

Tax Update



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WIPFLI ^{LLP}
CPAs and Consultants

Topics Covered

- 1. IRS and Congress**
2. Partnership Audit Reform
3. Recent Partnership Developments
4. IRS Correspondence
5. What's New/Other Planning
6. Taxation of Carried Interests
7. F Reorganizations
8. Mixing Bowl Transactions
9. State and Local Tax Update

IRS and Congress

- Tax environment (legislative/tax reform)
- State of IRS
- Interacting with IRS (audits, information document request (IDR) process)

Complexity Implications

- Almost 30 major new tax laws in the last 14 years
- 11th-hour tax bills - “2012” legislation signed into law in 2013!!
- Permanent tax law is no longer the norm—many extenders year after year
- Legislative uncertainty
- Thousands of pages of regulations (ex. Repairs and Affordable Care Act (ACA))
- Results in contempt for the law

Tax Reform

- Other than the typical year-end extender package, odds are remote
- Everyone agrees the system is broke
- Fundamental disagreements - Revenue neutral vs. revenue raising
 - Less tax brackets (less progressive) vs. pros of simplification
- Congressional infighting and budget battles
- Ryan known as a major advocate of tax reform in contrast to Boehner
- Next year - Presidential and other elections

Tax Reform

Common Reform Elements

- Reduced corporate tax rates
- Permanently extend expensing for small businesses
- R&D credit permanent
- Repeal LIFO
- Eliminate like-kind exchanges
- Uniform application of self-employment tax to pass-through entities
- Tax carried interest as ordinary income

Legislative Trends

Penalties

- The hidden tax increases - “Gotcha” mentality for minor foot faults
- Congressional trend to come up with revenue raisers to pay for legislation

Example: Late filing partnership returns - Watch for change in 50% or more of partners:

- \$195 per partner/shareholder per month up to 12 months (max. \$2,340)
- At one time was \$50 with 5-month max. (\$250 max.)
- Exception for small partnerships (certain conditions such as 10 or less partners (not S corporations))

Legislative Trends

Impact on IRS

- Funding cuts
 - Number of employees down 18% from 2010
 - Training \$172M in 2010, now \$22M
 - Retraining domestic agents to focus on international issues
 - Significant retirements, no ability to rehire (5 retire/ 1 hire)
 - Over ½ are 50 years old
- Unable to handle what is on its plate now—now add responsibility for ACA and identity theft!

State of IRS

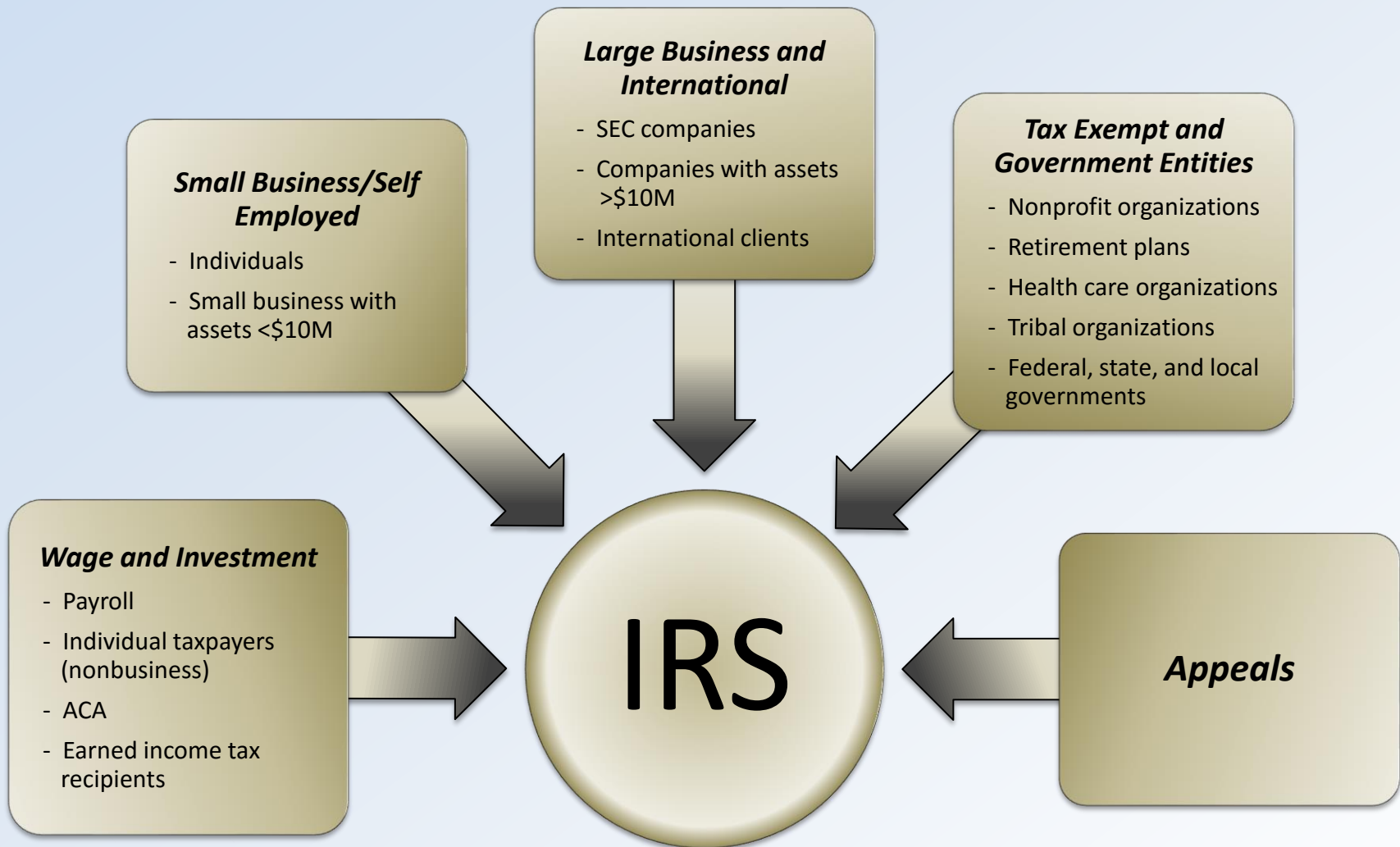
Doing Less With Less

- Query: Is it now easier to do business in Russia (pick your country) than with the IRS?
- Taxpayer Advocate: “For the segment of taxpayers who required help from the IRS, the filing season was by far the worst in memory.”
- Answered 17% of calls from taxpayers after being notified their returns blocked on suspicion of identity theft
 - Hold time was 28 minutes
- Practitioner Priority Service Line: Average hold time is 45 minutes, and only 45% got through.
- “Courtesy” Disconnect: IRS hangs up on taxpayers because its switchboard is overloaded:
 - Often happens after being on hold for significant time
 - 544,000 in 2014, 8.8 million in 2015

State of IRS

- Answered 37% of calls received; average hold time for those that got through was 23 minutes:
 - 2014 season 71% got through and hold time 14 minutes
- Treasury continues to promulgate overly complex rules that indicate a complete lack of understanding of the burden being imposed:
 - Relief from repair regs for small business issued in February 2015; year and half since final regs and after many returns were already filed
- IRS enforcement (and lack of enforcement) of ACA appears to show political influence within the agency

State of IRS



Roles of the IRS

Small Business/Self-Employed Division (SBSE)

- Has authority over 57 million taxpayers who are business owners with less than \$10M in assets
- Five organizations in SBSE:
 - Collection - Collect delinquent taxes and secure delinquent tax filings
 - Compliance Service Campus - Brookhaven, Philadelphia, Cincinnati, Memphis, and Ogden
 - Examination - Field and office audit management and correspondence audits
 - Specialty taxes - Employment, excise, estate, and gift
 - Communication and outreach with taxpayer groups (AICPA, ABA, VITA, etc.)

Roles of the IRS

Large Business and International (LB&I)

- Has authority over all businesses with assets over \$10M and all international taxpayers
- 210,000 taxpayers
- Examination - Field and office audits:
 - Less flexible standards; strict compliance
- Collection:
 - More aggressive requirements
 - Generally larger amounts owed

IRS Audit Issues

Typical Audit Areas

- Independent contractors/employees:
 - DOL and states also aggressively auditing
- Company autos - mileage logs
- Packer tickets and other entertainment
- Gift certificates (IRS treats as cash)
- Section 263A (Unicap)
- Section 199

IRS Audit Issues

Typical Audit Areas (Continued)

- Passive loss rules
- Real estate professionals
- Charitable contributions - Statement from charity
- Unreasonable compensation - Too low/too high
- Year end bonuses - Finding ways to disallow
- International
- Responsible person - Trust fund taxes

Who Gets Audited

- **No random audit exists**
- **DIF (discriminate index function) scores:**
 - All taxpayers (business, individual, nonprofits) have a DIF score
 - IRS will not tell you what a taxpayer's DIF score is
 - The higher the DIF score, the more likely the chance for an audit
- **Items affecting DIF score:**
 - Correspondence from IRS
 - Mismatch of items on a return (Form 1099, W-2)
 - Related returns being audited and adjustments occurring
 - NAICS businesses comparisons:
 - Business has lower gross profit than others in same NAICS group
 - Certain expenses are higher than others in the same NAICS group

Who Gets Audited

- IRS computer will list taxpayers with highest to lowest DIF scores.
- IRS employees will review DIF scores and returns prior to making recommendations for audit.
- Whistle blower/information returns:
 - Employees
 - Former spouses/former significant others
- Once taxpayers are selected for audit, they cannot be “unaudited,” even if an error occurred in the DIF scoring process.

Who Gets Audited

- Number of audits significantly decreasing:
 - 2015 1.0M
 - 2014 1.2M
 - 2013 1.4M
- Locally the number of business audits appears consistent

Best Practices During Office and Field Audits

- On irs.gov, search for Audit Technique Guides:
 - Review these audit technique guides, which are training materials for IRS agents.
 - The guides will show you what areas the IRS agent is supposed to focus on.
 - Penalty assessment. Regardless of the type of audit, the exam agent must consider penalties against the preparer and taxpayer. Prepare for this prior to first meeting with the exam agent.

Best Practices During Office and Field Audits

All Audits

- Scope of audit must be clear and in writing.
- IRS agent has right to meet with taxpayer by statute
 - POA often able to substitute
 - Don't have taxpayer meet alone with IRS agent.
 - Pros/cons of audit at taxpayer location
- Document all activity during audit.

Best Practices During Office and Field Audits

All Audits (Continued)

- Keep copies of everything provided to auditor.
- Be professional at all times.
- Being firm but reasonable/polite
- Many auditors will over-reach.
 - They may ask for more information outside the scope of the audit.
 - Change the focus back to IDR request and original scope of the audit.

Information Document Request (IDR) Process

- LB&I Division issued new directive
- Meant to improve efficiency and transparency in audit process as well as standardize
- Governs IDR issuance
- Governs enforcement procedures
- Note this is large case (LB&I):
 - Small case often significantly different:
 - Ex. moratorium on repairs
 - Time - Can be months between initial field work and subsequent follow-up

IDR Process

IDR Delivery

- Agent to provide IDR in draft form
- Agent to discuss issue up front and explain the information sought
- Intended to eliminate unnecessary back and forth and additional time and effort
- Only one issue per IDR
- Discuss and finalize within 10 business days of receipt of draft
- Mutually agree on response date
- Only the exam agent decides whether the IDR is complete or not

IDR Enforcement

- If IDR response is deemed incomplete or no response is late:
- Prescribed process, little flexibility
- Before enforcement process begins:
 - If warranted agent can grant one-time extension up to 15 business days of original due date
- Delinquency Notice
- Pre-Summons Letter
- Summons Letter

IDR Enforcement

Delinquency Notice

- First phase
 - Issued within 10 days of original response date
 - Response required within 10 business days from date of delinquency notice

IDR Enforcement

Pre-Summons Letter

- Issued no later than 10 business days after due date of Delinquency Notice
- IRS team manager, territory manager, and counsel involvement
- Letter goes to taxpayer management at a level higher than the individual who received the Delinquency Notice:
 - Could be the CFO or CEO or owner
- Response date no later than 10 business days

IDR Enforcement

Summons

- Failure to respond may result in Office of Chief Counsel seeking enforcement through Department of Justice
- Note how quickly this can progress to a Summons
- Agents are evaluated on how well they manage the process – it doesn't look good for them either if at any point the process is delayed
- How to best manage the IDR process? (next section)

IDR Best Practices

- Communication with agent
- Track all IDRs and periodically cross-check with agent
- Initial discussion regarding the issue, what information is requested and why needed
- Demonstrate/document intent to comply—can reduce likelihood of summons enforcement
- Maintain open dialogue with agent so when unexpected difficulties occur extensions are more reasonably granted
- Only answer the question
- Do not volunteer additional information

IDR Best Practices

- Assess info requested immediately upon receipt of draft
- Ability to negotiate scope and timing is at front end
 - In particular with overreaching requests
- Once issued, little to no flexibility
- Be realistic in how much time is needed to fully comply with the IDR:
 - Identify, gather, convert, and finalize the data
 - Assess need for outside third parties, former employees, other departments, etc.
- Discuss any unclear language, confined to a single issue and request adjustments where necessary

Best Practices During Office and Field Audits

IDR - SBSE

- SBSE audits do not have the same strict rules for IDR requests and deadlines; however, best practice is to conform to IDR requests and deadlines.
- Give yourself plenty of time to respond completely and timely to IDR requests.
- IDR request must be 100% complete. Anything less than that is “delinquent.”

Best Practices During Office and Field Audits

IDR - SBSE (Continued)

- Inform agent as soon as possible if deadline will be problematic.
- Ask for an extension if you need it so the deadline is not missed.
- Keep communications fluid between the exam agent and yourself.

Best Practices During Office and Field Audits

Statute of Limitations Extensions

- Concern of providing additional time to identify and raise additional issues.
- If refuse, IRS can issue a notice of deficiency.
- IRS generally will not let assessment period get within six months of expiration.
- IRS appeals: They request 12-month extension of statute to provide enough time for them to review the case.
- Limit statute of limitations extension request to certain issues and certain time. (IRS agent may push back on this.)

Alternative Dispute Resolution

Disagreed issues at the audit level, the taxpayer has options to address outstanding unresolved issues:

- **Fast-track settlement**
- Fast-track mediation
- Rapid appeals process
- Early referral
- **Normal appeals process**

Fast-track settlement

- Parties must be willing to concede at least 20%
- Intended for resolution within 120 days
- An Appeals Officer oversees as mediator
- Either party may withdraw
 - Goes back to Exam
 - Taxpayer retains traditional Appeals rights

Appeals Process

If the taxpayer is not satisfied with the IRS audit report, and issues remain:

- File a protest with IRS appeals
- Waiting period can be up to two years
- Appeals officer contacts the power of attorney and resolution attempts are made

IRS Audit Appeals

- Mission of IRS appeals: Resolve tax controversies without litigation on basis of fairness and impartiality to both the taxpayer and the Government
- Appeals will not:
 - Raise or consider new issues
 - Develop evidence not in the case file (is not the finder of fact)
 - Do job of exam agent/auditor
- Can assess and settle issues on the hazards of litigation (50% chance of success, etc.)

IRS Audit Appeals

Appeals Protest

This is your only written evidence to the IRS. Include everything; even things in addition to what is important to the IRS exam agent:

- At appeals:
 - Premeeting between appeals and exam agent. The taxpayer/POA is allowed to be there but is not allowed to speak. “Preconferences” is the official name for this meeting. The IRS exam team will explain position to appeals.
 - Attend this conference and take notes; this is the extent of IRS’s position.
 - You can learn from this and use it to explain why the exam agent is improper.

IRS Audit Appeals

Appeals Practice Tips

- Ideal to have the premeeting on the same day as the conference.
 - The appeals officer doesn't have a chance to have exam's position "ferment" for a long time.
 - Strategically, it is better for you to present your case to appeals soon after the premeeting.

Normal Appeals Process (Continued)

Options available after the appeals process:

- Petition to U.S. Tax Court (no tax payment is required)
- Petition to U.S. District Court (tax payment is required to be paid in full):
 - If payment is not received by the IRS, interest and penalties continue to accrue

LB&I Restructuring

- To be implemented in 2016
- Issues evaluated/pre-determined centrally by specialized staff
- Likely less autonomy for field agents
- Could have multiple agents on the audit
 - Ex. Inventory, Partnership issue, Reasonable Comp
 - Potential for “cut and paste” issue analysis – each taxpayer facts may differ though
 - With more people, could audits take longer
- More focus on international issues

Identity Theft

- Pervasive issues within and outside of IRS
- Collaboration with tax practitioners
- Accelerate information reporting
- Delays may occur in refund processing
- Identity Protection Personal ID No.:
 - Six-digit number assigned to certain taxpayers
 - Allows their returns to be processed without delay
 - Also available to Florida, Georgia, and D.C. residents

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Partnership Audit Reform

- The “Bipartisan Budget Act of 2015” significantly overhauls partnership audits
- Provisions are based on the “Partnership Audit Simplification Act” that was introduced in June
- Reasons for audit reform:
 - Number of partnerships has exploded in recent years
 - IRS audits a fraction of large partnerships compared to large corporations (0.8% compared to 27.1% in 2012)
 - Increasing complexity in auditing multi-tier partnership structures
 - Few large partnership audits result in adjustment
 - Audit reform is viewed as a revenue raiser without increasing taxes

Partnership Audit Reform

Objectives of Reform

- Provide centralized rules for audits
- Simplify partnership audit process
- Streamline partnership audits by making adjustments at the partnership level
- Eliminate need for partnerships and partners to file amended prior-year returns
- Minimize need to collect any resulting taxes from partners

Partnership Audit Reform

- New rules replace TEFRA and ELP audit rules
- Rules apply to all partnerships, except for a narrow category of small partnerships that may elect out
- A partnership may elect out on its tax return if:
 - It has 100 or fewer partners, and
 - Each of its partners is an individual, estate, C corporation, S corporation, or certain foreign entities
- Lower-tier partnerships may not elect out since they have a partnership as a partner
- Partnerships with trust partners may not elect out

Partnership Audit Reform

- Audits take place at partnership level.
- Any adjusted items of income, gain, loss, deduction, or credit are made at the partnership level.
- IRS will assess and collect any taxes, interest, and penalties at the partnership level, rather than at the partner level.

Partnership Audit Reform

- Adjustments will be taken into account on the partnership return for the year of the audit
- Adjustments that result in a decrease in income will be reflected as a reduction in income for the year of the audit
- Partners will not have joint and several liability for the partnership's liability (contrary to proposed bill)

Partnership Audit Reform

- Imputed underpayments are subject to tax at the highest individual or corporate tax rate in effect for the year under review.
- The law authorizes treasury regulations to:
 - Establish procedures that take into account lower tax rates applicable to qualified dividends or long-term capital gains
 - Take into account partners who file amended returns that pick up adjustments
 - Take into account the existence of tax-exempt partners
 - Make any other appropriate modifications

Partnership Audit Reform

- Partnerships may elect to include the audit adjustments on its partners' tax returns, including penalties and interest at 5% (rather than 3%).
- This mechanism could reduce the overall liability when partners have offsetting deductions that could be used against the underpayment.
- The new provisions apply for partnership tax years beginning after 2017.
- Partnerships may elect to have the new provisions apply for tax returns filed prior to 2018.

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Disguised Payment Regulations

- Recent proposed regulations provide guidance on when payments to a partner will be treated as a disguised payment for services under IRC §707(a)(2)(A).
- IRC §707(a)(2)(A) was enacted due to a concern that service providers were becoming partners to allow partnerships to deduct what would otherwise be non-deductible capital expenditures.

Disguised Payment Regulations

- As an example, a partnership wants to pay an architect to design a building.
- The partnership is required to capitalize the architect's fees into the basis of the pipeline.
- In the absence of IRC §707(a)(2)(A), the architect could become a partner and receive his or her fee in the form of an allocation and distribution.
- This essentially results in a deduction of the architect's fee since partnership income is being shifted away from other partners.

Disguised Payment Regulations

- IRC §707(a)(2)(A) addresses that type of situation by providing that a service partner's allocable share of partnership income will be treated as a fee paid to one who is not a partner.
- If IRC §707(a)(2)(A) applies, the payment is treated as a payment for services for all purposes of the code.
- The partnership must treat the disguised payment as payment to a non-partner in determining the partnership's taxable income or loss.
- The payment may need to be capitalized if required under the code.

Disguised Payment Regulations

- Disguised payment determination depends on facts and circumstances.
- The most important factor is whether the arrangement has significant entrepreneurial risk.
- An arrangement that lacks significant entrepreneurial risk is treated as a payment for services.

Accounting for Varying Partnership Interests

- IRS recently finalized regulations on determining distributive shares when a partner's interest changes during the year.
- IRC §706(d) provides that when a partner's interest changes during the year, the partner's distributive share is determined using any method set forth in regulations.
- Final regulations give the partnership greater flexibility.
- Partnerships can use a different method (closing of the books or proration) each time a variation in a partnership interest occurs except in the case of “extraordinary items.”

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IRS Notices

How to Respond to an IRS Notice

- The best way to respond to an IRS notice is with a letter.
 - Not all phone communications get reported properly.
 - A phone call is difficult to document and prove that it occurred.
- The IRS is triaging letters to get them addressed more quickly. Inefficient, long letters will be responded to by the IRS “when time permits.”

How to Respond to an IRS Notice (Continued)

- Keep letters focused and easy to read. An IRS employee needs only a high school equivalent education to serve in the position of answering/determining correspondence audits.
- Send all IRS correspondence by certified mail, return receipt requested.

How to Respond to an IRS Notice (Continued)

- First paragraph: State what you want:
 - “This letter requests the penalty be abated for reasonable cause.”
 - “This letter requests corrections to the proposed adjustments.”
- Second paragraph: Describe your authority to respond. If you have a signed Form 2848, *Power of Attorney and Declaration of Representative*, state this in the second paragraph and include a copy with your letter.

How to Respond to an IRS Notice (Continued)

- Third and Subsequent Paragraphs: Include the following:
 - Why penalty should be abated or what errors are listed in the notice.
 - Reasonable cause: Provide clear evidence, and document same. If medical issue, enclose specific criteria and medical documents confirming your statements.
 - Cite Internal Revenue Code (IRC) sections, Internal Revenue regulations, and/or court cases to support your position.
 - Don't repeat your request multiple times in the letter.

Power of Attorney Forms

- Make sure you have the most recent copy on file with the IRS. (July 2014 version)
- For joint returns, two Forms 2848 are required to be on file with the IRS—one for each taxpayer.
- Page 1 asks if you, as POA, want to receive copies of notices and communications. Check this box.

IRS Notices

- Taxpayers are allowed a one-time abatement in some circumstances. If taxpayers have not incurred a late-payment penalty or late-filing penalty in the last 36 months, they can assert this penalty relief. Quote Internal Revenue Manual 20.1.1.3.6.1 in your letter.
- However, use other penalty reasons first (such as reasonable cause) and save this one-time abatement in case you need it later.
- What is the one-time abatement relief? (next)

First-Time Penalty Abatement

- FTA program was established back in 2001.
- Qualifications:
 - No prior penalties in prior three years
 - Current or proper extension for all currently required returns and payments/valid installment agreement
- Over 1.5 million taxpayers that qualified were not offered the penalty abatement in 2010.
- Not mentioned in instructions or penalty letters.

First-Time Penalty Abatement (Continued)

- Now IRS is starting to use more, BUT:
 - In some instances, IRS personnel will insert the “one-time abatement” on the taxpayer’s account because it is easier for them. This may cause the taxpayer additional problems in the future if an actual late payment or late filing occurs.
 - Sometimes will incorrectly abate when taxpayer would qualify under other provisions
 - Don’t want to use the “get out of jail free” card until really needed.

Balances Due to IRS

If the taxpayer owes money to the IRS, options are available:

- Balance due - No special circumstances (see next slide)
- Not covered:
 - Balance due—special circumstances
 - Offer in compromise
 - IRS levy or lien

Balances Due to IRS

Balance Due - No Special Circumstances

- Form 9465, *Installment Agreement Request*:
 - If less than \$25,000 is owed, only the Form 9465 is required, with no bank information.
 - If more than \$25,000 and less than \$50,000 is owed, complete the Form 9465 and include bank information.
 - If more than \$50,000 is owed, complete Form 433A and Form 9465.

Balances Due to IRS

Balance Due - No Special Circumstances (Continued)

- Form 9465 sets up a monthly payment plan with the IRS. The taxpayer selects the date the payment is due and the amount of the monthly payment (not to exceed 72 months):
 - \$120 initial fee (\$52 fee if the taxpayer agrees to electronic withdrawals from his or her bank account or \$43 for low-income taxpayer. File Form 13844 to request reduced fee.) Interest and penalties continue to accrue.

IRS Taxpayer Advocate Service

- This agency is responsible for assisting taxpayers who are suffering hardship and where other means of communicating with the IRS have failed.
- There is a Taxpayer Advocate Service office in every state, District of Columbia, and Puerto Rico.
- To contact the Taxpayer Advocate Service:
 - File Form 911 - On this form the taxpayer states hardship claim and relief requested
 - Include Form 2848 with Form 911
 - Please make sure you qualify for hardship. Frivolous claims can result in a \$5,000 fine

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Penalties - New

Information Returns

	<u>Pre-2016</u>	<u>2016</u>
Annual	\$100	\$250
Correct by 30 days	\$30	\$50
Correct by Aug 1	\$60	\$100

NOTE: First-time abatement penalty relief does not apply to information returns.

Letter rulings increased from \$6,900 to \$9,800 for late elections:

- Other rulings \$19,000 now \$28,300

Filing Dates

Highway Trust Fund Extension law:

- For tax years beginning after 12/31/15:
 - C corps due 3½ months (Calendar year due 4/15), extended 9/15)
 - June 30 Y/E due 2 ½ months until after 12/31/2025!!
 - Extensions
 - 5 months for calendar years
 - 6 months for non-calendar, non-June 30)
 - 7 months for June 30
 - After 2025 all will be 3 ½ months with 6 month extension
 - S corps and partnerships: 2½ months, extension 6 months
 - Calendar year due 3/15, extended 9/15

Filing Dates

Individuals

- Individuals - 2015 returns:
 - Due 4/18/16
 - 4/15 is a Friday, but D.C. observes Emancipation Day on a Friday when April 16 is a Saturday
 - Also a Leap Year – more time for the CPA's to complete their work!!
- Foreign bank account Form 114:
 - Due 6/30/16, no extensions
 - Years beginning after 12/31/15:
 - Due 4/15, six-month extension available

Plan Contribution Timing

§404(a)(6) Due Date of Return Including Extensions

- A contribution to a qualified retirement plan is treated as having been made on the last day of the tax year if it is identified as being made on account of that year and is made by the due date of the corporation's tax return, including extensions, for that tax year. The rule applies equally to both accrual-basis and cash-basis taxpayers.
- Planning opportunities:
 - Pay by extended due date
 - Don't extend, pay after due date

Conversions From LLCs

- One class of stock rule
- Take care with LLCs that have made a corporate election
- Operating agreement may need to be amended if special allocation language in agreement
- Reasonable compensation— reevaluate going from guaranteed payment to wage
 - Unreasonably low may trigger payroll tax liabilities upon audit

Partnership Redemption vs. Cross Purchase

Partnership Redemption May be Preferred to Buying Partnership Interest to Avoid §1250 Recapture

- Gains from the sale of partnership interests and multi-member LLCs held over one year will be treated as unrecaptured §1250 gains (meaning 25% rate) to the extent of prior depreciation on real estate assets
- This rule does not apply to transactions that are treated as redemptions of partnership interest

R & D Credit

- Enacted in 1981, but was never made a permanent credit, resulting in 9 expirations and 16 extensions since 1981.
- Only once in its 32-year history was the tax credit not retroactively reenacted, which was from July 1, 1995 through June 30, 1996.
- The R&D credit again expired on December 31, 2014.

R & D Credit

Certain activities for which the §41 credit is not allowed, include:

- Computer software: Except to the extent provided in regulations, any research with respect to computer software that is developed by or for the benefit of the taxpayer primarily for **internal use (IUS)**:
 - To qualify, IUS in addition to the general requirements must also be innovative, bear significant economic risk, and not commercially available.

Proposed Regulations for IUS

- The IRS stated in the Preamble to proposed regulations its intended impact:
 - *“The objective of these proposed regulations is to provide a narrower exclusion of software from qualified research than provided in prior regulatory guidance.”*
 - *“Because these proposed regulations provide a narrower definition of internal use software, the research credit will be available to a greater number of small entities than was previously available under prior guidance.”*

R & D Credit

Pro-Taxpayer:

- Software developed to enable a taxpayer to interact with third parties or to allow third parties to interact with the taxpayer
- IUS definition agrees with what most view as IUS (i.e., “back office software enabling/supporting G&A functions)
- Addresses uncertainty over the treatment of software that is typically used in e-commerce
- Impacts a wide range of taxpayers that use software to deliver products and services
- **Remember:** Base consistency for traditional and ASC research credits

R & D Credit

Examples of software that is treated as not primarily for internal use under proposed regs:

- Enable third parties to execute banking transactions
- Track the progress of a delivery of goods
- Search a taxpayer's inventory for goods
- Purchase tickets or make reservations
- Receive services over the Internet
- Store and retrieve a third-party's digital files

R & D Credit

The list of general and administrative functions that would be IUS is consistent with what most would regard as back-office:

- Financial Management - Financial management and the supporting recordkeeping
- Human Resources Management - Workforce management
- Support Services - Other functions that support day-to-day operations

Bonus Depreciation

Qualified Leasehold Improvements

- 50% bonus and 15 year s/l
- Contrast with 39 year s/l
- Over three years after building placed in service
- Not an enlargement, common area structural component, or internal structural framework
- Not a related party lease:
 - 80% or more common ownership (rather than the “typical” 50%), thus more leases qualify

Placed in Service Date

- When it is in a condition or state of readiness and available
- Can be placed in service prior to its actual use if it is in a state of readiness
- Retail Building – IRS disagreed despite certificate of occupancy had been issued
 - Store wasn't open but fully functional
 - Contrast with airplane without conference table & screens (taxpayer not viewed credibly)

Partial Disposition Rule

- Resulting from repair regulations
- Claim a loss on disposition of structural component:
 - Windows, walls, doors, tiling, roofs, electrical, etc. that might be “buried” in building account
 - Determine original cost:
 - PPI
 - Relative value to current building X building cost
 - Reconstruct (cost seg)
 - Original records

Depreciation Asset Classes

- Fully understand the addition and its use:
 - Part of “process” or facility
- Application of repair rules – unit of property
- Class 57 assets - “Distributive trades and services: Assets in wholesale and retail trade and personal and professional services”
 - Five-year rather than seven-year life

Repairs

- De minimis safe harbor (\$5,000/\$500):
 - If not audited f/s, submission of f/s to government agency may also provide opportunity for up to \$5K
 - Annual statement required
 - Policy in place (BOY if >\$500)
- Routine maintenance safe harbors
- Small taxpayer safe harbors

FICA Nonqualified Deferred Comp

- FICA generally assessed when actually or constructively received
- Special timing rule for NQDC assessed later of:
 - Services performed
 - No longer subject to substantial risk of forfeiture
- Pro-taxpayer vs. assessing when paid:
 - Recipient often over FICA base in service years vs. retirement payment stream (“pay as you go”)
- District court held employer liable for missing special timing rule

Reliance on IRS Guidance

- Cannot always rely on IRS Publications - case in point:
- IRA multiple rollovers:
 - IRS publication had indicated the one IRA rollover/year applies on an individual IRA basis rather than aggregating all IRA's
 - Taxpayer rolled over IRAs multiple times in one year
 - Viewed as abusive in obtaining short-term loans via a series of multiple rollovers.
- “Rollover” does not include direct trustee-to-trustee transfers.

Rescind a Transaction

- Can undo a transaction in the same taxable year
- Rev. Rule 80-58 cited by IRS in several letter rulings:
 - Undid a distribution of subsidiary stock
 - Rescinded conversion of LLC to C corporation

Proactive Accounting Method Change

- Opportunity to “come clean”
- Four-year spread of income in year of change
- Audit protection
- If IRS catches:
 - They go back to earliest open year and compute adjustment
 - Interest and penalties
 - Generally least favorable method

Proactively Manage Prepays

- Manage timing of payment to either deduct or defer
- Alternatively can elect to not apply the 12-month rule (assuming a prior prepaid election was made) to capitalize:
 - Election is irrevocable for that year
 - Applies on a category by category basis (could capitalize prepaid insurance but continue to deduct prepaid 12-month service contract)

Bad Debts and Partial Bad Debts

For businesses, a deduction:

- Wholly worthless
- Partially worthless
- Must be charged off on books and records:
 - Not a “reserve” - Crediting a reserve account is not sufficient

IPIC LIFO

- Inflationary environment
- Relatively easy to use
- Use of PPI may result in larger LIFO reserve
- Even if LIFO terminated via legislation, likely liberal recapture

ACA

- Employer reimbursements of employee premiums – post 6/30/15 issue:
 - Cannot condition payment on the premium
 - Can reimburse S corp 2% shareholder (report on W2, s/h deducts “above the line”)
- Large employer information reporting:
 - Form 1095: 50 FTEs during preceding year
 - Info may reside in several departments (Accounting and HR)

Accrual of Ratable Service Contracts

A service contract for similar services on a regular basis, with independent value, does not exceed 12 months:

- Examples: Janitorial and landscaping
- Example: Calendar year taxpayer pays \$12,000 on 12/31/15 for landscape maintenance for | 1/1/16 through 12/31/16:
 - File return on 9/15/16
 - Use recurring item and 3½ rules - Can deduct $8.5/12 * \$12k = \$8,500$ on 2015 return

Local Lodging

- In-town lodging excludable under safe harbor (not taxable to employee, deductible by employer):
 - Does not exceed five days only once per quarter
 - Employer requires employee to remain at function overnight
 - Not lavish/extravagant
 - Necessary for bona fide meeting, conference, training, etc.

Individual Planning

- Be aware of AMT - Typical culprits
 - Large State and local tax deductions
 - Large capital gains:
 - Although same tax rate, large gains can reduce/ eliminate AMT exemption
- ISOs
- Taxable income in the \$250K to \$600K range (varies based on exemptions, etc., but taxpayers in this range often susceptible (AMT exemption phase-out, not “enough” regular income at highest rate, etc.)
- Before prepaying taxes, consider AMT

Individual Planning

- Beware of phase-outs and other taxes
- MFJ roughly \$300K - Can add about 1%:
 - Personal exemptions
 - Itemized deductions
- 0.9% increase on wages (\$200K/\$250K)
- 3.8% net investment income tax
- Tax-exempt investments start to look more favorable

Recent Market Swings

ROTH IRA Conversions

- Time at lowest possible value
- Can transfer back to regular IRA
- Can reconvert back to ROTH (timing limit - 30 days or beginning of following tax year)

Recent Market Swings

Tax Loss Harvesting

- Remember wash sale rules (30 days before, after):
 - Buy more of the same and sell at least 31 days later
 - Sell and buy more of the same 31 days later
- Mutual funds: Can sell original holding and buy shares in similar fund (careful if “substantially identical”, query S&P 500 fund)

ROTH IRA

- “Back door” for those subject to AGI limits and have not opened a regular IRA:
 - Doesn’t work as well if previously deductible IRAs – more of the conversion will be taxable (\$5k back-door, \$20k previous deductible, 20/25 x \$5k is taxable)
- Contribute to a regular IRA (nondeductible contribution)
- Shortly thereafter, convert the nondeduction contribution from the traditional IRA to the ROTH IRA:
 - No defined time; first year is the safest, many wait one statement (a month)
- Tax is on any appreciation, which is should be minimal

Federal Estate, Gift, and GST Rules

Per Person	2015
Estate, Gift, and GST Tax Exemption Amount*	\$5,430,000
Gift Tax Annual Exclusion Amount (per donee)	\$14,000
Highest Estate, Gift, and GST Tax Rate	40%
Portability of Spouse's Unused Estate Tax Exemption**	Yes
Unlimited Basis Step-Up (down)	Yes
** If used, not indexed for inflation after first death.	
Wisconsin repealed its estate tax as of 1/1/08. No gift tax imposed either.	

Portability

- Purpose of law: Permit use of both spouse's exemptions even when their plan (or lack of one) would not result in it.
- Federal estate tax exemption now “portable.”
- Surviving spouse may use most recently-deceased spouse's unused exemption (DSUE) amount at second death.
- Deceased spouse's unused exemption amount NOT indexed for inflation.
- Requires the deceased spouse's estate to timely file a federal estate tax return even if the estate <\$5.43 million (for 2015).

Lifetime Gifting Strategies

- Annual exclusions (use it or lose it)
- Present interest requirement
- 529 plan contributions - Prefund five years at once
- Marital deduction - Unlimited to U.S. citizen spouses
- Certain direct payments on behalf of donee not considered a gift:
 - Tuition and medical exclusions:
 - Unlimited
 - No relation required
 - Use it or lose it
 - Must be DIRECT payment

Topics Covered

1. IRS and Congress
2. Partnership Audit Reform
3. Recent Partnership Developments
4. IRS Correspondence
5. What's New/Other Planning
- 6. Taxation of Carried Interests**
7. F Reorganizations
8. Mixing Bowl Transactions
9. State and Local Tax Update

Taxation of Carried Interest

Background

- Terminology: “Carried interest” also referred to as “profits interest,” “promote,” the “sponsor’s share,” or the “back-end piece.”

Taxation of Carried Interest

Receipt of Profits Interest

Rev. Proc. 93-27, 1993-2 C.B. 343, defines two types of partnership interests, as determined at time of issuance:

- *Capital Interest:* Partnership interest that would entitle the holder to a share of liquidation proceeds if partnership assets were sold at FMV.
- *Profits Interest:* Any partnership interest that is not a capital interest; generally entitles holders only to a share of post-issuance partnership income and gain.

Taxation of Carried Interest

Example of Profits Interest

A contributes \$1,000,000 for 80% interest

B contributes \$0 for 20% profits only interest

Asset sold for \$1,000,000

A receives \$1,000,000

B receives \$0

Asset sold for \$2,000,000

A receives \$1,800,000

B receives \$200,000

Taxation of Carried Interest

Receipt of Profits Interest - Current Law

The IRS will accept that the receipt of a profits interest in exchange for services is not a taxable event for the partnership or the recipient, if:

- The interest isn't related to a substantially certain and predictable stream of income from partnership assets
- The interest is not disposed of within two years
- The interest is not a limited partnership interest in a publicly traded partnership

Taxation of Carried Interest

Unvested Profit Interest

- Rev. Proc. 2001-43, 2001-2 C.B. 191
- If a partnership grants an unvested profits interest, the service provider will not be taxed on receipt or vesting if:
 - Conditions of Rev. Proc. 93-27 are met
 - Partnership and service provider treat service provider as tax owner of the interest and service provider reports its distributive share of partnership tax items for tax purposes
 - Upon grant or vesting of the interest, neither partnership nor any partner takes deductions based on the profits interest at grant or vesting

Taxation of Carried Interest

Carried Interest - The Legislative Timeline

2007: Introduction

Legislation introduced by Rep. Sander Levin (D-MI)

Hearings held in House and Senate

Passed the House as an offset for temporary tax extenders

2008: Passed by the House

Passed the House as an offset for AMT Relief

Senate declined to consider legislation

2009: Passed by the House

Passed the House as an offset for temporary tax extenders

Senate held off consideration for larger tax reform debate

2010: Passed by the House

Passed the House as part of “the American Jobs and Closing Tax Loopholes Act of 2010”

Senate unable to move legislation forward (by three votes)

Taxation of Carried Interest

Carried Interest - The Legislative Timeline (Continued)

2011: Proposal made by Obama Administration

2012: Proposal made by Obama Administration

2014: Congressman Levin re-introduces Act to House

2015: Levin introduces “Carried Interest Fairness Act of 2015”

Taxation of Carried Interest

Carried Interest Fairness Act of 2015

- Values capital interests using the liquidation method unless elect otherwise.
- Adds a new IRC §710 that recharacterizes allocated capital gain as ordinary income for an investment services partnership interest.
- The valuation provision would be effective for interests transferred after the date of enactment.
IRC §710 effective for all tax years ending after the date of enactment.

Taxation of Carried Interest

Recharacterization Rule

- Capital gain treated as ordinary income
- Capital loss recharacterized as ordinary loss to the extent of prior recharacterized gain
- Dividend income not treated as qualified dividend income
- Gain on disposition of interest treated as ordinary income
- Loses taint if gift or die, but transferor must recognize all inherent gain as ordinary income

Taxation of Carried Interest

What is Investment Services Partnership Interest?

- An interest in an “investment partnership” acquired in connection with a specific trade or business.
- Specific trades or businesses:
 - A. Advising as to the advisability of investing in, purchasing, or selling any specified asset
 - B. Managing, acquiring, or disposing of any specified asset
 - C. Arranging financing with respect to acquiring specified assets
 - D. Any activity in support of any service described in subparagraphs (A) through (C)

Taxation of Carried Interest

Investment Partnership

- Substantially all of the assets (ignoring goodwill) are “specified assets” meaning securities, rental or investment real estate, partnership interests, commodities, cash, options or derivative contracts with respect to such assets.
- Less than 75% of the capital of the partnership is attributable to qualified capital interests which constitute property held in connection with a trade or business of the owner.
- This language would not apply to profits interest issued by a regular active business.

Taxation of Carried Interest

Exception for Certain Capital Interests

- Recharacterization rule does not apply if the partnership interest is a qualified capital interest.
- Must have allocations similar to other capital interests.
- Interest is not a qualified capital interest to the extent interest is acquired in connection with a loan from or guaranteed by partnership or another partner.

Taxation of Carried Interest

Planning Ideas

- Junior stock in C corporation
- Highly leveraged partnership
- Compensation plan conditionally grossed up if deduction is used

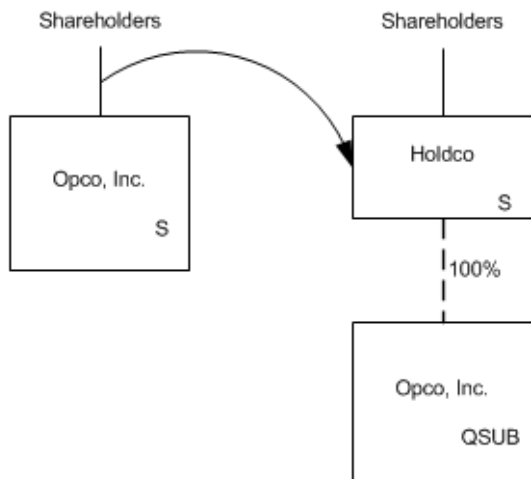
Topics Covered

1. IRS and Congress
2. Partnership Audit Reform
3. Recent Partnership Developments
4. IRS Correspondence
5. What's New/Other Planning
6. Taxation of Carried Interests
- 7. F Reorganizations**
8. Mixing Bowl Transactions
9. State and Local Tax Update

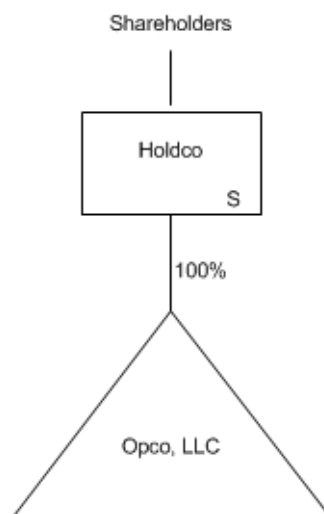
F Organizations

Illustration of F Reorganization

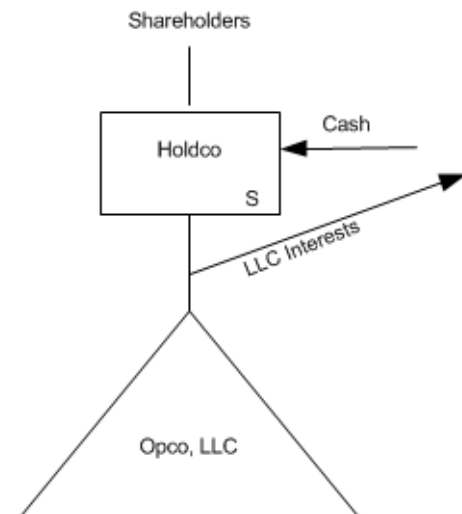
1. Shareholders transfer Opco, Inc. Stock to New Holding Company



2. Convert Opco, Inc. to LLC



3. Holdco sells LLC Interests to Buyer



F Organizations

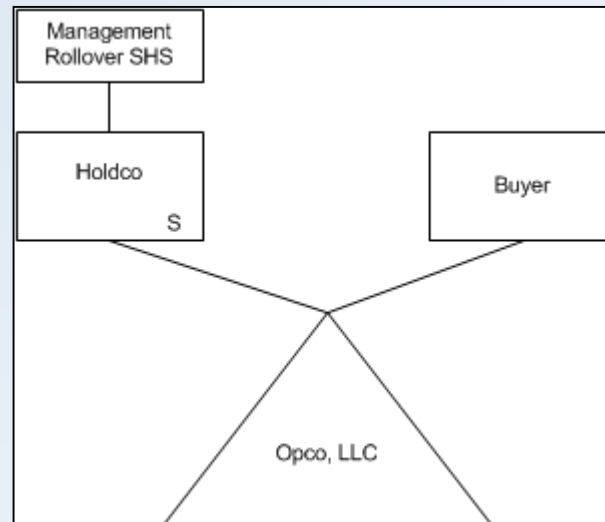
Benefits Over §338(h)(10) Election

- Allows deferral of gain in rollover equity
- Allows greater use of installment sale method
- Allows seller to obtain deduction for deferred compensation payments
- Buyers generally prefer F reorganizations to IRC § 338(h)(10) or 336(e) elections because buyer does not lose basis step-up if the S election is invalid

F Organizations

F Reorganization - After the Deal

- 704(c) issues and relationship to tax distributions
- If Management not a direct owner of Opco, LLC, no self-employment tax and management receives a W-2



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Mixing Bowl Transactions

Overview of Mixing Bowl Rules

- If appreciated or depreciated property is distributed to a member of the LLC other than the contributing member within seven years of the contribution, treated as a sale of the property from the contributor to the distributee (IRC §704(c)(1)(B)).
- If appreciated property is contributed to an LLC, distribution to contributing member within seven years may trigger gain recognition (IRC §737).

Mixing Bowl Transactions

Section 704(c)(1)(B)

<u>A</u>	<u>B</u>	<u>C</u>
<u>Blackacre</u>	<u>Equipment</u>	<u>Cash</u>
20 Basis	40 Basis	100
100 Value	100 Value	

If partnership distributes Blackacre to “C” in first seven years, “A” recognizes up to \$80 of gain.

Mixing Bowl Transactions

Section 737

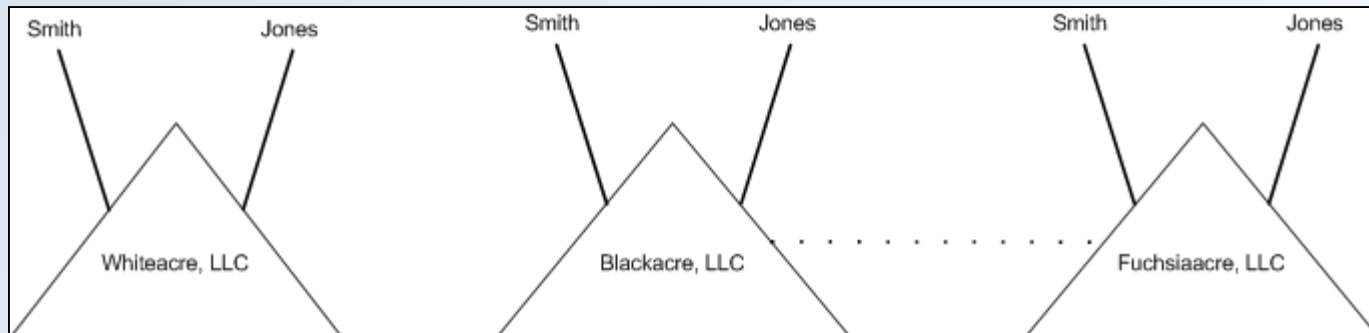
<u>A</u>	<u>B</u>	<u>C</u>
<u>Blackacre</u>	<u>Equipment</u>	<u>Cash</u>
20 Basis	40 Basis	100
100 Value	100 Value	

If partnership distributes equipment to “A” in first seven years, “A” recognizes gain.

Mixing Bowl Transactions

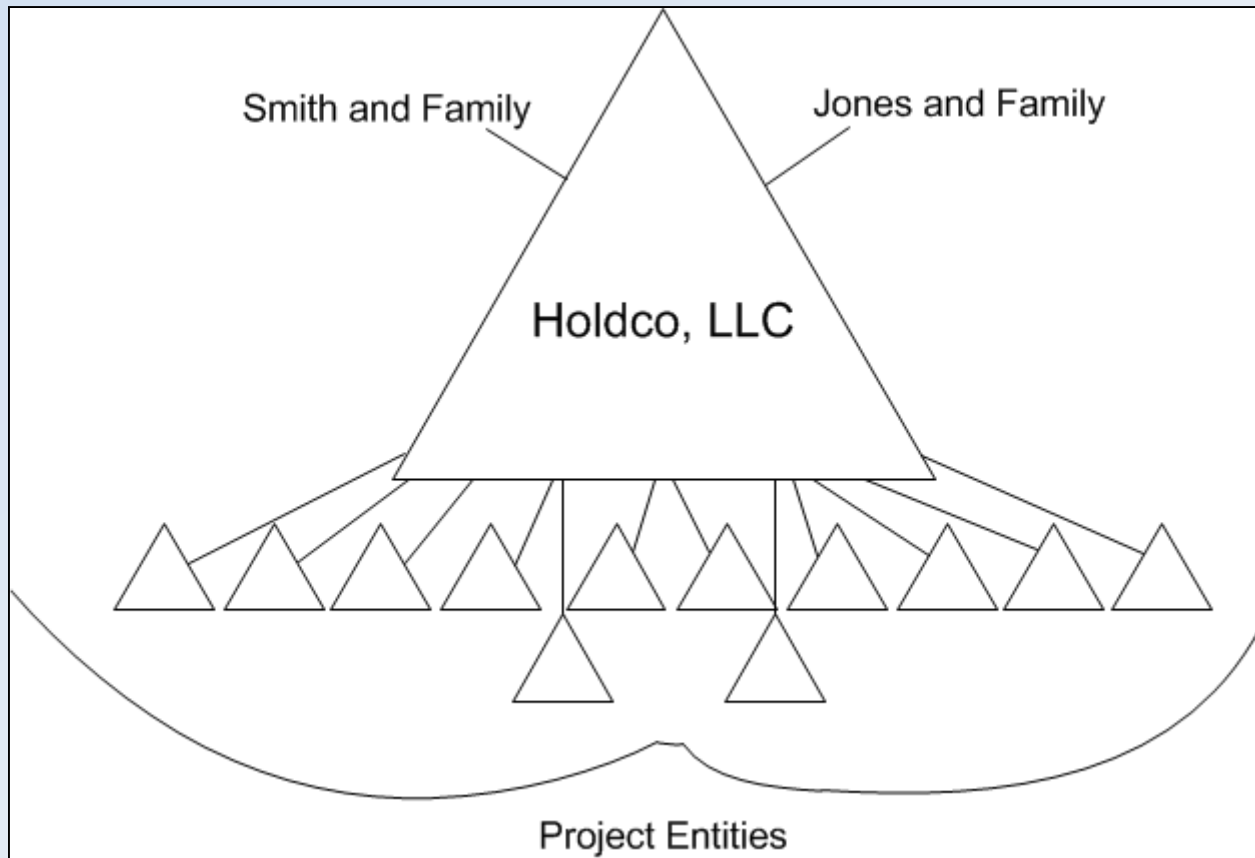
The Problem

- Smith and Jones want a tax-free breakup
- Have operated for long-time so a lot of built-in gain
- Amicable situation



Mixing Bowl Transactions

The Solution - Formation of Mixing Bowl



Mixing Bowl Transactions

Mixing Bowl Issues to Consider

- Treatment of minority partners
- How do you divide properties?
- Need to value every property going in if disparate ownership
- Technical termination?
- Gain from liability shifts?

Mixing Bowl Transactions

What if Parties Can't Wait Seven Years?

- Special allocation at subsidiary level
- Identical ownership exception (Prop. Reg. §1.704-4(c)(4)(ii)(E) and Prop. Reg. §1.737-2(b)(1)(ii)(E))

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State and Local Tax Update - Wisconsin

Job Creation Deduction Sunset

- Effective for taxable years beginning on or after January 1, 2015.
- The subtraction from income based on the increase in the number of full-time employees may not be claimed for taxable years beginning on or after January 1, 2015.

State and Local Tax Update - Wisconsin

Research Credit Limited

The following research credits may not be computed for taxable years beginning after December 31, 2014:

- The 5 percent credit for increasing research expenses,
- The 10 percent credit for research related to designing internal combustion engines for vehicles, and
- The 10 percent credit for research related to the design and manufacturing of energy efficient lighting systems, building automation and control systems, or automotive batteries for use in hybrid-electric vehicles, that reduce the demand for natural gas or electricity or improve the efficiency of its use.

The election to use a different computation method to calculate the research credits listed above is limited to taxable years beginning prior to January 1, 2015.

State and Local Tax Update - Wisconsin

Research Credit Amended

For taxable years beginning after December 31, 2014, an individual, a partner of a partnership, a shareholder of a tax-option corporation, a member of a limited liability company, and any corporation, may compute research credits.

State and Local Tax Update - Wisconsin

Research Credit for Increasing Research

- The credit is equal to 5.75% of the amount by which the claimant's qualified research expenses for the taxable year exceed 50% of the average qualified research expenses for the three taxable years immediately preceding the taxable year for which the claimant claims the credit.
- If the claimant had no qualified research expenses in any of the three taxable years immediately preceding the taxable year for which the claimant claims the credit, the claimant may claim an amount equal to 2.875% of the qualified research expenses for the taxable year for which the credit is claimed.

State and Local Tax Update - Wisconsin

Research Credit For Activities Related to Internal Combustion Engines

- The credit is equal to 11.5% of the amount by which the claimant's qualified research expenses for the taxable year exceed 50% of the average qualified research expenses for the three taxable years immediately preceding the taxable year for which the claimant claims the credit.
- If the claimant had no qualified research expenses in any of the three taxable years immediately preceding the taxable year for which the claimant claims the credit, the claimant may claim an amount equal to 5.75% of the qualified research expenses for the taxable year for which the credit is claimed.

State and Local Tax Update - Wisconsin

Research Credit For Activities Related to Certain Energy-Efficient Products

- The credit is equal to 11.5% of the amount by which the claimant's qualified research expenses for the taxable year exceed 50% of the average qualified research expenses for the three taxable years immediately preceding the taxable year for which the claimant claims the credit.
- If the claimant had no qualified research expenses in any of the three taxable years immediately preceding the taxable year for which the claimant claims the credit, the claimant may claim an amount equal to 5.75% of the qualified research expenses for the taxable year for which the credit is claimed.

State and Local Tax Update - Wisconsin

Manufacturing and Agriculture Credit Revised

Effective for taxable years beginning on January 1, 2013, the definition of "direct costs" and "indirect costs" were amended.

- "Direct costs" includes all of the claimant's ordinary and necessary expenses paid or incurred during the taxable year in carrying on the trade or business that are deductible as business expenses under the IRC and identified as direct costs in the claimant's managerial or cost accounting records.

State and Local Tax Update - Wisconsin

Manufacturing and Agriculture Credit Revised

(Continued)

- "Indirect costs" includes all of the claimant's ordinary and necessary expenses paid or incurred during the taxable year in carrying on the trade or business that are deductible as business expenses under the IRC, other than cost of goods sold and direct costs, and identified as indirect costs in the claimant's managerial or cost accounting records.

State and Local Tax Update - Wisconsin

Manufacturing and Agriculture Credit Revised

(Continued)

Effective for taxable years beginning on January 1, 2013, a claimant who the department approves to be classified as a manufacturer for purposes of s. 70.995, Wis. Stats., but who is not eligible to be listed on the department's manufacturing roll until January 1 of the following year, may claim the credit in the year in which the manufacturing classification is approved.

For taxable years beginning after December 31, 2014, and before January 1, 2016, the rate of credit is reduced to 5.025% from 5.526%.

State and Local Tax Update - Wisconsin

Business Development Credit Created

The business development tax credit is a refundable credit effective for taxable years beginning on or after January 1, 2016 equal to all of the following, as determined by WEDC:

1. The amount of wages the claimant paid to an eligible employee in the taxable year, not to exceed 10% of such wages.
2. In addition to any amount claimed for an eligible employee under 1 above, the amount of wages that the claimant paid to the eligible employee in the taxable year, not to exceed 5% of such wages, if the eligible employee is employed in an economically distressed area.

State and Local Tax Update - Wisconsin

Business Development Credit Created (Continued)

3. An amount equal to up to 50% of the claimant's training costs incurred to undertake activities to enhance an eligible employee's general knowledge, employability, and flexibility in the workplace; to develop skills unique to the claimant's workplace or equipment; or to develop skills that will increase the quality of the claimant's product.

State and Local Tax Update - Wisconsin

Business Development Credit Created (Continued)

4. The amount of the personal property investment, not to exceed 3% of such investment, and the amount of the real property investment, not to exceed 5% of such investment, in a capital investment project that involves a total capital investment of at least \$1,000,000 or, if less than \$1,000,000, involves a capital investment equal to at least \$10,000 per eligible employee employed on the project.

State and Local Tax Update - Wisconsin

Business Development Credit Created (Continued)

5. An amount equal to a percentage of the amount of wages that the claimant paid to an eligible employee in the taxable year if the position in which the eligible employee was employed was created or retained in connection with the claimant's location or retention of the claimant's corporate headquarters in Wisconsin and the job duties associated with the eligible employee's position involve the performance of corporate headquarters functions.

State and Local Tax Update - Wisconsin

Audit Summary

Department reorganization of auditors – will be focused on only one tax type for future audits.

Department auditors do not disclose when issues are gray and make everything appear black and white.

Best practice to handle audits:

- Preliminary discussion before audit starts with external state tax professional
- Manage audit progress internally seeking advice as needed
- External review of proposed report

Speakers and Contact Information

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