

2-53. The query should include several of the following key words:

capitalize
fringe benefits
overhead
build
building
slack time
idle time
employee
employee costs
addition
factory

Examples of queries include the following:

capitalize & overhead & fringe /3 benefits (CheckPoint)

capitalize and overhead and fringe w/3 benefits (Lexis)

2-54. The query should include several of the following key words:

retroactive
election
accounting
accounting methods

Examples of queries include the following:

“accounting /20 method” and retroactive* (CheckPoint)

accounting w/20 method and retroactive (Lexis)

2-55. Suitable search queries might be:

constructive /10 dividend (CheckPoint)

constructive w/10 dividend (Lexis)

2-56. a. Issues that may be relevant in determining whether Sam Manuel may deduct the losses from his "activity" include the following:

1. Is the activity considered a hobby or a business activity?

2. Is the fact that Mr. Manuel previously operated the activity on a full-time basis relevant to the question of whether the loss is deductible?

3. Does the taxpayer have the burden of proof in determining whether the activity is operated for income or profit?

4. Does Mr. Manuel have to establish a profit motive for each year that losses are incurred, or once a profit motive is established is this adequate proof for subsequent years?

5. Is the fact that the activity was conducted on a part-time basis by Mr. Manuel, who was a full-time employee of another entity, indicative that the activity must be a hobby and not a business carried on with intent to earn a profit?

6. How much of his time does Mr. Manuel spend on this activity?

7. Does Mr. Manuel invest a significant amount of his money and other resources for the activity?

8. Does Mr. Manuel advertise and otherwise solicit buyers for his products?

9. Can Mr. Manuel substantiate the expenditures that he has incurred?

10. Does Mr. Manuel keep detailed accounting records for the activity separate and apart from his other activities?

11. Is a reasonable expectation of making a profit required in order to determine whether an activity is a trade or business?

b. Examples of key words: hobby, business, activity, losses, employee, profit.

2-57. a. Issues relevant to the tax treatment of the payment received by the partner include the following:

1. Was the $125,000 payment received by Matthew Broadway a distribution in liquidation of his partnership interest?

2. If the payment is a payment in liquidation of Matthew's partnership interest, should the amount be treated as ordinary income or should the amount be treated as received in exchange for his interest in the partnership?

3. Will the entire payment be subject to the same tax treatment, or should $45,000 of the payment, representing the settlement of the fee dispute, be treated differently from the remainder of the payment?

4. Does the partnership use the cash or the accrual basis of accounting for tax purposes?

5. Under the partnership's method of accounting, when would the fee income be included in the partnership’s ordinary income?

6. Was the fee accounted for in the partnership's prior year return or was the fee included in partnership income only upon settlement of the dispute in the year following the year of receipt?

7. Does the fact that the fee was placed in an escrow account until the dispute was settled influence the proper time for including the fee in income?

8. Does the constructive receipt doctrine apply to the partnership?

9. Does the assignment of income doctrine apply in this case to make the fee income taxable to Matthew Broadway, the partner who is withdrawing?

b. Examples of key words: accrual, cash, accounting, partnership, distribution, constructive receipt.

2-58 a. Issues which may be important in determining the allocation of the costs among the lots include:

1. Is the increase in fair market value of improved property indicative of the benefits derived by the property?

2. What was the taxpayer's purpose behind making the improvements?

3. Does the taxpayer intend to sell all six of the lots?

4. Do the street, water, and sewer improvements benefit the three undeveloped lots?

5. What was the fair market value of each lot immediately after the subdivision, but prior to the improvements?

6. Are certain of the lots more desirable because of easier access, etc?

7. Is the relative sales price of each of the three single-family homes relevant for allocating the construction costs?

b. Examples of key words: improvements, subdividing, real estate, realty, costs.

2-59. a. Issues which may be relevant to the tax treatment of the proceeds from the sale of the home include:

1. Can Tom take advantage of the §121 exclusion from the sale of a primary residence?

2. If Tom's gain is taxable, can he take advantage of the installment sale provisions?

3. If the property has previously been used for business (i.e. rental or home office) will there be any depreciation recapture?

4. What is the basis of the old home?

5. How was title of the old home held by Tom and his wife?

6. Does the divorce decree specify anything other than a 50/50 split of the residence between Tom and his wife?

b. Examples of key words: divorce, decree, house, residence, gain, exclusion, occupies, Section 121.

2-60. a. Additional information that would be helpful in this situation, based on relevant factors for determining a profit motive as listed in Regulation §1.183-2, includes the following:

1. Does Vinny plan to continue his medical practice while he works on his winery?

2. If he does plan to continue working at his medical practice, does he plan to continue full-time?

3. How much time and effort are he and/or his family members planning to devote to the winery?

4. If other family members will be helping with the winery, will they be leaving their occupations to have more time to help out?

5. Does he plan to carry on the winery endeavor in a business-like manner, keeping books and records, etc.?

6. Did the taxpayer attempt to acquire knowledge about the winery business or talk to experts in the field?

7. Is the couple’s wealth sufficient to maintain them if future profits don’t materialize?

8. Does Vinny derive little personal or recreational pleasure from this activity?

b. Additional questions posed to the taxpayer.

c. No. What Vinny’s two children now do for a living is irrelevant.

d. Will the winery be considered by the IRS to be a bona-fide business with a profit motive or merely a hobby?

e. Additional research questions might include:

1. Is the taxpayer close to retirement age, and if so, how much will his retirement income be?

2. How much in losses is the business expected to incur in the start-up years?

3. What were the start-up costs?

4. Where did the investment money come from?

5. What is the tax-entity form of the business?

6. What is the taxpayer's past, present, and projected marginal tax rates?

7. Are there special tax rules that apply to the winery business?

2-61. a. Additional information that would be helpful in this situation includes the following:

1. Was there any oversight of the accountant by the home office or by a CPA?

2. What types of internal controls, if any, were in place to prevent the embezzlement?

3. Was there an audit performed by competent outside auditors?

4. What system, if any, did the taxpayer have in place to receive and review payroll tax deposits and remittances?

b. Additional questioning of the taxpayer.

c. Yes.

d. Did the taxpayer exercise "ordinary business care and prudence in providing for the payment of its tax liabilities" by establishing oversight of the manager's actions to the extent that, as a result, relief is mandated by the statute, warranting abatement of the penalties due to "reasonable cause"?

e. Additional research questions might include:

1. Has the taxpayer already submitted an offer in compromise to the IRS?

2. Have there been any arrangements made for the accountant to repay the embezzled funds?

3. If so, has the taxpayer remitted any funds to the IRS and, if so, how much?

4. Does the taxpayer have an unblemished history of making past payroll tax deposits on time?

2-62. a. Additional information that would be helpful in this situation includes the following:

1. Is there a divorce decree that calls for the monthly fixed payments of $12,000?

2. If so, does the divorce decree stipulate what the payments are for?

3. Are there any children involved from the marriage, and if so, is any of the $12,000 considered provision for child support?

4. Is the taxpayer legally required to continue the monthly payments after death of the ex-spouse?

5. Are the monthly payments being made in cash or property?

b. Additional questioning of the taxpayer.

c. The taxpayer's age is not necessarily significant to this issue.

d. Are tax payments on payments to an ex-spouse deductible?

d. Additional research questions might include:

1. What is the ex-spouse's financial situation, and has it changed significantly since the divorce?

2. Has the ex-spouse since remarried?

3. Was there a pre-nuptial agreement?

4. Have the taxpayer's been living in the same household since the divorce?

2-63. a. The primary tax issues involved with this case are as follows.

1. Are lottery winnings considered ordinary income or capital gains?

2. What is the basis of a winning lottery ticket?

3. Is the assignment of rights to the winnings to a third party considered constructive receipt of the winnings to the taxpayer?

4. Is the assignment of rights to a third party considered a capital investment?

b. Examples of key words:

lottery
installments
future
investment
gross income
capital gain
lump-sum
ordinary income

2-64. a. The primary tax issues involved with this case are as follows:

1. Are there any restrictions on starting a business on an Indian Reservation?

2. Can an Indian tribe be a shareholder in an S corporation?

3. Is the Indian tribe a Federally recognized tax-exempt organization?

4. What restrictions are there on tax-exempt organizations in S Corporations?

5. Is an Indian tribe considered an "individual" for Federal income tax purposes?

b. Examples of key words:

Indian tribe
individual
shareholder
S corporation
tax-exempt
tribal government
eligible

Chapter 2

2-1. a. The primary tax issues involved with this case are as follows:

1. Which, if any, of the seminar expenses qualify as deductible?

2. Does the location of the seminar and the partial vacation aspect of the trip disqualify the expenditures as deductible?

3. Is the first class air fare a reasonable expense?

4. How will the total cost of the trip be allocated between the pleasure and the business portions?

5. Have the Greens ever been audited by the IRS regarding attendance at seminars? If so, what were the results? Was an agreement entered into which would disallow the current year's deduction?

6. Does Barney or Edith have either a financial or a family relationship with the persons or entity that sponsored the seminar?

b. Examples of key words:

seminar
investment
business
travel
airfare
Section 274
Deduction
meals
lodging

c. Note to instructor: there are many possible search queries many of which will locate the answer to this case. For example, a proximity query using CheckPoint could be as follows:

seminar /25 investment

This query should return IRS Publications 17, 529, and 550 (among others), all of which state that the investment seminar expenses are not deductible.

2-2. a. 1. Are expenses associated with emotional illnesses considered "medical" expenses?

2. Does Katt need to be a claimed as a dependent in order for Ban to be able

to take a deduction?

3. Was the special school recommended, or "prescribed," by a doctor?

4. Does the school have special programs which relate specifically to Katt's medical problems?

5. What is Ban's projected medical expense floor and what other medical expenses does Katt anticipate?

6. Are there any provisions in the divorce decree which would impact Ban's right to the deduction?

7. What portion of the expense can be considered "educational" as opposed to "medical"?

b. Examples of key words:

school
deduction
medical
§213
psychiatrist
dependent
emotional illness
prescription
special education

c. Note to instructor: there are many possible search queries many of which will locate the answer to this case. For example, a proximity query using CheckPoint could be as follows.

special /25 school /25 medical

This query should return IRS Publications 3, 17, 502, and 554 (among others), all of which state that the special school medical expenses are deductible (subject to the 10% limitation).

2-3. IRC §213 allows a deduction for medical expenses incurred for medical care. Included in this definition are "amounts paid for the cure, treatment, or prevention of disease, or the purpose of affecting any structure or function of the body." Reg. §1.213-1(e)(1)(iii) expands qualifying medical expenses to include any capital expenditures which have, as their primary purpose, the medical care of the taxpayer, his or her spouse, or any dependent. If the capital expenditure results in permanent improvement or betterment of the property and would not ordinarily be for the purpose of medical care, it still may qualify as a medical expense to the extent that the expenditure exceeds the increase in the value of the related property.

a. Consequently, the tax issues involved with the case are as follows:

1. Does a residential swimming pool qualify as a deductible medical expense based on the above definition?

2. Does the tax treatment differ depending on whether the pool is purchased at a new residence or constructed on the taxpayer's existing property?

3. If a residence is purchased that has an existing pool, how is the value of the pool determined for tax purposes?

4. Are pool maintenance expenses deductible and, if so, is any allocation necessary?

5. How is the deduction for the pool taken: as an immediate deduction or depreciated over a specified number of years?

6. Is there a limitation on the deduction based on the elaborateness of the pool?

7. If the home is to be paid for over an extended number of years, would the amount of the deduction be affected?

b. Examples of key words:

swimming
pool
medical
deduction
§213
arthritis
home
capital expenditure
costs
cure
treatment
disease

c. Note to instructor: there are many possible search queries many of which will locate the answer to this case. For example, a proximity query using CheckPoint could be as follows:

swimming /25 medical

This query should return IRS Revenue Rulings 83-33, 70-19, and 54-57 (among others). Revenue Ruling 83-33 states that capital costs for swimming pools constructed primarily for medical expenses are deductible (subject to the 10% limitation).

2-4. a. Possible tax research issues might include:

1. Would payment of the tax by Gwen constitute financial hardship?

2. Was Gwen involved in taking care of the couple's finances?

3. Was Gwen abused by her ex-spouse?

4. Was there a divorce decree that would cause Darrell to be responsible for making the tax payments?

5. Did Gwen derive benefit from the IRA distribution?

b. Examples of key words:

IRA
distribution
medical
tax liability
spouse
divorce
joint return
relief
innocent
deceit

c. Note to instructor: there are many possible search queries many of which will locate the answer to this case. For example, a proximity query using CheckPoint could be as follows:

"spouse tax liability" and divorce and "joint return"

This query should return Code §6015, which explains that it's possible Gwen could be relieved of the tax liability if she files for relief from joint and several liability on her joint return.

2-5. a. Possible tax research issues might include:

1. Is this a qualified casualty loss?
2. If it is a casualty loss, how much is deductible?
3. What if there is no damage to the taxpayer's property?
4. If it is a casualty loss, when is it deductible?

b. Examples of key words:

casualty loss
property
value
damage
itemized deduction

c. Note to instructor: there are many possible search queries many of which will locate the answer to this case. For example, a proximity query using CheckPoint could be as follows:

Casualty /5 loss

This query should return *IRS Pub 17: Part 5 Standard Deduction and Itemized Deductions* (among other items). Trevor does not have a casualty loss since there was no damage to his property. Losses in value do not qualify as a casualty loss deduction.

After Tax Reform – Business Tax Update

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Course Development Resources

- The author gratefully acknowledges RIA Checkpoint for use of certain materials included in this presentation.
- Additional materials are adapted from various authoritative pronouncements of the IRS.
- The opinions expressed within, however, are solely the responsibility of the author.
- Circular 230 Disclaimer: These materials are educational in nature and users of these materials should do their own independent research before advising clients.

Contents

- The tax reform legislation (Tax Cuts and Jobs Act) (hereafter, the Act) is final.
- The "date of enactment" is December 22, 2017.
- *Effective Dates:* unless otherwise mentioned, however, the effective date of the provision under discussion is <u>tax years beginning after 2017</u>.

General Approach

- *If a particular topic is not discussed here (for instance, accounts receivable), the topic has not been changed by the Act.*
- *If a particular topic is discussed here (for instance, depreciation), only the portion of the topic specifically changed by the legislation is covered. Assume that other aspects of the topic remain unchanged.*
- *The legislation also contains "new" topics (for instance, the family and medical leave credit) that were not in prior law.*

Corporate Tax Rates

- **Prior law:** A C or regular corporation's income tax liability generally was determined by applying the following tax rate schedule to its taxable income:

Taxable income:	Tax rate:
$0-$50,000	15 percent
$50,001-$75,000	25 percent
$75,001-$10,000,000	34 percent
Over $10,000,000	35 percent

Corporate Tax Rates

- The 15- and 25-percent rates were phased out for corporations with taxable income between $100,000 and $335,000.
- As a result, a corporation with taxable income between $335,000 and $10,000,000 effectively was subject to a flat tax rate of 34 percent.
- Similarly, the 34-percent rate was gradually phased out for corporations with taxable income between $15,000,000 and $18,333,333, such that a corporation with taxable income of $18,333,333 or more effectively was subject to a flat rate of 35 percent.
  - This tax rate schedule still applies to corporations whose fiscal year began in 2017.

Corporate Tax Rates

- Personal service corporations were not entitled to use the graduated corporate rates below the 35-percent rate.
- A personal service corporation is a corporation the principal activity of which is the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and such services are substantially performed by the employee-owners.

Corporate Tax Rates

- The corporate tax rate is now a flat 21-percent rate beginning in 2018.
- Personal services corporations are also subject to a flat 21-percent corporate tax rate.
- The provision is effective for tax years beginning after 2017.
- Thus, the prior law 15% rate on the first $50,000 of taxable income is <u>increased</u> to 21%. So there is a tax increase of $3,000 (6% X $50,000).

Corporate Tax Rates

- **Impact on Accounting for Income Taxes.** Under ASC 740 (Accounting for Income Taxes) when there is a rate change (either up or down) the deferred tax asset or liability account must be adjusted *as of date of enactment.*
- *Since the date of enactment is 12/22/17, 2017 financial statements are impacted.*
- The tax rate used to compute the deferred tax liability or asset was the *effective tax rate* for the taxpayer, not necessarily the *statutory* tax rate.

Corporate Tax Rates

- The adjustment to the deferred account is a current item, not a prior period adjustment, so it goes through the income statement for the tax year of the enactment.
- If the change to 21% is *less* than the effective tax rate and there is a deferred tax asset, the asset is *reduced*, so there is additional *expense.*
- If the change to 21% is *more* than the effective tax rate and there is a deferred tax asset, the asset is *increased*, so there is additional *income.*

Corporate Tax Rates

- If the change to 21% is *less* than the effective tax rate and there is a deferred tax liability, the liability is *reduced*, so there is additional *income.*
- If the change to 21% is *more* than the effective tax rate and there is a deferred tax liability, the liability is *increased*, so there is additional *expense.*
- *Expect many publicly-traded companies to announce the impact of the rate change – will their stock price be impacted?*

Corporate Tax Rates

- For instance, FedEx Corp. has said it would increase adjusted earnings for the fiscal year ending in May as much as $5.50 a share on the revaluation of deferred tax liabilities and the corporate tax rate cut.
- In addition to revaluations of deferred tax assets, companies will be making announcements related to permanently reinvested earnings, exposure to repatriation tax bills, and expected tax rates.

Corporate Alternative Minimum Tax

- The C corporation AMT (but not the individual AMT) is repealed for tax years beginning after 2017.
- For tax years beginning after 2017 and before 2022, the AMT credit is refundable and can offset regular tax liability in an amount equal to 50% (100% for tax years beginning in 2021) of the excess of the minimum tax credit for the tax year over the amount of the credit allowable for the year against regular tax liability.
- Accordingly, the full amount of the minimum tax credit will be allowed in tax years beginning before 2022.

Dividends Received Deduction

- Under prior law, C corporations that received dividends from other corporations were entitled to a deduction for dividends received.
- If the corporation owned at least 20% of the another corporation, an 80% dividends received deduction was allowed. Otherwise, a 70% deduction was allowed.
- For tax years beginning after Dec. 31, 2017, the 80% dividends received deduction is reduced to 65%, and the 70% dividends received deduction is reduced to 50%.

Executive Compensation

- The $1 million compensation limit on deductible public corporation executive pay is modified.
- Many commentators felt that this limitation contributed to the “rise” of stock options and an over focus on “exotic” compensation plans.

Executive Compensation

- The exceptions to the $1 million deduction limitation for commissions and performance-based compensation are repealed.
- The provision also revises the definition of "covered employee" to include the CEO, the chief financial officer, and the three other highest paid employees, realigning the definition with current SEC disclosure rules.
- The result of this change? – More nondeductible salaries for executives of public companies.

Depreciation – Sec. 179

- **Increased Sec. 179 Immediate Expense Election.** The Sec. 179 deduction was scheduled to be $520,000 for 2018 with the excess purchase limitation starting at $2,070,000.
- The small business expensing limitation is increased to $1 million and the phase-out amount is increased to $2.5 million.

Depreciation – Sec. 179

- These expensing limitations are indexed for inflation after 2018.
- The provision is effective for property acquired and placed in service in tax years beginning after 2017.
- There is still a “business income limitation” for deduction of the Sec. 179 expense.

Depreciation – Sec. 179

- In general, qualifying property is still defined as depreciable tangible personal property that is purchased for use in the active conduct of a business, and
- Includes off-the-shelf computer software and qualified real property.
- Qualified real property prior to 2018 included qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property.

Depreciation – Sec. 179

- The definition of Sec. 179 property is expanded to include certain depreciable tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging.
- Formerly, property used predominantly to furnish lodging or in connection with furnishing of lodging was not eligible for Sec. 179, except for
  - (A) energy property, (B) some expenditures for certified historic structures, (C) property used to lodge transients (e.g. hotels) and (D) nonlodging commercial facilities available to the general public (e.g., shops in apartment buildings).

Depreciation – Sec. 179

- The definition of Sec. 179 property now includes certain depreciable tangible personal property used predominantly to furnish lodging or in connection with the furnishing of lodging .
- **Examples** of this property are beds and other furniture, refrigerators, ranges, and other equipment used in the living quarters of a lodging facility such as an apartment house, dormitory, or any other facility (or part of a facility) where sleeping accommodations are provided and leased.

Depreciation – Sec. 179

- The definition of real property eligible for Sec. 179 property is expanded to use the “qualified improvement property” definition that was formerly in Sec. 168(k).
- The Act changes the definition of “qualified real property” (for which treatment as Sec. 179 property could be elected) by substituting “qualified improvement property” (described below) for “qualified leasehold improvement property,” “qualified retail improvement property” and “qualified restaurant property.”

Depreciation – Sec. 179

- **Such qualified improvement property no longer is eligible for Sec. 168(k).**
- Also added, as included property, are roofs; heating, ventilation and air-conditioning property (HVAC property); fire-protection and alarm systems; and security systems (that meet the requirements described under **Certain structural components** below).

Depreciation – Sec. 179

- The above changes to the definition of qualified real property are greatly expansive of what property qualifies because:
- (1) “Qualified improvement property” includes property without regard to what business it is used in or whether the improved space is leased space,
- (2) Qualified leasehold improvement property and qualified retail improvement property had to be placed in service at least three years after the building that they improve was placed in service,

Depreciation – Sec. 179

- (3) Qualifying roofs, HVAC property, fire protection and alarm systems and security systems that are structural components of buildings are treated as qualified real property even if they are not qualified improvement property (see **Certain structural components** below) and
- (4) The only way in which the Act definition of qualified real property is more restrictive than the definition under prior law is in its exclusion of restaurant buildings and some restaurant improvements.

Depreciation – Sec. 179

- For example, the definition of qualified restaurant property didn't exclude building enlargements, while qualified improvement property does exclude enlargements.
- **Qualified improvement property** is any improvement to an interior portion of a building *which is non-residential real property* if the improvement is placed in service after the date the building was first placed in service.

Depreciation – Sec. 179

- **But,** qualified improvement property <u>does not include</u> any improvement for which the expenditure is attributable to:
- (1) Enlargement of the building,
- (2) Any elevator or escalator or
- (3) The internal structural framework of the building.
- <u>Qualified improvement property has a 15-year straight-line life</u>.

Depreciation – Sec. 179

- **Certain structural components.** Roofs, HVAC property, fire-protection and alarm systems, and security systems are qualified real property if they are improvements to *non-residential real property* that are placed in service after the date that the non-residential real property was placed in service.
- The current taxpayer does not have to be the taxpayer that originally placed the nonresidential real property in service.

Depreciation – Sec. 179

- **Analysis:** Roofs are almost inevitably structural components of buildings and thus almost always need the qualified improvement property classification to qualify as Sec. 179 property.
- However, HVAC property, fire-protection and alarm systems and security systems may or may not be considered building structural components, based on the highly fact-specific issues of:
  - (1) Whether and how they are attached to the building and (2) How they are used.

Depreciation – Sec. 179

- **Sec. 179 SUV limitation:** For tax years beginning after 2018, the $25,000 limit on Sec. 179 for SUVs is indexed for inflation.
- As we will see with the discussion of Sec. 168(k), it may now be difficult to decide whether to use Sec. 179 or Sec. 168(k).
- The example that follows illustrates the Sec. 179 rules.

Depreciation – Sec. 179

- **Example:** Taxpayer purchases $1,500,000 of used 7-year MACRS tangible personal property in 2018 and has $2,300,000 of qualified improvement property.
- In order to maximize total depreciation, the taxpayer claims $1,000,000 of Sec. 179 expenses out of the $2,300,000 of qualified improvement property.

Depreciation – Sec. 179

- Total "eligible property" for purposes of the Sec. 179 phaseout threshold is $2,500,000 ($1,500,000 tangible personal property + $1,000,000 *elected* real property).
- The remaining $1,500,000 of used tangible personal property is eligible for 100% Sec. 168(k), but the $1,300,000 of remaining qualified improvement property *is not* eligible for Sec. 168(k) depreciation.
  - It does have a 15-year straight-line life instead of 39 years.

Depreciation – Sec. 168(k)

- Under prior law, taxpayers could take additional (or bonus) depreciation under Sec. 168(k) in the year in which it placed certain “qualified property” in service through 2019 (with an additional year for certain qualified property with a longer production period).
- The amount of this additional depreciation was 50% of the cost of such property placed in service during 2017 and phased down to 40% in 2018 and 30% in 2019.

Depreciation – Sec. 168(k)

- Qualified property that is eligible for this additional depreciation is tangible personal property with a MACRS recovery period of 20 years or less, certain off-the-shelf computer software, and water utility property, but no longer <u>qualified improvement property</u>.
- Certain trees, vines, and plants bearing fruit or nuts are also eligible for this additional depreciation when planted or grafted, rather than when placed in service.

Depreciation – Sec. 168(k)

- Finally, to be eligible for this additional depreciation, the original use of the property had to begin with the taxpayer.
- **AMT credits in lieu of bonus depreciation.** Prior law allowed taxpayers to elect to accelerate the use of their AMT credits in lieu of this additional depreciation.
- The Act eliminated that provision.

Depreciation – Sec. 168(k)

- The Sec. 168(k) deduction is now 100% *beginning with property acquired and placed in service after September 27, 2017.*
- The bonus depreciation will be in place through 2025.

Depreciation – Sec. 168(k)

- **Election Out.** The change from 50% to 100% bonus depreciation can be deferred to apply only to qualified property and specified plants placed in service after the first tax year ending after Sept. 27, 2017.
- **Anti-Abuse Rule.** Property isn't treated as acquired after Sept. 27, 2017 if a written binding contract for its acquisition was entered into before Sept. 28, 2017.

Depreciation – Sec. 168(k)

- The “original use” requirement (in other words, “new”) is repealed, so *used property is eligible for Sec. 168(k).*
- Instead, the property is eligible for the additional depreciation if it is the *taxpayer’s first use*.
- <u>However, the limitations that make used property ineligible for Sec. 179 now are also applicable to Sec. 168(k).</u>
- Those rules are as follows:

Depreciation – Sec. 168(k)

- An asset isn't qualified property if the transaction is between certain related persons;
- An asset isn't qualified property if the transaction is between members of the same controlled group;.
- An asset isn't qualified property if the basis of the property acquired is determined –
  - (1) In whole or in part by reference to the adjusted basis of the property in the hands of the person from whom acquired (carryover basis transactions) (for example, gifts) or
  - (2) Property acquired from a decedent (for example, under a will or by intestacy).

Depreciation – Sec. 168(k)

- Sec. 179(d)(3) requires when the basis of property is determined by reference to the basis of other property held at any time by the acquiring person (substituted basis transactions), the substituted basis portion of the acquisition cost does not qualify as section 179 property
- Thus, for example, in the case of a trade-in, the property received is only qualified property for Sec. 168(k) purposes to the extent of any money paid in addition to the traded-in property.

Depreciation – Sec. 168(k)

- **Sale-leaseback rule eliminated.** The Act eliminated the sale-leaseback rule. Sec. 168(k)(2)(ii)
- Presumably, the sale-leaseback rule was eliminated because the lessor doesn't have to be the original user of the property in order for the property to be qualified property in the lessor's hands.

Depreciation – Sec. 168(k)

- Qualified property does not include any property used by a regulated public utility company (unless it is a water utility).
- The taxpayer's election to use AMT in lieu of the additional depreciation is repealed. The repeal of this election would be effective for tax years beginning after 2017.

Depreciation – Sec. 168(k)

- The Act adds certain qualified film or television productions and certain qualified live theatrical productions as "qualified property."
- It is a qualified film or television production as defined in Sec. 181(d) (generally a film or television production 75% of the total compensation of which is paid to actors, production personnel, directors and producers for services performed in the U.S.

Depreciation – Sec. 168(k)

- It is a qualified live theatrical production as defined in Sec. 181(e) (generally a live staged production 75% of the total compensation of which is paid to actors, production personnel, directors and producers for services performed in the U.S).
- Sec. 181 expired after 2016, but has been "re-enacted" as part of Sec. 168(k).

Depreciation – Sec. 168(k)

- **Placed-in-service rule.** For purposes of determining whether the production satisfies the placed-in-service requirement for qualified property —
- A qualified film or television production is considered to be placed in service at the time of initial release or broadcast, and
- A qualified live theatrical production is considered to be placed in service at the time of the initial live staged performance.

Depreciation – Sec. 168(k)

- The Act excludes from "qualified property" --
- (1) Any property which is primarily used in a public utility business and
- (2) Certain businesses that have floor plan financing debt.

Depreciation – Sec. 168(k)

- **Public Utility Property:** Businesses that furnish or sell (1) electrical energy, water, or sewage disposal services, (2) gas or steam through a local distribution system, or (3) transportation of gas or steam by pipeline, if the rates for the furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof.

Depreciation – Sec. 168(k)

- **Vehicle dealer property exclusion.** Excluded from being qualified property is any property used in a business that has had floor plan financing debt [as defined in Sec. 163(j)(9)] if the floor plan financing interest related to that debt is deductible under Sec. 163(j)(1)(C).
- Sec. 163(j) disallows the deduction of certain business interest. So if the dealer's interest is deductible, it cannot use Sec. 168(k).
  - See the discussion later in this presentation of disallowed interest.

Depreciation – Sec. 168(k)

- **Example Revisited:** Taxpayer purchases $1,500,000 of used 7-year MACRS tangible personal property in 2018 and has $2,300,000 of qualified improvement property.
- In order to maximize total depreciation, the taxpayer claims $1,000,000 of Sec. 179 expenses out of the $2,300,000 of qualified improvement property.
- The $1,500,000 for the equipment is 100% deductible under Sec. 168(k).
- The remaining $1,300,000 of building is 15-year SL.

Depreciation – Farm Equipment

- The Act applies a 5-year MACRS recovery period to items of machinery and equipment used in a farming business if –
- (1) The item's original use began with the taxpayer and
- (2) The item isn't a grain bin, cotton ginning asset, fence or other land improvement.

Depreciation – Farm Equipment

- Under prior law, all MACRS farming property was depreciated under the 150% declining balance method except for buildings, trees or vines bearing fruits or nuts (which had to be depreciated under the straight line method) and farming property subject to the alternative depreciation system.
- Under the Act, MACRS farming property is generally depreciated under the 200% declining balance method.

Depreciation – Farm Equipment

- 200% declining balance is not available for –
  - (1) Buildings and trees or vines bearing fruits or nuts (to which the straight-line method applies),
  - (2) Property for which the taxpayer elects either the straight-line method or 150% declining balance method,
  - (3) 15 year or 20 year MACRS property that has to be depreciated under the 150% declining balance method, and
  - (4) property subject to the alternative depreciation system.

Depreciation – Farm Equipment

- One category of property included as 15-year property is land improvements other than buildings.
- However, fences and grain bins have a 7-year recovery period and single purpose agricultural or horticultural structures (e.g., greenhouses, specialized housing for livestock) have a 10-year recovery period.

Depreciation – Farm Equipment

- 20-year MACRS property includes “farm buildings”,
- Which are certain structures that are neither conventional buildings nor single purpose agricultural or horticultural structures;
- These include tobacco barn uses for curing and further processing, through boxing, of tobacco leaves.

Luxury Autos

- The Act provides that the base amounts of depreciation caps for a passenger automobile are as follows—
- $10,000 for the year that a vehicle is placed in service,
- $16,000 for the second year in the recovery period,
- $9,600 for the third year in the recovery period,
- $5,760 for the fourth, fifth and sixth year in the recovery period, and
- $5,760 for any years after the recovery period.

Luxury Autos

- The above limits are more than three times higher than the ones in place under prior law.
- For example, for passenger automobiles placed in service in calendar year 2017, the placed-in-service year limit is $3,160.
- The higher limits, will, except for automobiles for which 100% bonus depreciation is allowed or for which the taxpayer wishes to claim Sec. 179 expensing deductions, more truly reflect “luxury” vehicles.

Luxury Autos

- For vehicles that are qualifying property for which bonus depreciation is allowed, $8,000 is added to the otherwise-applicable placed-in-service year limit.
- So, the first year amount is $18,000 rather than $10,000.
- For 2018 there is no distinction between passenger autos and trucks and vans in the base depreciation amount.
- The base amount is indexed for inflation after 2018.

Listed Property

- Because of their potential for personal use, Sec. 280F categorizes certain types of property as listed property and
- Subjects listed property to reduced, or possibly reduced, tax benefits and heightened substantiation requirements.

Listed Property

- Under prior law, subject to exceptions, listed property included
  - (1) Passenger automobiles,
  - (2) Other property used as a means of transportation,
  - (3) Property of a type generally used for purposes of entertainment, recreation, or amusement,
  - (4) Computer or peripheral equipment, and
  - (5) Any other property of a type specified in regs. (none specified
- Earlier legislation removed cell phones from listed property.

Listed Property

- The Act has now removed computer and peripheral equipment as a type of property included in the definition of listed property.
- Computers and peripheral equipment are therefore no longer subject to the heightened substantiation requirements that apply to listed property.
- Additionally, computers and peripheral equipment are no longer subject to the rules for listed property that limit, or may limit, tax benefits.

Interest Deduction

- **Earnings stripping.**
- A corporation's payment of deductible interest to a related person who pays no U.S. tax on the corresponding income is referred to as earnings stripping.
- To prevent earnings stripping, prior law denied a corporation's interest deduction for “disqualified interest” to the extent of the corporation's “excess interest expense” in any year that the corporation had a debt-to-equity ratio greater than 1.5 to 1.

Interest Deduction

- The Act repeals the earnings stripping rules and replaces them with a limitation on the deduction of business interest.
- Many businesses, regardless of entity form, are subject to a disallowance of "net interest expense" in excess of 30% of the business's "adjusted taxable income."
- The net interest expense disallowance is determined at the tax filer level—for example, at the partnership level instead of the partner level.

Interest Deduction

- Adjusted taxable income is a business's taxable income computed without regard to business interest expense, business interest income, net operating losses, and depreciation, amortization, and depletion.
- Any interest amounts disallowed are carried forward indefinitely and are a tax attribute of the business (as opposed to its owners).

Interest Deduction

- Special rules apply to allow a pass-through entity's unused interest limitation for the taxable year to be used by the pass-through entity's owners and
- To ensure that net income from pass-through entities is not double counted at the partner level.
- <u>There is an exemption from the disallowed interest rules for businesses with a prior 3-year average gross receipts of $25 million or less</u>.

Interest Deduction

- The deduction for business interest for any tax year can't exceed the sum of:
- (1) The taxpayer's business interest income for the tax year;
- (2) 30% of the taxpayer's adjusted taxable income for the tax year; plus
- (3) The taxpayer's floor plan financing interest for the tax year.
- The amount at (2), above (30% of adjusted taxable income), can't be less than zero.

Interest Deduction

- **Example:** For 2018, Corporation X has $100,000 of adjusted taxable income, $2,000 of business interest income, and $12,000 of business interest expense.
- It has no floor plan financing interest.
- X can deduct all $12,000 of its business interest expense, because that is less than its $2,000 of business interest income plus 30% of its adjusted taxable income (30% × $100,000 = $30,000).

Interest Deduction

- Because the business interest limitation ties the amount of deductible business interest to the taxpayer's adjusted taxable income, it can hurt a business that has had an unsuccessful year.
- The reduction in the taxpayer's adjusted taxable income in the off year will reduce the amount of interest that the taxpayer can deduct in that year.
- This effect is partly, but not fully, mitigated by the carryforward of disallowed interest.

Interest Deduction

- **Example (continued):** In 2019, Corporation X has only $10,000 of adjusted taxable income and again has $2,000 of business interest income and $12,000 of business interest expense.
- Here, X's deduction for business interest is limited to $5,000—its $2,000 of business interest income plus 30% of its adjusted taxable income (30% × $10,000 = $3,000).
- The $7,000 of disallowed interest can be carried forward indefinitely.

Interest Deduction

- **Example (continued):** Assume that in 2019, Corporation X had adjusted taxable income of ($20,000), $2,000 of business interest income, and $12,000 of business interest expense.
- Because X's adjusted taxable income is negative, it is deemed to be zero for purposes of the business interest limitation.
  - X can deduct $2,000 of its business interest, an amount equal to its $2,000 of business interest income.
  - It can carry forward the $10,000 of disallowed interest indefinitely.

Interest Deduction

- "Business interest expense" means any interest paid or accrued on debt properly allocable to a business.
  - Such as interest paid on loan proceeds used in the business.
- It does not include investment interest expense.
  - Such as interest expense from loans *from* shareholders?

Interest Deduction

- The term “business interest income” means the amount of interest includible in the gross income for the taxable year which is properly allocable to a business.
  - The does not include investment interest income.
- So, interest income from notes receivable arising in the normal course of business is business interest income, but interest income from loans to shareholders is not.

Interest Deduction

- **C corporation's interest income and expense.**
- Because Sec. 163(d) (the interest expense limitation rules) doesn't apply to C corporations, a C corporation has neither investment interest nor investment income within the meaning of Sec. 163(d).
- Thus, a C corporation's interest income and interest expense is properly allocable to a business, unless the business is otherwise excluded from the application of the business interest limitation.

Interest Deduction

- **Adjusted taxable income** means the taxpayer's taxable income computed without regard to:
  - Any item of income, gain, deduction, or loss that isn't properly allocable to a business;
  - Any business interest expense or business interest income;
  - The amount of any net operating loss (NOL) deduction;
  - The amount of any qualified business income deduction allowed under Sec. 199A (added by the Act);
  - For tax years beginning before Jan. 1, 2022, any deduction allowable for depreciation, amortization, or depletion.

Interest Deduction

- **Floor plan financing debt** means debt:
  - Used to finance the acquisition of motor vehicles held for sale or lease, and
  - Secured by the inventory so acquired.
- The term “motor vehicle” means any of the following:
  - Any self-propelled vehicle designed for transporting persons or property on a public street, highway, or road.
  - A boat.
  - Farm machinery or equipment.

Interest Deduction

- **Partnerships.**
- The business interest limitation applies to partnerships at the partnership level.
- Any deduction for business interest is taken into account in determining the partnership's nonseparately stated taxable income or loss.
- This amount is the “Ordinary business income or loss” reflected on Form 1065 (U.S. Return of Partnership Income).

Interest Deduction

- Each partner's adjusted taxable income is determined without regard to the partner's distributive share of any of the partnership's items of income, gain, deduction, or loss.
- This rule is intended to prevent double counting.
- Without such a rule, the same dollars of adjusted taxable income of a partnership could generate additional interest deductions as the income is passed through to the partners.

Interest Deduction

- **Example:** ABC is a partnership owned 50-50 by XYZ (a C corporation) and an individual.
- ABC generates $200 of noninterest income. Its only expense is $60 of business interest.
- The deduction for business interest is limited to 30% of adjusted taxable income, which is $60 (30% × $200).
- ABC deducts $60 of business interest and reports ordinary business income of $140.

Interest Deduction

- XYZ's 50% distributive share of ABC's ordinary business income is $70.
- XYZ has net taxable income of zero from its other operations, not including its business interest expense of $25.
- None of XYZ's income is interest income.

Interest Deduction

- In the absence of a double-counting rule, the $70 of taxable income from XYZ's distributive share of ABC's income would allow XYZ to deduct up to an additional $21 of interest (30% × $70).
- As a result, XYZ's $100 share of ABC's adjusted taxable income would generate $51 of interest deductions, well in excess of the intended 30% limitation.

Interest Deduction

- If XYZ were a pass-through entity rather than a C corporation, then additional deductions might be available to its partners as well, and so on.
- The double-counting rule prevents this result by providing that XYZ has adjusted taxable income computed without regard to its $70 distributive share of ABC's nonseparately stated income.

Interest Deduction

- As a result, XYZ has adjusted taxable income of $0.
- XYZ's deduction for business interest is limited to 30% × $0, which is $0, resulting in a deduction disallowance of $25.
- <u>Rules similar to those under “Partnerships,” above, apply to any S corporation and its shareholders</u>.

Interest Deduction

- The general carryforward rule doesn't apply to partnerships or S corporations.
- Instead, any business interest that isn't deductible by a partnership or S corporation for any tax year because of the business interest limitation isn't treated as business interest paid or accrued by the partnership or S corporation in the next tax year.
  - Instead, it's treated as excess business interest that's allocated to each partner in the same manner as the partnership's nonseparately stated taxable income or loss.

Interest Deduction

- For purposes of the business interest limitation, the term “business” doesn't include:
- The business of performing services as an employee,
- Any *electing* real property business,
- Any *electing* farming business, and
- Certain businesses of regulated utilities.
- **Note: if these elections are made, Sec. 168(k) depreciation is not available and SL depreciation must be used.**

Interest Deduction

- An “electing real property trade or business” is a business described in Sec. 469(c)(7)(C) (for purposes of qualifying as real estate professional under the passive loss rules).
- Thus any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage business.

Interest Deduction

- This definition is intended to include any such real property business,
- Including such a business conducted by a corporation or real estate investment trust (REIT).
- It's also intended that operating or managing a lodging facility is a real property operation or management business.

Interest Deduction

- The taxpayer must elect treatment as an electing real property business under Sec. 163(j)(7)(B) at the time and in the manner that the IRS prescribes.
- Once made, the election is irrevocable.
  - The description of a real property business refers only to the Sec. 469(c)(7)(C) description.
  - It doesn't refer to other rules of Sec. 469.
  - Therefore, those other rules aren't made applicable to the business interest limitation.

Interest Deduction

- An "electing farming business" is:
- A farming business, as defined in Sec. 263A(e)(4) (basically, any farm), that makes an election under Sec. 163(j)(7)(C) or
- A business of a specified agricultural or horticultural cooperative, as defined in Sec. 199A(g)(2) which makes the election.
- The election must be made at the time and in the manner that the IRS prescribes. Once made, the election is irrevocable.

Interest Deduction

- **Example:** A C manufacturing corporation has 2018 taxable income of $1,234,000.
- It purchased $1,000,000 worth of equipment and depreciated it all under Sec. 168(k).
- It borrowed $800,000 to acquire the equipment and paid $40,000 in interest expense during the year.
- It had $22,000 of interest income from trade notes receivable.
- Its "adjusted taxable income" is $1,234,000 TI - $22,000 business interest income + $40,000 business interest expense + $1,000,000 depreciation = $2,252,000; $2,252,000 X .3 = $675,600 = no limitation on interest deduction.

Repeal of Sec. 199

- The domestic activities production deduction (Sec. 199) is one of the most complex provisions ever enacted.
- It is repealed effective for taxable years beginning after 2017.

Net Operating Losses

- The net operating loss carryforward is indefinite (rather than 20 years) and
- There is generally no NOL carryback.
- Taxpayers are able to deduct an NOL carryover only to the extent of 80% of the taxpayer's taxable income (determined without regard to the NOL deduction).

Net Operating Losses

- Farms (no matter what their gross receipts) are still able to carryback NOLs for 2 years.
- **Effective:** NOLs arising in tax years ending after Dec. 31, 2017.
  - This effective date means that NOLs that arose in tax years that ended before Jan. 1, 2018, are subject to the two-year carryback/20-year carryforward rule. Taxpayers will have to distinguish between the two types of NOLs when computing the NOL deduction.
  - Taxpayers with fiscal tax years that began in 2017 are subject to the no-carryback/indefinite carryforward rule.

Entertainment Expenses

- This provision has some of most sweeping impact of the entire Act.
- It is a reaction to the many “Google” situations where lavish on premises benefits have been provided to tech employees.
- No deduction is allowed for entertainment, amusement or recreation activities, facilities, or membership dues relating to such activities or other social purposes.

Entertainment Expenses

- Under prior law, a deduction was allowed for ordinary and necessary expenses for an activity of a type generally considered to be entertainment, amusement, or recreation, or for a facility used in connection with such an activity,
- But only if the taxpayer established that the expense was directly related to or associated with the active conduct of the taxpayer's business or income-producing activity.

Entertainment Expenses

- However, the restrictions on deducting entertainment expenses don't apply to nine types of expenses that are listed in Sec. 274(e), including the following:
  - Expenses for goods, services, and facilities that are treated as compensation to an employee on the employer's income tax return and as wages of the employee for withholding purposes.
  - Expenses paid or incurred by the taxpayer, in connection with the performance of services for another person, under a reimbursement or other expense allowance arrangement, if the taxpayer accounts for the expenses to that person.

Entertainment Expenses

  - Expenses for recreational, social, or similar activities (including related facilities) primarily for the benefit of the taxpayer's employees, other than highly-compensated employees.
  - The bar on deducting expenses of an entertainment facility applied in the case of a club, unless the taxpayer established that the facility was used primarily for the furtherance of the taxpayer's business and that the item was directly related to the active conduct of that business.
- The deduction allowed for entertainment expenses was limited to 50% of the otherwise deductible amount of the expense.

Entertainment Expenses

- The Act repeals the rule that allowed a deduction for entertainment, amusement, or recreation that was directly related to or associated with the active conduct of the taxpayer's trade or business.
- These entertainment expenses are completely nondeductible, regardless of whether they are directly related to or associated with the taxpayer's business, unless one of the exceptions in Sec. 274(e) applies.

Entertainment Expenses

- Also repealed is the exception to the 50% deduction limit that applied to expenses that were part of a package that included a ticket to attend certain charitable sporting events.
- Thus a payment to attend, for instance, a charity golf outing is no longer deductible.

Entertainment Expenses

- The 50-percent limitation applies only to expenses for food or beverages and to qualifying business meals, with no deduction allowed for other entertainment expenses.
- Furthermore, no deduction is allowed for reimbursed entertainment expenses paid as part of a reimbursement arrangement that involves a tax-indifferent party such as a foreign person or an entity exempt from tax.

Entertainment Expenses

- So what happens to the “accountable plan” rules for employee reimbursements?
- They are still there because if the employee is reimbursed, they do not have income, but the employer has no deduction.
- If the employee is not reimbursed, the employee has no deduction because unreimbursed employee expenses are no longer deductible.

Entertainment Expenses

- What should employers do? Stop entertaining?
- No, but give employees an "entertainment allowance" that grosses up for the fact the allowance is additional wages to the employee and the employee will not get a deduction for the expenses.
- What about the Rotary (and similar organizations) dues? They now seem to be non-deductible although they have been exempted by IRS regs until now.

Entertainment Expenses

- **Example:** Larry is a plumbing contractor who attends an industry convention in Maui. He has the following expenses: $1,200 airfare, $1,000 hotel, $400 convention registration (includes $180 of meals), $400 golf green fees, $300 sightseeing trip, $630 meals, $127 rental car, and $65 miscellaneous expense.
- What would be his deduction under current law and the Act?
- The only change is that the golf green fees are nondeductible.

Fringe Benefits

- In addition, no deduction is allowed for:
  - Transportation fringe benefits (employer-paid parking or commuter highway vehicle or transit pass expenses),
  - Benefits in the form of on-premises gyms and other athletic facilities, or
  - For amenities provided to an employee that are primarily personal in nature and that involve property or services not directly related to the employer's business.
  - Although the Act denies the employer a deduction for the qualified transportation fringe benefit, it doesn't change the employee's exclusion of the benefit from income.

Fringe Benefits

- Meals provided for the convenience of the employer are now subject to 50% nondeductibility.
- Under prior law, employers could 100% deduct the cost of business meals that were excludable from the income of employees because they were provided at an employer-operated eating facility for the convenience of the employer.
- Things like pizza provided to employees during tax return season.

Qualified Equity Grants

- The Act has a new provision [Sec. 83(i)(1)] that allows tax deferrable stock grants to closely held corporation employees who are not at least 1% owners.
- A qualified employee could elect to defer, for income tax purposes, but not for FICA and FUTA purposes, the FMV of qualified stock transferred to the employee by the employer for up to 5 years.
- The grants must be made available to at least 80% of the company's employees and have substantial documentation requirements.

Local Lobbying Expenses

- Federal law already disallows deductions for lobbying, except for certain "local" lobbying.
- So deductions for lobbying and political expenditures with respect to legislation and candidates for office, are nondeductible, except for lobbying expenses with respect to legislation before local government bodies (including Indian tribal governments).
- The Act makes the expense of local lobbying nondeductible.

Like Kind Exchanges

- Like kind exchanges of non-real property are no longer tax deferred for exchanges occurring after December 31, 2017.
- However, there is a transition rule to allow like-kind exchanges of personal property to be completed if the taxpayer has either disposed of the relinquished property or acquired the replacement property on or before December 31, 2017.
  - In other words, deferred like kind exchanges where part of the exchange was done in 2017 are grandfathered.

Like Kind Exchanges

- An interest in a partnership which has in effect a valid election under section 761(a) to be excluded from the application of all of subchapter K shall be treated as an interest in each of the assets of such partnership and not as an interest in a partnership.
- Thus allowing such "partnerships" to make like kind exchanges of their "partnership" interests.
- Also, foreign real estate could no longer be exchanged for domestic real estate.

Fines and Penalties

- In addition to denying deductions for the payment of any fine, etc., to a government (as under prior law), the Act denies deductions for payments to, or at the direction of, a government or governmental entity.
- There are exceptions for restitution payments and payment of taxes.
- The Act requires government agencies to file an information return where the aggregate amount required to be paid or incurred to or at the direction of the government is at least $600.

Sexual Harassment Payments

- The Act denies a deduction for any settlement, payout, or attorney fees related to sexual abuse or sexual harassment if the payments are subject to a nondisclosure agreement.
- **Effective:** Amounts paid or incurred after Dec. 22, 2017.

Cash Method of Accounting

- Under prior law, businesses structured as sole proprietorships, partnerships (without a corporate partner), and S corporations generally could use the cash method of accounting.
- Businesses structured as corporations and partnerships with a corporate partner could only use the cash method of accounting if its average gross receipts did not exceed $5 million for all prior years (including the prior taxable years of any predecessor of the entity).

Cash Method of Accounting

- Farm corporations and farm partnerships with a corporate partner could only use the cash method of accounting if their gross receipts did not exceed $1 million in any year.
- An exception allowed certain family farm corporations to qualify if its gross receipts did not exceed $25 million.
- Under current law, businesses are required to use an inventory method if the production, purchase, or sale of merchandise is a material income-producing factor to the business.
- Businesses that are required to use an inventory method must also use the accrual method of accounting for tax purposes.

Cash Method of Accounting

- An exception from the accrual method of accounting was provided for certain small businesses with average gross receipts of not more than $1 million, and a second exception was provided for businesses in certain industries (which are not otherwise prohibited from using the cash method) whose annual gross receipts did not exceed $10 million.
- Businesses that fell within these exceptions may also account for inventory as materials and supplies that are not incidental (*i.e.*, “non-incidental materials and supplies”) under applicable Treasury regulations.

Cash Method of Accounting

- Under the Act, the $5 million threshold for corporations and partnerships with a corporate partner is increased to $25 million and the requirement that such businesses satisfy the requirement for all prior years is repealed.
- The increased $25 million threshold is extended to farm corporations and farm partnerships with a corporate partner, as well as family farm corporations.
- Also under the provision, the average gross receipts test is indexed to inflation.

Cash Method of Accounting

- Businesses with average gross receipts of $25 million or less are permitted to use the cash method of accounting even if the business has inventories.
- Under the cash method of accounting, a business may account for inventory as non-incidental materials and supplies.
- *Book conformity option.* A business with inventories that qualifies for and uses the cash method of accounting is able to account for its inventories using its method of accounting reflected on its financial statements or its books and records.
  - *But this option requires an "applicable financial statement" like that required for the capitalization safe harbor.*

Cash Method of Accounting

- Businesses with average gross receipts of $25 million or less are fully exempt from the UNICAP rules.
- This exemption applies to real and personal property acquired or manufactured by such business.
- The $10 million average gross receipts exception to the percentage-of-completion method is increased to $25 million.
- Thus businesses that meet the increased average gross receipts test are permitted to use the completed-contract method (or any other permissible exempt contract method).

Cash Method of Accounting

- Businesses currently on the accrual method of accounting receive automatic permission to switch to cash, but will likely have a Sec. 481 adjustment.
- This provision is a result of the push and pull from different factions to either expand the cash method or eliminate it entirely. The “cash expansion” advocates have won.

Credit Changes

- Credit for clinical testing expenses for certain drugs for rare diseases or conditions (orphan drug credit) is **reduced to 25% from 50%.**
- Rehabilitation credit is **limited to historic buildings and has to be taken ratably over 5 years.**
  - There are some transition rules that postpone this change for property owned for at least two years.

Family Medical Leave Credit

- The Act adds new "**SEC. 45S. EMPLOYER CREDIT FOR PAID FAMILY AND MEDICAL LEAVE**". The credit is:
- Limited to 12 weeks per year,
- Equal to 12.5% to 25% of regular compensation for the employee,
- Requires a written policy,
- Not available for highly compensated employees.
- Medical leave is defined by the previously passed Medical Leave Act.

S Corporations Converting to C

- Under prior law an S corporation switching to a C corporation had a very limited time to make distributions from its accumulated adjustments account (AAA). The Act liberalizes this provision.
- Distributions from an "eligible terminated S corporation" are treated as paid from its accumulated adjustments account *and* from its earnings and profits on a pro rata basis.
- Resulting adjustments are taken into account ratably over a 6-year period.

S Corporations Converting to C

- An eligible terminated S corporation is any C corporation which --
- (i) Was an S corporation on the date before the 12/22/17 enactment date,
- (ii) Revoked its S corporation election during the 2-year period beginning on the enactment date, and
- (iii) Had the same owners on the enactment date and on the revocation date (in the same proportion).

Termination of Partnerships

- Under prior law, a partnership terminated only if:
- (1) No part of any business, financial operations, or venture of the partnership continued to be carried on by any of its partners, or
- (2) Within a 12-month period there was a sale or exchange of 50% or more of the total interests in partnership capital and profits.
- The second type of termination is commonly referred to as a <u>technical termination</u>.

Termination of Partnerships

- When a technical termination occured, the business of the partnership continued in the same legal form, but the partnership was treated as newly formed and had to make new elections for various accounting methods, depreciation lives, and other purposes.
- The technical termination rule is repealed.
- Thus, the partnership is treated as continuing even if more than 50% of the total capital and profits interests of the partnership are sold or exchanged, and new elections are not required or permitted.

Concluding Comments

- I hope your understanding of the breadth and depth of Tax Reform related to business has been enhanced by this webinar.
- Thank you very much for attending.