

A man in a dark suit and white shirt is seen from behind, looking out over a sprawling city skyline at night. The city is illuminated with warm yellow and orange lights, contrasting with the cool blue tones of the sky and the window panes. The man's hands are raised in front of him, palms facing forward, as if he is gesturing or presenting. The background is a dense urban landscape with numerous skyscrapers and buildings, some of which are brightly lit. The overall atmosphere is professional and forward-looking.

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## Federal Tax Case Law Update

Bill Smith

Managing Director

CBIZ MHM National Tax Office

September 28, 2017

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*Bill Smith is a managing director in the CBIZ National Tax Office. Bill monitors federal tax legislation and consults nationally on a broad range of foreign and domestic tax services for businesses and individuals. He is frequently sought after by a myriad of media outlets to comment on the changing tax environment and its effects on companies and individuals. He has authored numerous tax articles, edits the CBIZ MHM InTouch newsletter and federal Tax Alerts, and lectures on a broad range of tax topics across the country.*

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# JUDICIAL UPDATE



## *Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner, 149 T.C. No. 3*

- Foreign company invested in US partnership, and redeemed its interest at a profit
- Parties agreed that portion attributable to real estate was US sourced income under FIRPTA
- The Code provides for U.S. taxation of the income of a foreign corporation if under section 882 the income of a “foreign corporation engaged in trade or business within the United States during the taxable year” is “effectively connected with the conduct of” that trade or business.
- Redemption of partnership interest treated as sale or exchange of a capital asset
- TP argued sale of intangible (personal property) – the partnership interest – so no tax
- IRS used “aggregate” approach and claimed income was taxable as the sale of separate interests in each asset owned by the partnership
- *Held:* Gain is not US sourced and no “US office” exception applied.



## Hardy v. Commissioner, T.C. Memo. 2017-16

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- Previously reported on *Renkemeyer, Campbell & Weaver v. Commissioner*, in which law firm partners were held liable to pay self employment tax on 100% of their distributive share of LLC profits.
- Section 1402(a)(3) exempts limited partner income (other than for services to the partnership) from self employment tax as limited partner is considered an investor
- *Renkemeyer* held that revenue was derived from legal services performed by partners in their capacity as partners, they were not acting as investors
- Dr. Hardy was an investor in MBJ, LLC surgical center. He and other doctors performed surgeries there. He did not manage MBJ. He was paid separately for his surgical fees, and MBJ charged clients for the use of the facility, similar to a hospital.
- Held: Dr. Hardy received his MBJ income in his capacity as an investor so amounts not subject to self employment tax.



## Scott Singer Installations, Inc. v. Commissioner, T.C. Memo 2016-161

- Singer was sole shareholder and officer of S corporation
- S corporation reported all of Singer's advances as loans from shareholder on its general ledgers and Forms 1120S
  - no promissory notes between Singer and S corporation,
  - no interest charged, and
  - no maturity dates imposed.
- Singer advanced a total of \$646,443 to S corporation between 2006 and 2008. He financed S corporation's operations from 2009 through 2011 by borrowing an additional \$513,099 from his mother.
- Business not profitable 2009 – 2011
- Business paid Singer's personal expenses and treated as repayment of shareholder loans





## Scott Singer Installations, Inc. v. Commissioner, T.C. Memo 2016-161

- IRS assessed S corporation for failure to withhold employment taxes on Singer's distributions because they should have been treated as wages
- Court considered list of factors in determining loan vs. capital contribution and added "Transfers to closely held corporations by controlling shareholders are subject to heightened scrutiny, and the labels attached to such transfers by the controlling shareholder through bookkeeping entries or testimony have limited significance unless these labels are supported by other objective evidence."
- Court held that consistent treatment indicated intent to create debtor-creditor relationship
- Reasonable expectation of repayment sufficient in early profitable years, but insufficient after 2008



## *Seaview Trading, LLC v. Commissioner*, (9<sup>th</sup> Cir. June 7, 2017)

- IRS did not finish the audit of an LLC (treated as a partnership) before the statute of limitations on one of the LLC's members (partners) expired.
- Ordinarily, in such case, the partner would not be subject to tax as a result of any adjustment flowing from the partnership audit.
- However, unless an exception applies, TEFRA extends the statute of limitations of the partners with respect to their partnership items (such as their allocable shares of the partnership's income, gain, loss, deduction and credits) until the close of the partnership's statute of limitations.
- The taxpayer claimed that it qualified for the so-called "small partnership" exception to TEFRA because it had less than 10 members (partners)
- The IRS pointed to the "pass-thru" partner rule -- the small partnership exception does not apply to a partnership if any of its partners is a "pass-thru" partner, such as a partnership, estate, trust, S corporation, nominee or *another similar person* through whom other persons hold an interest in the partnership.



## *Seaview Trading, LLC v. Commissioner*, (9<sup>th</sup> Cir. June 7, 2017)

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- Since TEFRA was passed in 1982, well before the concept of a "disregarded entity" was adopted through tax regulations in 1997, there has been a certain level of ambiguity regarding whether a disregarded entity, such as a single-member LLC, counted as a pass-thru partner despite IRS published stance to the affirmative.
- This Ninth Circuit case wipes away any doubt that previously may have existed on this question.



## *IRS Nonacquiesces in Stein and Shea Homes*

- *Stine, LLC v. U.S.*, 2015-1 U.S.T.C. ¶150,172 (W.D. La. 2015): Two buildings designed to be retail stores were placed in service when the buildings were substantially complete. Buildings were ready and available for their intended use – to store and house equipment, racks, shelving and merchandise. Certificate of Occupancy had been issued, but it limited occupancy and did not allow customers. The court rejected the government’s argument that the buildings were not placed in service until they were open to the public for business.
- *Shea Homes, Inc. v. Commr*, 2016-2 USTC ¶150,391 (CA-9): Under the completed contract method of accounting, a home construction contract was completed when it incurred 95 percent of the estimated cost of constructing an entire development, not the individual houses and lots. The IRS argued that the taxpayers applied the 95-percent test incorrectly because the subject matter of the contract didn’t include the other houses in the community; the 95-percent test was met when the taxpayers incurred 95 percent of the budgeted costs of the contracted-for house, lot and common amenities, but not the costs of the other houses.



## *Shea Homes, Inc. v. Comm’r*, 142 T.C. 3, aff’d Aug. 24 by 9<sup>th</sup> Cir.

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- In EOW for 1<sup>st</sup> Quarter 2014 we reported on the Shea Homes case, which was affirmed by the 9<sup>th</sup> Cir. On August 24
- Developer of planned residential communities purchased land, constructed infrastructure and amenities as common improvements, and constructed homes.
- Developer marketed the community and the life-style of the development, not just the individual home itself.
- Before the buyer and seller closed on a home, the seller was required to construct all common improvements or post a performance bond.



## *Shea Homes, Inc. v. Comm'r*, 142 T.C. 3, aff'd Aug. 24 by 9<sup>th</sup> Cir.

### Internal Revenue Code § 460

- The CCM is available for home construction contracts.
  - 80 percent of the estimated total contract costs will be attributable to dwelling units and to real property improvements related to and on the site of the dwelling units.
  - Includes the cost of the dwelling units the allocable share of costs for common improvements (sewers, roads, clubhouses) that benefit the units and that the taxpayer is obligated to construct.
- A long-term contract is a contract to build, install or construct property that will not be completed in its initial tax year.
- A contract is completed upon the customer's use of the "subject matter of the contract" and at least 95 percent of the costs of the contract's subject matter have been incurred.



## *Shea Homes, Inc. v. Comm’r*, 142 T.C. 3, aff’d Aug. 24 by 9<sup>th</sup> Cir.

- Taxpayer: the subject matter of the contracts was the entire development, and that completion did not occur until the final road is paved and the final performance bond is released.
- IRS : each contract was completed when the home escrow closed, and common improvements to the developments were secondary items and that these costs should not be counted in applying the 95 percent threshold.
- Tax Court: the subject matter of the contract was the entire development, and the developer was obligated to provide amenities and infrastructure as part of the contract. The Court considered:
  - The lifestyle advertised for the developments
  - The amounts budgeted and incurred for indirect costs
  - The performance bonds securing completion of the common improvements
  - The obligations imposed by the CC&Rs (Covenants, Conditions and Restrictions)
  - Homeowners’ Association rules



## *Shea Homes, Inc. v. Comm’r*, 142 T.C. 3, aff’d Aug. 24 by 9<sup>th</sup> Cir.

- 9<sup>th</sup> Cir.:
  - The IRS “took the very crabbed view that the subject matter was limited to the house and the lot.” “We suspect that the Commissioner was satisfied that his position on those points would win the day and, therefore, that he need not concentrate his firepower on the overall planned community development aspect of the contracts. The resulting outcome was due to his misperception rather than a Tax Court mistake.”
- Caution
  - Very fact specific case where the court conducted extensive analysis of the contract laws of numerous states.
  - Based in part on the lack of clarity in the regulations, and similar cases are currently working their way through the system.
  - Treasury has indicated that it may change the regulations





## *RERI Holdings I, LLC v. Commr*, 149 T.C. No. 1

- The taxpayer, a limited liability company (LLC), acquired real property in 2002. The taxpayer paid approximately \$3 million for the property. In 2003, the taxpayer assigned the property to a university.
- The taxpayer claimed a charitable contribution deduction of about \$33 million for its assignment, 17 month after its purchase.
- The taxpayer's appraisal summary showed that it acquired the property by purchase in 2002 but it showed no amount for the donor's cost or other adjusted basis.
- The court found this omission prevented the appraisal summary from achieving its intended purpose. "The significant disparity between the claimed fair market value and the price the taxpayer paid to acquire the property just 17 months before the assignment, had it been disclosed, would have alerted the IRS to a potential overvaluation of the property." The taxpayer's failure could not be excused by substantial compliance. Because the donor did not satisfy the substantiation requirements, the court concluded that the donor was not entitled to any deduction.

## Izen v. Commissioner, 148 T.C. No. 3

- Taxpayer donated a 50% interest in 1969 model Hawker-Siddeley DH125-400A private jet to the Houston Aeronautical Heritage Society (a 501(c)(3) organization).





## *Izen v. Commissioner, 148 T.C. No. 3*

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- On April 14, 2016, petitioner filed an Amended Tax Return, for 2010. On this return he claimed for the first time a deduction of \$338,080 for his alleged contribution to the Society of a 50% interest in the aircraft. Petitioner included with this amended return:
  - an acknowledgment letter addressed to Philippe Tanguy, dated December 30, 2010, and signed by Drew Coats as president of the Society;
  - a Form 8283 executed by Amy Rogers, managing director of the Society, and dated April 13, 2016;
  - a copy of an “Aircraft Donation Agreement” allegedly executed on December 31, 2010, by Drew Coats as president of the Society but bearing no other signatures; and
  - an appraisal by Winston McKenzie dated April 7, 2011, opining that the fair market value of petitioner's 50% interest in the aircraft, as of December 30, 2010, was \$338,080.



## *Izen v. Commissioner*, 148 T.C. No. 3

- IRS would “not process petitioner's amended 2010 tax return.”
- The requirement that a CWA be obtained for charitable contributions described in section 170(f)(8) and (12) is a strict one. In the absence of a CWA meeting the statute's demands, “no deduction shall be allowed.”
- The court found that none of the documents provided by taxpayer satisfied the strict requirements of section 170(f) and refused Petitioner's request that it “read together” multiple documents, which would have been more compelling if the Society had filed (as section 170(f)(12)(D) required) a Form 1098-C that timely supplied the IRS with petitioner's TIN and the other information specified in paragraph (12)(B).
- The doctrine of “substantial compliance” does not excuse strict substantiation.



## ***15 W. 17th St. LLC v. Commissioner, 147 T.C. No. 19***

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- On December 20, 2007, the 15 W. 17th St. LLC (“LLC”) executed a historic preservation deed of easement in favor of the Trust for Architectural Easements (“Trust”).
- On May 14, 2008, the Trust sent the LLC a letter acknowledging receipt of the easement. This letter did not state whether the Trust had provided any goods or services to the LLC, or whether the Trust had otherwise given the LLC anything of value, in exchange for the easement.
- The LLC secured an appraisal concluding that, as of February 8, 2008, the property had a fair market value of \$69,230,000 before placement of the easement. Opining that the property was worth only \$4,740,000 after the donation, the appraisal concluded that the easement had reduced the property's value by \$64,490,000.



## 15 W. 17th St. LLC v. Commissioner, 147 T.C. No. 19

- The LLC included with its return a copy of the appraisal report, a copy of the Trust's May 14, 2008, letter, and Form 8283, Noncash Charitable Contributions, executed by the appraiser and by a representative of the Trust.
- Section 170(f)(8)(A) provides: “No deduction shall be allowed \* \* \* for any contribution of \$250 or more unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgment of the contribution by the donee organization that meets the requirements of subparagraph (B).”
- The requirement that a CWA be obtained for charitable contributions of \$250 or more is a strict one. In the absence of a CWA meeting the statute's demands, “[n]o deduction shall be allowed.”

- The Tax Court improperly held that the parent of a closely held manufacturing group's payments to a Domestic International Sales Corporation (DISC) were not commissions and that the dividends the DISC paid to its Roth IRA shareholders were excess contributions.
- The parent used the DISC and Roth IRAs for their congressionally sanctioned tax-minimizing purposes.
- There was no basis for recharacterizing the transactions or the law's application to them.
- Moreover, while the IRS's claim that the purpose of the transaction was to funnel money into the Roth IRAs without triggering the contribution limits was true, the substance-over-form doctrine did not authorize the IRS to undo a transaction just because taxpayers undertook it to reduce their tax bills.



## *McGaugh v. Commissioner*, 2017-2 U.S.T.C. ¶150,272 (7<sup>th</sup> Cir.)

- The taxpayer directed a wire transfer of cash from his individual retirement account (IRA) at Merrill Lynch (ML) to a corporation to purchase its shares and remit them to the IRA custodian.
- ML, as IRA custodian, had refused to purchase the stock
- When ML received the stock, it treated wire transfer as taxable distribution
- IRS asserted that McGaugh took a distribution because he constructively received the IRA proceeds
- *Court*: “McGaugh didn't direct a distribution to a third party; he bought stock. That is a prototypical, permissible IRA transaction.”
- The taxpayer was a mere "conduit" of IRA funds, without actual or constructive receipt of them, so that the 60-day rollover rule did not apply





## *May v. US*, 2017-1 U.S.T.C. ¶50,233 (9<sup>th</sup> Cir.)

- Code Sec. 6011 requires taxpayers to report certain transactions. Failure to do so can result in a penalty assessment under Code Sec. 6707A.
- Code Sec. 6501(c)(10)(A) provides the IRS with one year to assess the penalty under Code Sec. 6707A, starting from either the time when the necessary information was furnished or the date that a material advisor meets the requirements of Code Sec. 6112, whichever is earlier.
- A listed transaction penalty was not time barred even though the assessment occurred more than one year after the examining agent came into possession of enough information to justify the penalty.
- In reversing the district court, the Ninth Circuit found that the limitations period does not start until a taxpayer disclosing a listed transaction does so on Form 8886, Reportable Transaction Disclosure Statement, and then properly mails it.



## *Thompson v. Commissioner, 148 T.C. No. 3*

- Section 6662A(a) imposes a penalty on any reportable transaction understatement. If a taxpayer fails to adequately disclose a reportable transaction giving rise to an understatement under section 6662A, the penalty is imposed at a rate of 30%, and there are no available defenses.
- However, if a taxpayer sufficiently discloses the details of the transaction, the penalty rate is 20% of the amount of the reportable transaction understatement.
- A taxpayer may be able to avoid the penalty under section 6662A if he or she shows reasonable cause and good faith, as well as that there is or was substantial authority for a position he or she took on a tax return, and the taxpayer reasonably believed that such treatment was more likely than not the proper treatment of the transaction in question.



## *Thompson v. Commissioner*, 148 T.C. No. 3

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- Taxpayers argued that the reportable transaction understatement penalty is unconstitutional because it violates the Excessive Fines clause of the Eighth Amendment.
- The Excessive Fines Clause limits the government's power to extract payments, whether in cash or in kind, as punishment for some offense. However, additions to tax are not meant to punish but to deter noncompliance with the tax law.
- In addition, neither a high rate of taxation nor an obvious deterrent purpose automatically marks a tax penalty as a form of punishment.
- The 30% strict liability penalty it serves as an important deterrent that alters taxpayers' cost-benefit analysis when they consider participating in reportable or listed transactions.



## Groves v. US, (D.C. III.)

- A tax shelter promoter penalty, which the IRS imposed on an individual a decade after his alleged tax shelter violations, was not barred by the three-year statute of limitations (SOL) under Code Sec. 6501.
- Code Sec. 6501 depends on filing a return to trigger the running of the limitations period but Code Sec. 6700 penalty assessments do not depend on filing a return; rather, they occur when the IRS discovers that an individual's activities are prohibited by Code Sec. 6700.
- The individual's argument that the limitations period could be triggered by the returns on which his clients allegedly understated their tax liability was rejected. The conduct prohibited by Code Sec. 6700 is not the client's filing of an inaccurate return, but a tax shelter promoter's making a statement that falsely touts the shelter's tax benefits: a tax shelter promoter can violate Code Sec. 6700 even if the client does not file a return.



## Avrahami v. Commissioner, 149 T.C. No. 7

- Taxpayers owned 3 successful jewelry stores and 6 companies that owned commercial real estate in Phoenix
- TPs were referred to captive specialist attorney in NY
- She set up captive (“Feedback”) in St. Kitts in 2007
- Feedback filed election under § 953(d) to be treated as a domestic corporation for US income tax purposes, and an election under § 831(b) to be taxed as a small insurance company
- Feedback wrote P&C policies and anti-terrorism policies with premiums totaling \$1.1 million in 2009 (\$730,00 for direct policies and \$360,00 for terrorism) and \$1.3 million in 2010 (\$810,00 for direct policies and \$360,00 for terrorism)
- Premiums were determined by an actuary
- Terrorism policies were written through a risk pool that “ceded” risk to the pool and in return accepted the same amount of risk from the pool



## Avrahami v. Commissioner, 149 T.C. No. 7

- The \$360,000 terrorism risk pool premium was 30% of its target premiums
- No claims were filed against Feedback under any direct policies in 2009 or 2010
- TPs established Belly Button LLC, putatively owned by their children, unbeknownst to the kids
- Feedback loaned Belly Button approx. \$2.3 million to purchase real estate (either directly or through TP), with commercial note terms
- Feedback had total assets of \$3.9 million on 2010 return but because of § 831(b) election it had paid no tax on premiums (only on investment income)
- **IRS:** Feedback is not an insurance company, so all premiums paid are not deductible as insurance premiums by TPs, and all “loans” are distributions that are not qualified because § 953(d) election only available to insurance companies.



## Avrahami v. Commissioner, 149 T.C. No. 7

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- **Court:**
- When the issue has come to us, we have applied and construed the Supreme Court's definition of insurance in *Le Gierse* and its four nonexclusive criteria. To be considered insurance the arrangement must:
  - involve risk-shifting;
  - involve risk-distribution;
  - involve insurance risk; and
  - meet commonly accepted notions of insurance.



## *Avrahami v. Commissioner, 149 T.C. No. 7*

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- **Court:**
- Risk-distribution
  - Because risk pool was not legitimate insurance company, the “reinsurance” of 30% of Feedback’s risk though the pool was not risk distribution
- Insurance in Commonly Accepted Sense
  - Feedback was not run in a business-like manner (e.g., “invested only in illiquid, long-term loans to related parties and failed to get regulatory approval before transferring funds to them;” dealt with claims on ad hoc basis; no claims at all before IRS audit; premiums unreasonable and set to hit target)





## *Avrahami v. Commissioner, 149 T.C. No. 7*

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- **Court:**
- Effect on Feedback
  - Parties agreed premiums not taxable in US
- Effect on TPs
  - Premiums not deductible for insurance
  - Loans were not taxable as distributions (which IRS argued were ordinary since Feedback is foreign corporation so dividends not qualified)
    - There were enough indicia of bona fide indebtedness that loans were upheld
- Penalties: Court held TPs reasonably relied on non-promoter professionals



## *Amazon.com, Inc. v. Commissioner*, 148 T.C. No. 8

- The Tax Court has once again rejected the IRS's use of a discounted cash-flow (DCF) methodology to determine a U.S. parent's determination of the value of a "buy-in payment" by a foreign subsidiary for use of pre-existing intangible assets.
- The Tax Court allowed use of the more taxpayer-favorable comparable uncontrolled transaction (CUT) method.
- The Tax Court had previously rejected the IRS's use of the DCF method in *Veritas Software Corp. v. Commr*, 133 T.C. 297 (2009).
- Both decisions, however, involved tax years prior to the release of re-tooled cost-sharing regulations, which now refer to intangible contributions as a "platform contributions."
- The court did not address whether the IRS would win in similar situations under these new regulations, which were issued in part with *Veritas* in mind.



**QUESTIONS**



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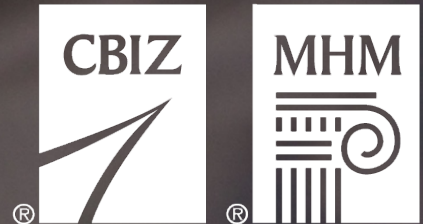
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A man in a dark suit is seen from behind, looking out over a city skyline at night. The city lights are blurred and glowing, with several bright, ethereal light trails or digital effects radiating from the center of the image. The overall atmosphere is professional and forward-looking.

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# A Guide to Successful IRS Examination Outcomes

Tom Gedelian, CPA  
The University of Akron  
2017 National Tax Conference



**What is a successful outcome?**



# A successful outcome

- › Timely
- › Cost Effective
- › Yielding acceptable results

# Notification process

- › **The taxpayer will be notified by mail**
  - › Phone calls and emails will not be used by the IRS to notify a taxpayer of an upcoming audit

# Power of Attorney (“POA”) Form 2848

- › Spouses must each file a separate Form 2848
- › Be sure to specify what year(s) and tax matter(s)
- › Make sure form is properly signed and dated

# Types of audits

- › Correspondence
- › Field
- › Office
- › Coordinated Examination Program

# Preparing from the audit

- › Review the returns
- › Gather the documents listed on the IDR
- › Reconciliation of source documents and amounts reported
- › Only provide documents which have been specifically requested on the IDR
- › Review IRS Audit Technique Guides (“ATGs”)

# Preparing from the audit

## › Tips

- › Identify possible issues (goal is no surprises)
- › Review all documents
- › Organize
- › Make it as easy as possible for the agent
- › Respond quickly to follow up questions and document request
- › Have additional substantiation ready
- › Prepare client for interview

# Tips for Interaction with examiner

- › Be professional and friendly
- › Build rapport
- › Impress them with your knowledge of the client and the issues
- › Appear to make their job easier
- › Provide comfortable and private work space
- › Try to accommodate their schedule
- › Don't give unrestricted access to records
- › Keep track of all documents provided to examiner
- › Always be present when agent is talking to client
- › Use caution regarding other tax years or other related returns

# Handling technical issues

- › **Responses should include the following:**
  - › Statement of facts
  - › Summary of the law relating to issues
  - › Analysis of facts and law
  - › Conclusion based upon the analysis



# Agreed Cases

- › Agreement form is signed
- › “No change”

# Unagreed Cases: Next steps

- › Meeting with the examiner's supervisor
- › Meeting with an Appeals Officer
- › 30-day letter
- › 90-day letter
- › Court

# Taxpayer Penalties

- › Substantial Understatement Penalty
- › Fraud penalty
- › Relief from Substantial Understatement Penalty

# Return preparer penalties

- › Understatement from an undisclosed position with no substantial authority
- › Understatement from willful conduct or reckless disregard of rules and regulations
- › Fraudulent statements



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A man in a dark suit and white shirt is seen from behind, looking out of a large window at a sprawling city skyline at night. The city lights are vibrant, with many buildings illuminated in yellow and white, and some in red and blue. The sky is a deep blue. The man's hands are raised in front of him, palms facing forward, as if he is gesturing or presenting. The overall scene is professional and modern.

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# 2017 National Tax Conference

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2017 MID-YEAR ACCOUNTING AND TAX UPDATE

# Federal Tax Aspects of Manufacturing and Distribution





# Today's Discussion Topics

- Potential Impacts of Tax Reform
  - Rate Change Impacts
  - Which provisions survive
  - Territorial System
- R&D Tax Credit
- Sec 199
- IC DISC
- Accounting Methods





## Tax Reform - Impact of Rate Change

- Rate change - 25%, 15%???
- Impact on tax timing differences - real, permanent cash savings
- Impact on financial statements - all deferred tax assets and liabilities get revalued as of effective date to new rates. Change run through income tax expense on income statement



# Tax Reform - Which Provisions Survive?

- R&D tax credit
- Section 199
- IC-DISC's
- LIFO



# Tax Reform - Switch to Territorial System?

- One time tax on unrepatriated earnings - at what rate?
- Impact on structuring - no more need to structure for deferral of income
- Increased emphasis on transfer pricing

# Research Tax Credit

- The PATH Act permanently extended the Section 41 research tax credit.
- The incremental research credit may be claimed for increases in business-related qualified research expenditures and for increases in payments to universities and other qualified organizations for basic research.
- The credit applies to excess of qualified research expenditures (QREs) for the tax year over 50% of the average annual qualified research expenditures measured over the three preceding years.



# R&D Tax Credit

## Qualified Activities

### Qualified Research

- Permitted Purpose Test - attempt to develop or improve the functionality, performance, reliability, or quality of a “business component”
- A “business component” is a product, process, software, technique, invention, or formula which is to be either (1) held for sale, lease, or license, or (2) used by the company in one of its trades or businesses
- Process of Experimentation Test - 80% or more of the activities must comprise a process of experimentation, i.e., a process designed to evaluate one or more alternatives to achieve a result where both:
  - Technological in Nature Test - that process fundamentally relies on the principles of engineering or the physical, biological, or computer sciences; and
  - Uncertainty Test - the capability or the method of achieving that result, or the appropriate design of that result, is uncertain at the activities’ outset



# R&D Tax Credit

## Qualified Costs

### Qualified Research Expenses (“QREs”)

- **Wages:** taxable—W-2, box 1—wages of employees who perform or directly supervise or directly support Qualified Research (“Qualified Services”)
  - Stock options subject to withholding qualify
- **Supplies:** costs for tangible, personal property, not of a character subject to the allowance for depreciation, used in qualified research
- **Contractor Research Expenses:** 65%, 75%, or 100% of payments to contractors for Qualified Services, depending on the nature and activity of the contractor, and provided the payments were not contingent on the activity’s success and the taxpayer retained substantial rights to the research’s results
- **Computer rents/leases.** Computer can’t be owned by company or on company’s premises

# R&D Tax Credit

## Path Act - Enhancements

- Made the R&D tax credit permanent (effective immediately)
- For taxable years beginning after December 31, 2015:
  - Allows Eligible Small Businesses to utilize the credit against AMT, and
  - Allows Qualified Small Businesses to utilize the credit against Employer Payroll tax
- AMT Offset - Eligible Small Business means, with respect to any taxable year -
  - (i) a corporation the stock of which is not publicly traded, a partnership, or a sole proprietorship,
  - (ii) if the average annual gross receipts of such corporation, partnership, or sole proprietorship for the 3-taxable-year period preceding such taxable year does not exceed \$50,000,000.

# Recent Developments

## Path Act - Qualified Small Businesses

- Qualified Small Business are corporations, partnerships, or persons
  - (i) not exempt from income tax under IRC section 501;
  - (ii) with gross receipts in the taxable year of less than \$5 million; and
  - (iii) with no gross receipts prior to the five taxable years ending in the taxable year
- Ability to claim credits (up to \$250,000) as a payroll tax credit against employer's portion of payroll taxes
  - Can only be made for 5 years
- All members of the same controlled group treated as a single taxpayer
  - Each member may separately elect the payroll tax credit but not in excess of its allocated amount





## Claiming the Section 199 Domestic Production Activities Deduction

Businesses taxpayers can claim a deduction under Code Section 199 if they have income from domestic manufacturing and other domestic production activities.

The Code Sec. 199 deduction equals 9% of the smaller of:

- (a) the taxpayer's "qualified production activities income" (QPAI) for the tax year, or
- (b) the taxpayer's taxable income, without regard to the Code Sec. 199 deduction, for the tax year.

The Code Section 199 deduction can't exceed 50% of the W-2 wages paid by the taxpayer for the tax year.

# Claiming the Section 199 Domestic Production Activities Deduction - continued

Qualified production activities eligible for the deduction include:

- Manufacture, production, growth or extraction of qualifying production property (*i.e.*, tangible personal property such as clothing, goods, or food as well as computer software or music recordings) by a taxpayer either in whole or in significant part within the U.S.
- Film production (other than production of certain sexually explicit films) if at least 50% of the total compensation relating to the production is for services performed in the U.S. by actors, production personnel, directors, and producers.
- Production of electricity, natural gas, or water in the U.S.

# Claiming the Section 199 Domestic Production Activities Deduction - continued

- Construction or substantial renovation of real property in the U.S., including residential and commercial buildings and infrastructure such as roads, power lines, water systems, and communications facilities.
- Engineering and architectural services performed in the U.S. and relating to the construction of real property.

In the simplest case, a taxpayer whose entire taxable income is from qualified production activities multiplies that amount by 9% to determine its tentative Section 199 deduction for 2015. This often results in an effective tax rate reduction of at least 3%.

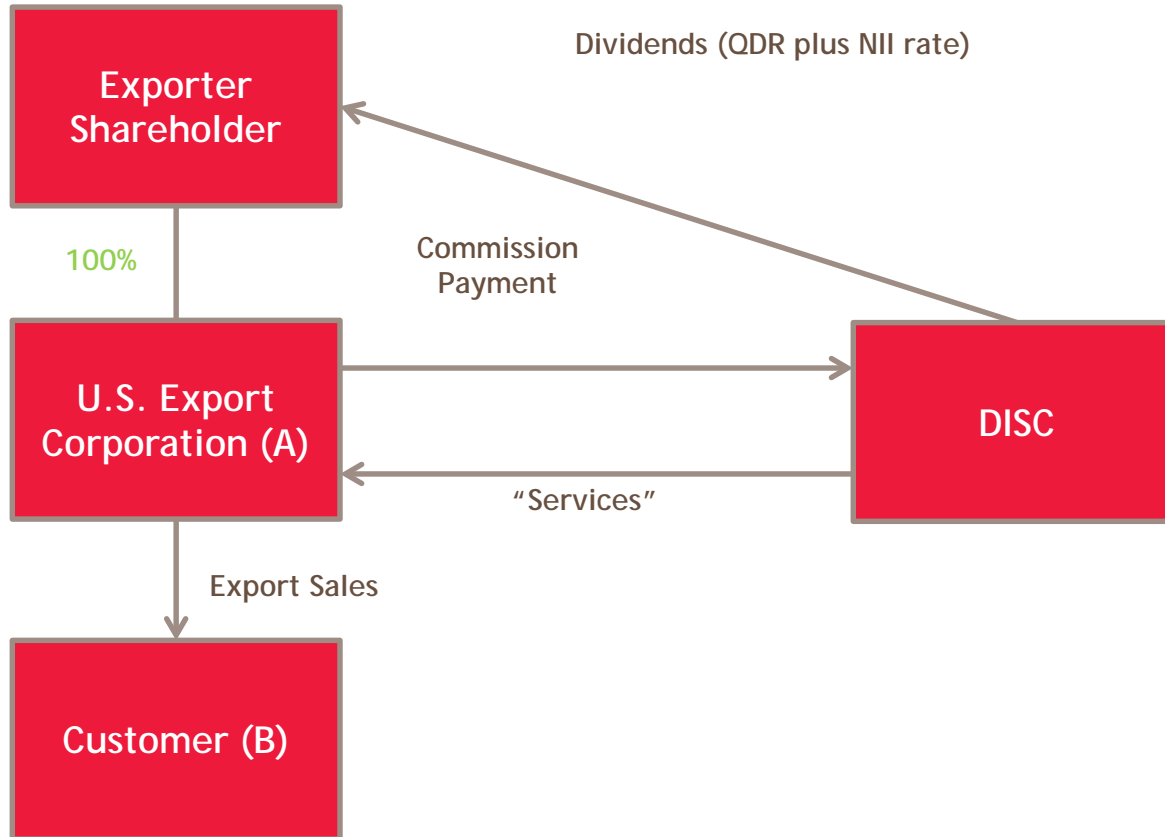
## Export Incentive History

- 1971 - Domestic International Sales Corp. (DISC) *Allowed Exporters to accumulate DISC income without paying taxes until distributed*
- 1984 - DISC regime challenged as an illegal export subsidy
- 1984 - Foreign Sales Corp. (FSC)/Interest Charge DISC (DISC) *FSC income granted partial exemption from U.S. taxation, DISC can still accumulate DISC income but shareholders must pay interest charge*

## Export Incentive History (continued)

- 1999 WTO Rules FSC Illegal Export Subsidy
- 2000 FSC Repealed, ETI Enacted. *ETI allows all exporters to benefit by excluding portion of profits attributable to export income*
- 2001 WTO Rules ETI Illegal Export Subsidy
- October 2004 - ETI Repealed
- **IC-DISC Remains Unchallenged and Available**  
(as of 4.18.2016)
  - Qualified dividends are permanent at 0 to 23.8% with no sunset provisions

# Shareholder-Owned DISC Structure (C Corp.) - Typical Structure



## How is a DISC taxed?

- A DISC generally is not taxed on its income
- The shareholders of a DISC are taxed on deemed or distributed DISC income
- The **related supplier (exporter)** gets a deduction for the DISC commission paid or accrued
- An interest charge may apply to the shareholders if the DISC reports **accumulated IC-DISC income (i.e., undistributed income)** in consecutive years

## How is a DISC Commission Calculated?

- The DISC commission is calculated as the greater of:
  - 4% of qualified export receipts (not to exceed **combined taxable income**), or
  - 50% of combined taxable export income
- The commission cannot exceed the combined taxable income on the export transaction
- Combined Taxable Income
  - Calculated with fully loaded expense allocation
    - Can be a general or specific allocation



# DISC Benefits Summarized

- S Corporations
  - Effectively converts ordinary income (39.6% or 43.4% rate) into qualified dividend income plus NII (23.8% rate)
    - Depends on rate differential, and DISC dividends are qualified dividend income
- C Corporations
  - Tax-deductible dividends

# Revenue Recognition Upon Delivery /Acceptance

- Many taxpayers bear the risk of loss until the goods are delivered to the customer.
  - Common method: Taxpayers recognize income upon shipment of the goods.
  - Proposed method: Taxpayers may be able to defer the revenue recognition of goods under section 451 principles until they are delivered to or accepted by the customer, particularly where risk of loss remains with the taxpayer until delivery of the goods.
  - Method Change Procedure: Non-automatic under Rev. Proc. 97-27.

# Warranty Accruals

- Many taxpayers sell warranties in connection with the sale of their goods, and use either their employees or independent contractors to service the warranty obligations.
  - Common method: Taxpayers add the warranty reserves back for tax purposes and deduct when the claims are paid (flux beginning and ending reserve balance).
  - Proposed method: Taxpayers may be able to deduct warranty costs in the year in which the liability fixes under the terms of the warranty agreement.
  - Method Change Procedure: Automatic under Rev. Proc. 2017-30 (cash to accrual for specific items) or non-automatic under Rev. Proc. 97-27.

# Uniform Capitalization

- Producers and resellers are generally subject to the uniform capitalization rules under section 263A .
  - Common Method:
    - Potential IRS audit exposure from undercapitalizing costs due to:
      - Failure to capitalize additional section 263A costs (no Sch. M-3 adj. or 263A amount in Schedule A)
      - Use of a frozen absorption ratio year after year
      - Mixed service costs are not allocated.
    - Potential opportunity if overcapitalizing costs due to non-optimal UNICAP methodologies.
  - Proposed method: Change to simplified production method (producers and reseller-producers) or simplified resale method (resellers), or change to a reasonable UNICAP method that suits the taxpayer's facts.
  - Method Change Procedure: Generally automatic under Rev. Proc. 2017-30.

# Valuation - LCM

*Lower of Cost or Market (LCM) - what is tax "market" value:*

General rule: Market is replacement or reproduction cost

*Exception*: If no open market exists or it is inactive, then market value can be shown by evidence of sales

- IRS narrowly interprets inactive market

Item level detail calculation required (by SKU or part number)

- GAAP: generally summarized by category or product-line

- Documentation critical (IRS exam)



# LIFO

- LIFO (last-in, first-out) inventory method allows taxpayer to deduct most recently acquired items in costs of goods sold, while leaving older items capitalized in inventory
  - If significant inflation for all or parts of the taxpayer's inventory can result in substantial tax savings
  - External price indices can be used
  - Initial adoption on Form 970 filed with the taxpayer's return
  - Requires financial statement conformity

A man in a dark suit and white shirt is seen from behind, looking out over a vibrant city skyline at night. His hands are raised in front of him, palms facing forward, as if presenting or welcoming. The city lights are a mix of warm yellows and oranges and cool blues, creating a dynamic and professional atmosphere. The background is a dense urban landscape with numerous skyscrapers and buildings, some with glowing windows. The overall scene suggests a high-level business or professional event.

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# 2017 National Tax Conference

*In Honor of Alvin H. Lieberman*



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# Climbing a Wall of Worry

## A Review of Investor Concerns and Risks

**Uma M. Rajeshwar, CFA, CTFA, CFP®**  
Managing Director  
Relationship & Portfolio Management

**Jason D. Pride, CFA**  
Director of Investment Strategy

**Economic and Market Outlook** represents a review of issues or topics of possible interest to Glenmede's clients and friends, and not as personalized investment advice. It contains Glenmede's opinions, which may change after the date of publication. Information gathered from third-party sources is assumed reliable but is not guaranteed. This presentation contains projections which though arrived at in good faith, are not guaranteed. This document is not a recommendation of any particular investment. Actual results may differ materially from projections. Actual investment decisions for clients are made on an individualized basis and may be different from what is expressed here. All investments have risk and are subject to loss. Clients are encouraged to discuss anything they see here of interest with their Glenmede representative.

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## Wall of Worry

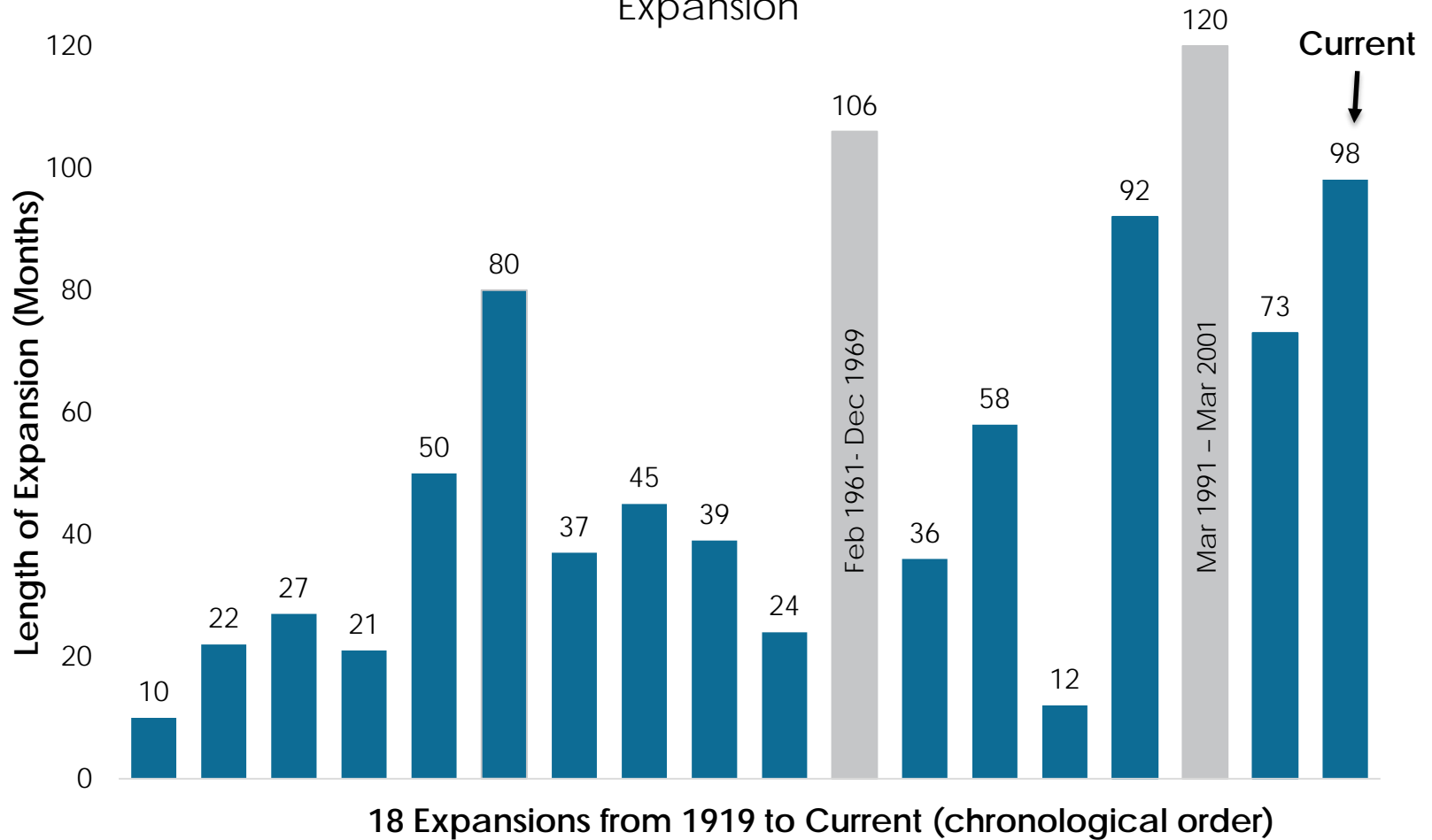
- #1 Over-Extended Markets
- #2 Deflation / Low Inflation
- #3 Tightening Monetary Policy
- #4 Geopolitical Instability



## Wall of Worry

- #1 Over-Extended Markets  
(9-Year Long Bull Market / Stretched Multiples)
  
- #2 Deflation / Low Inflation
  
- #3 Tightening Monetary Policy
  
- #4 Geopolitical Instability

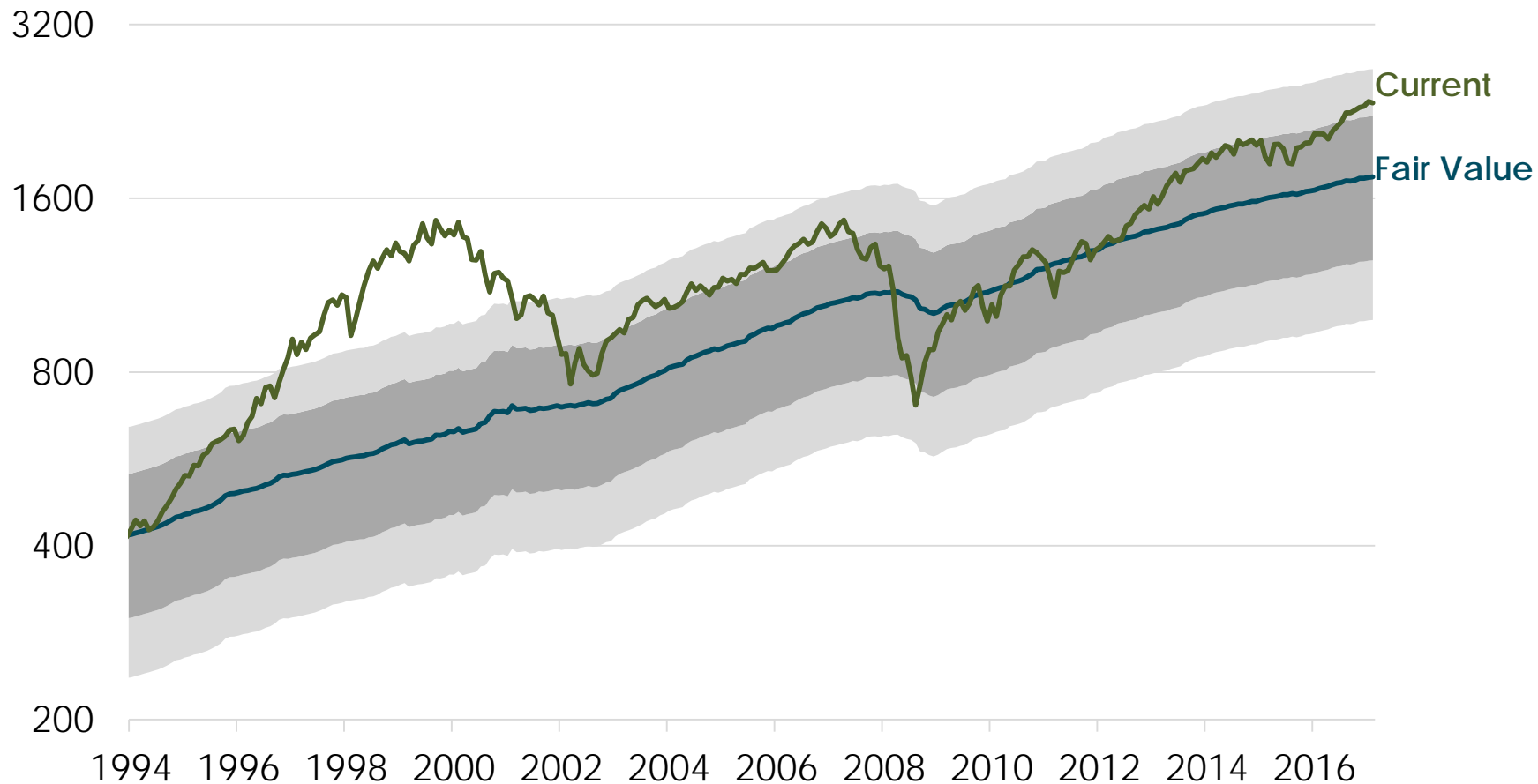
### Two Economic Expansions Have Lasted Longer than the Current Expansion



Source: National Bureau of Economic

Data as of 8/31/2017

## U.S. LARGE CAP EQUITIES ARE SOMEWHAT EXPENSIVE



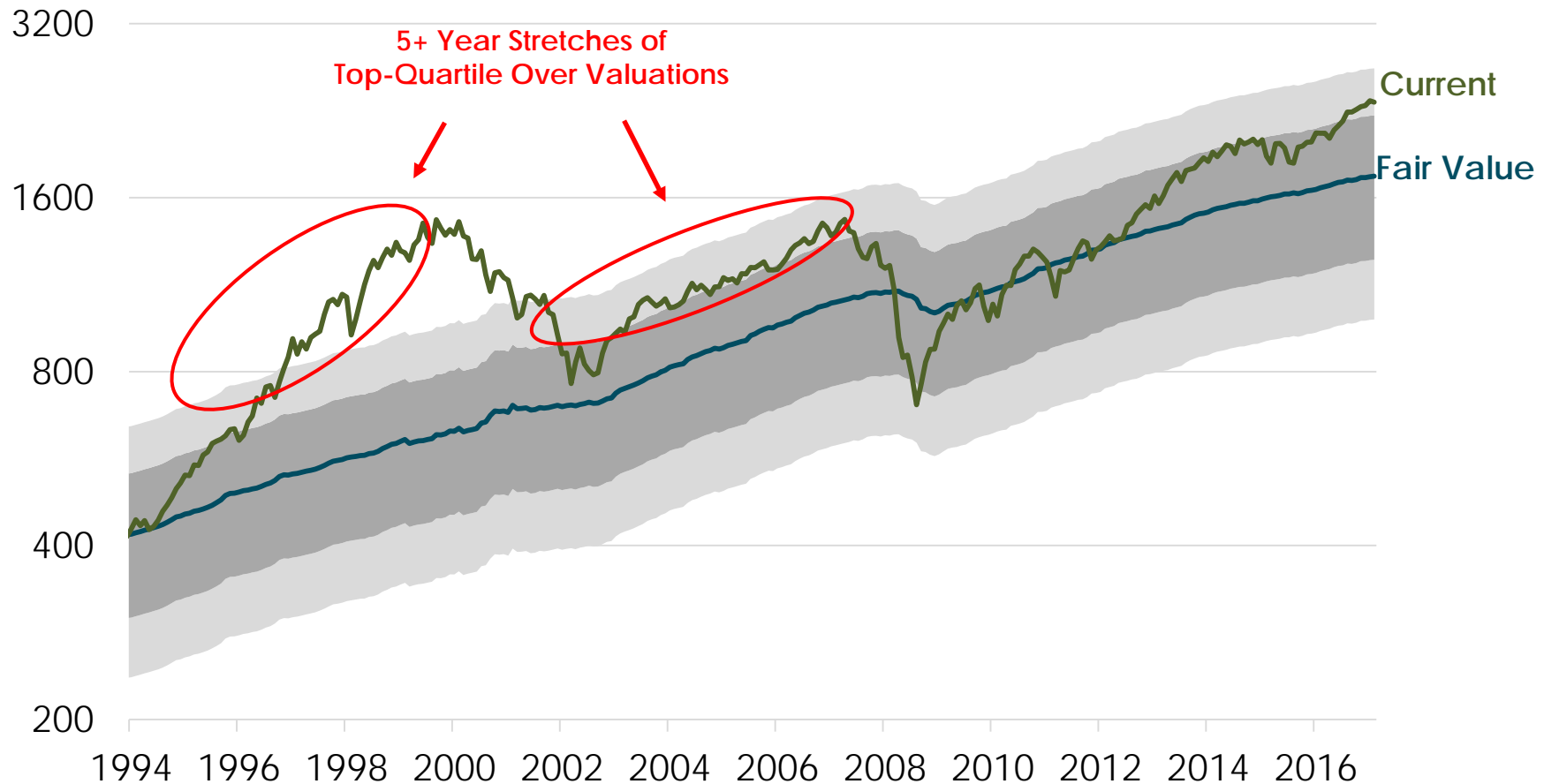
Source: Glenmede, MSCI

Data as of 8/31/2017

The index used for the analysis is MSCI USA.

Note: Long-term fair value based on normalized earnings, cash flows, and book value using MSCI's USA Index. Past performance is not indicative of future returns. This is an unmanaged, total return index with dividends reinvested. One cannot invest directly in an index.

## BUT VALUATIONS CAN REMAIN ABOVE AVERAGE FOR LONG PERIODS



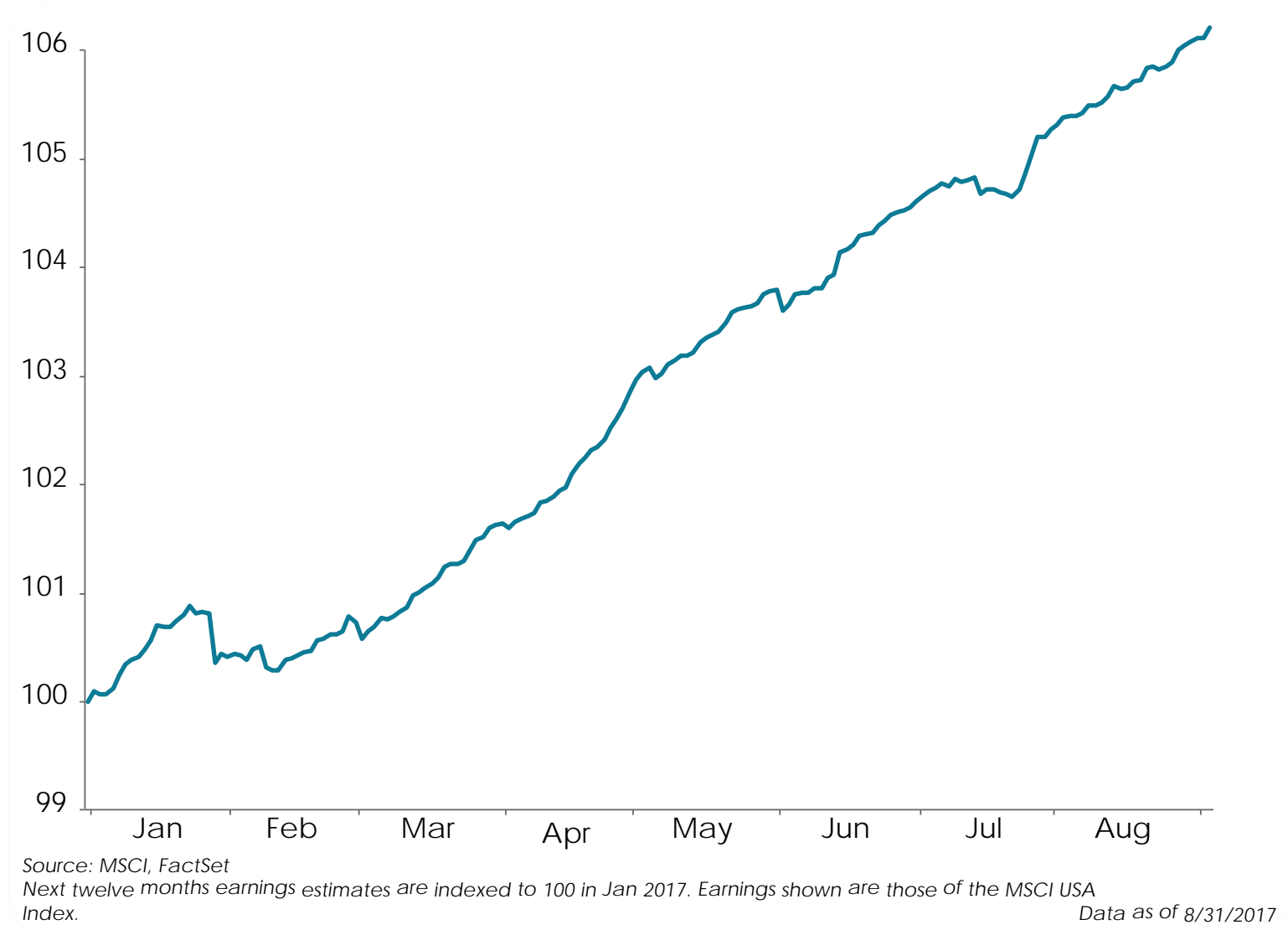
Source: Glenmede, MSCI  
The index used for the analysis is MSCI USA.

Data as of 8/31/2017

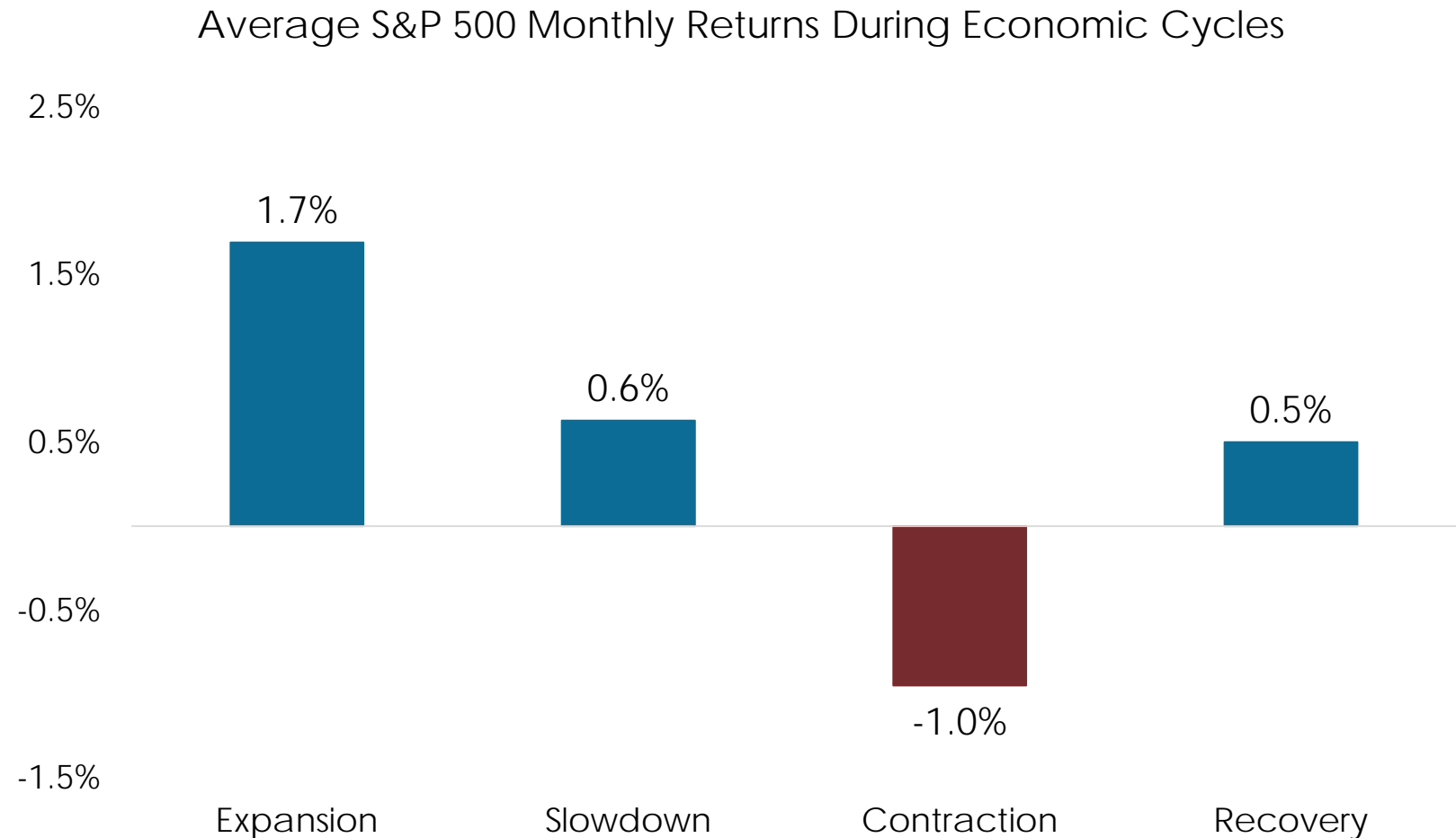
Note: Long-term fair value based on normalized earnings, cash flows, and book value using MSCI's USA Index. Past performance is not indicative of future returns. This is an unmanaged, total return index with dividends reinvested. One cannot invest directly in an index.



## US EARNINGS ESTIMATES CONTINUE TO RISE, SUPPORTING EQUITIES



## EQUITIES TEND TO PERFORM WELL, EXCEPT DURING ECONOMIC CONTRACTIONS

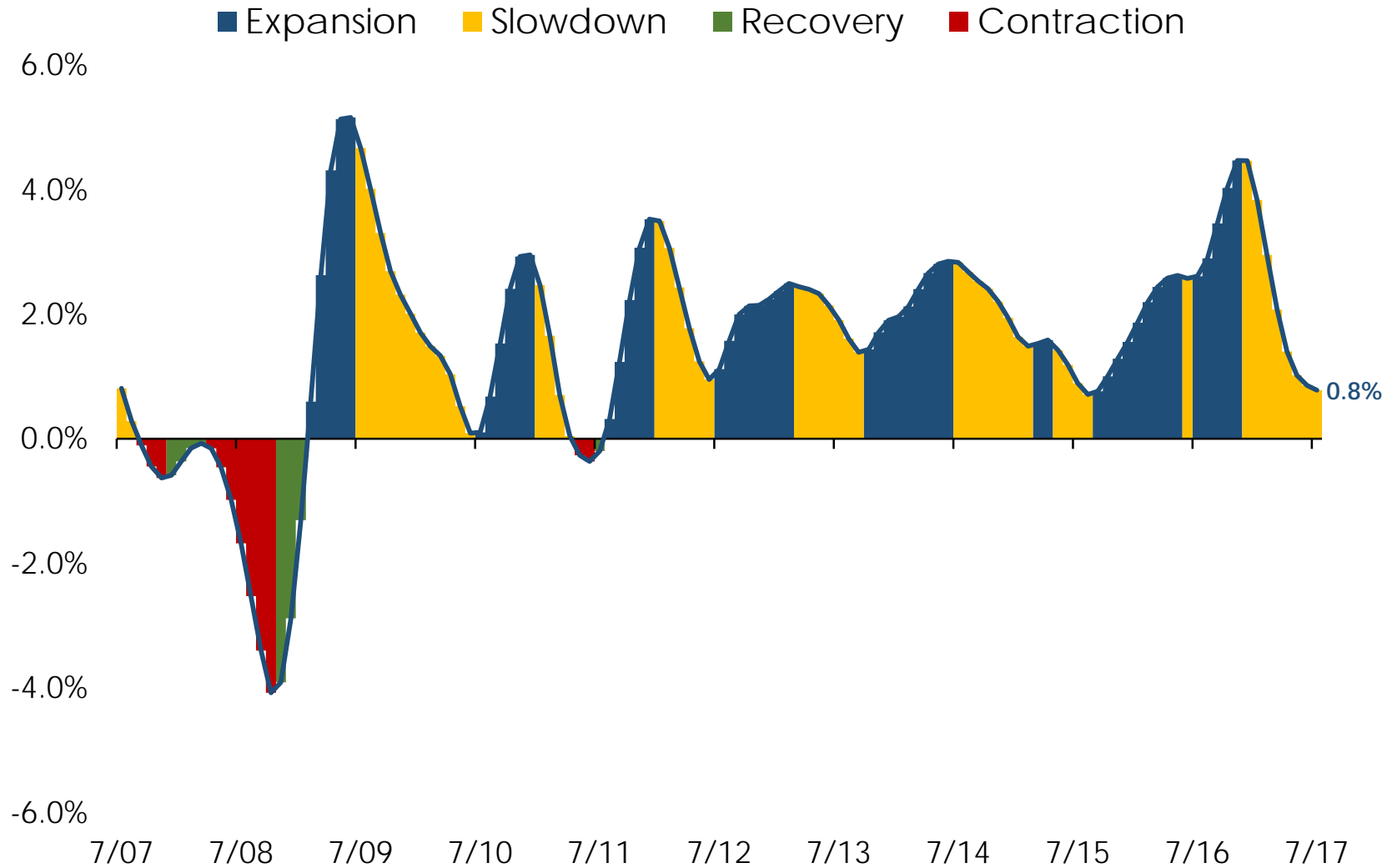


Source: Glenmede

The chart represents average monthly S&P 500 returns during economic cycles outlined in Glenmede's Leading Economic Indicators.

*Past performance is not indicative of future returns. The S&P 500 is an unmanaged, total return index with dividends reinvested. One cannot invest directly in an index.*

# GLENMEDE'S LEADING U.S. ECONOMIC INDICATORS POINT TO GROWTH



Source: Glenmede

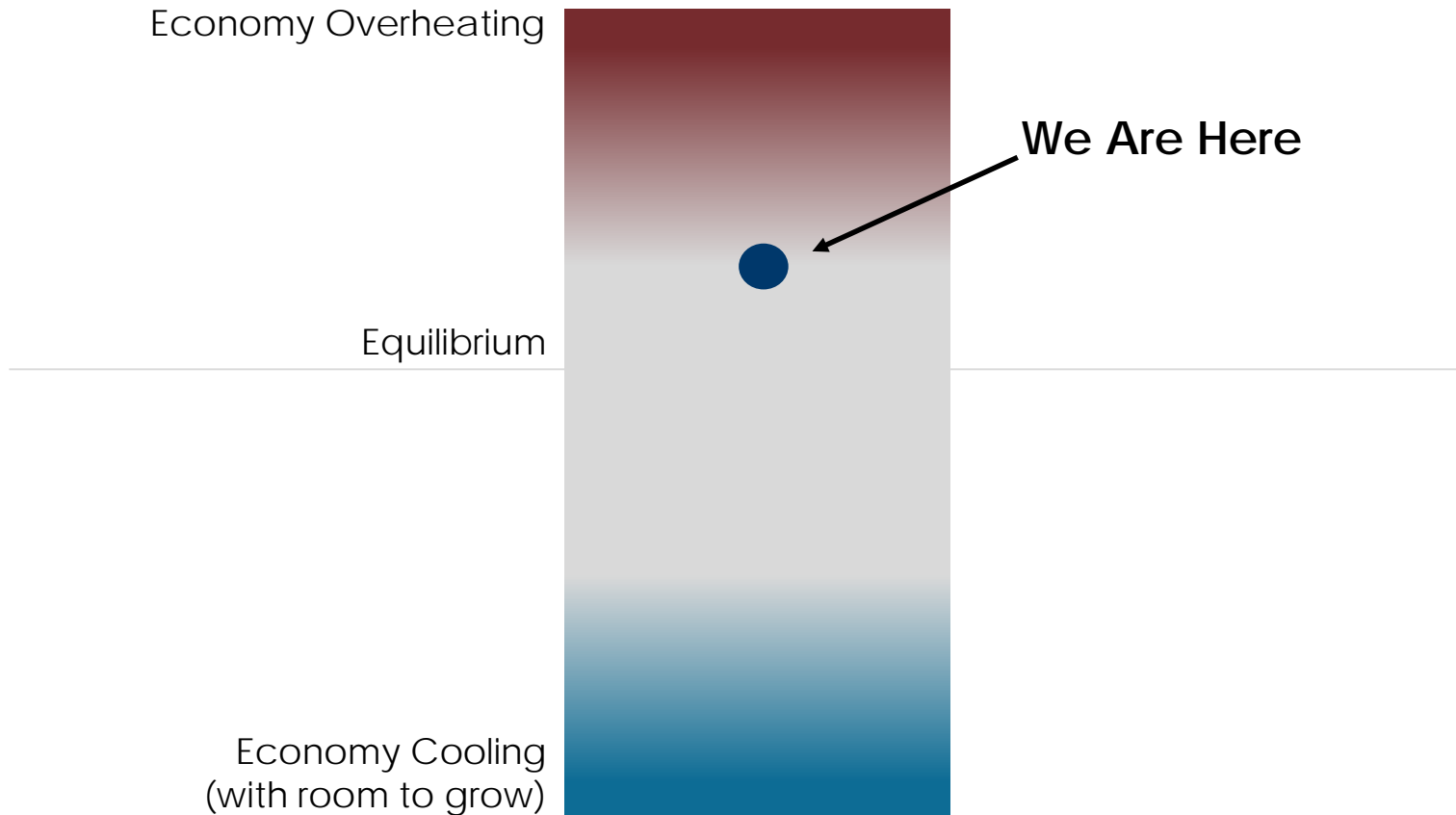
Glenmede's leading economic indicator is a tool developed by Glenmede to help determine general economic trends. The main components are employment, business climate, monetary policy, housing, industrial conditions, and sentiment. Though created in good faith, there can be no guarantee that these indicators will be accurate.





# ECONOMY APPEARS AHEAD OF POTENTIAL BUT NOT OVERHEATING

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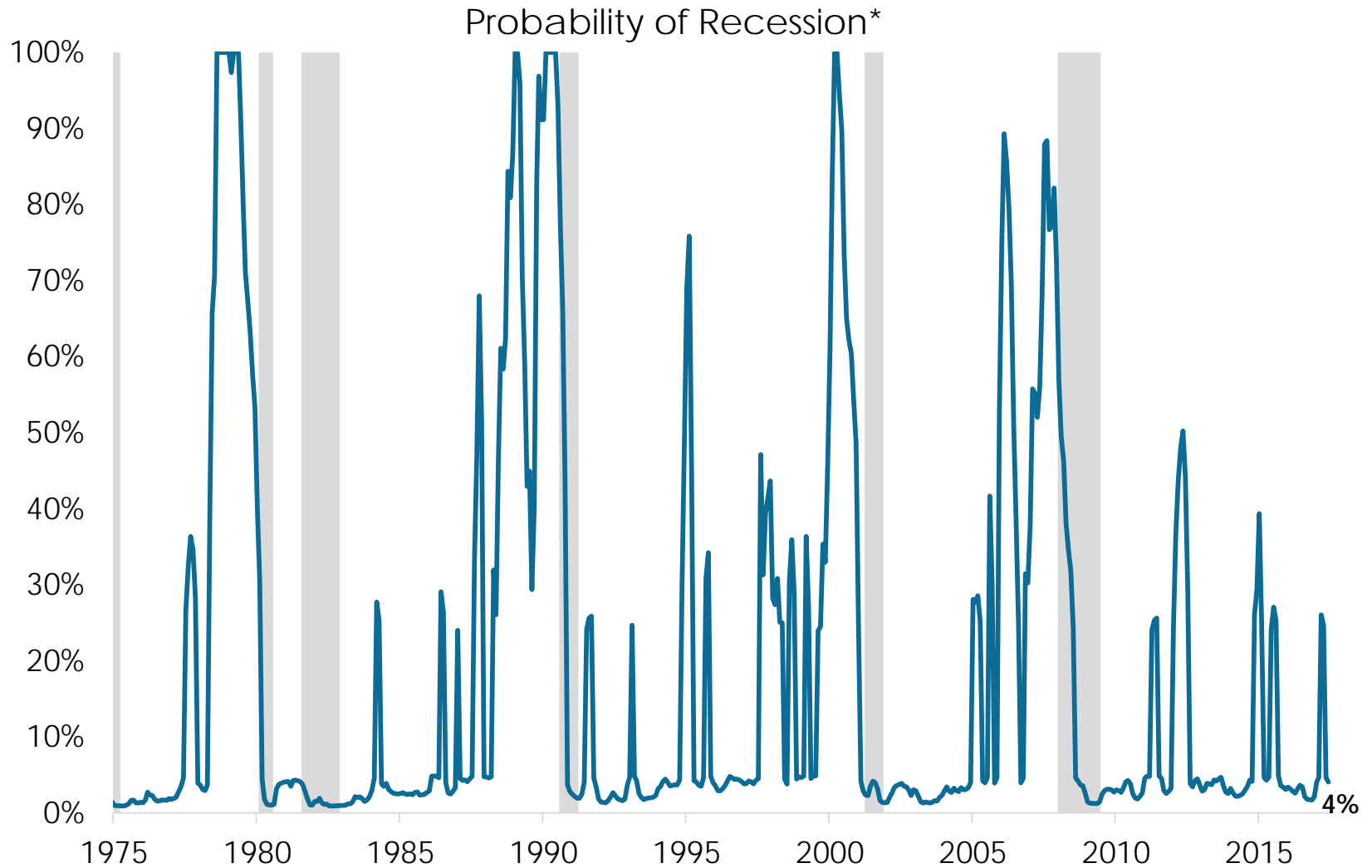


Source: San Francisco Federal Reserve

\*The output gap is closely followed by the Federal Reserve and measures the difference between actual and potential economic output. Potential output is the maximum amount of goods and services an economy can produce efficiently. Note that the upper and lower ends of the bar chart represent the 90% and 10% percentile from 1961 – 2016.

The baseline model used to calculate the output gap is described in "Measuring the Natural rate of Interest," by Thomas Laubach and John C. Williams.

# GLENMEDE MODEL SUGGESTS LOW LIKELIHOOD OF RECESSION

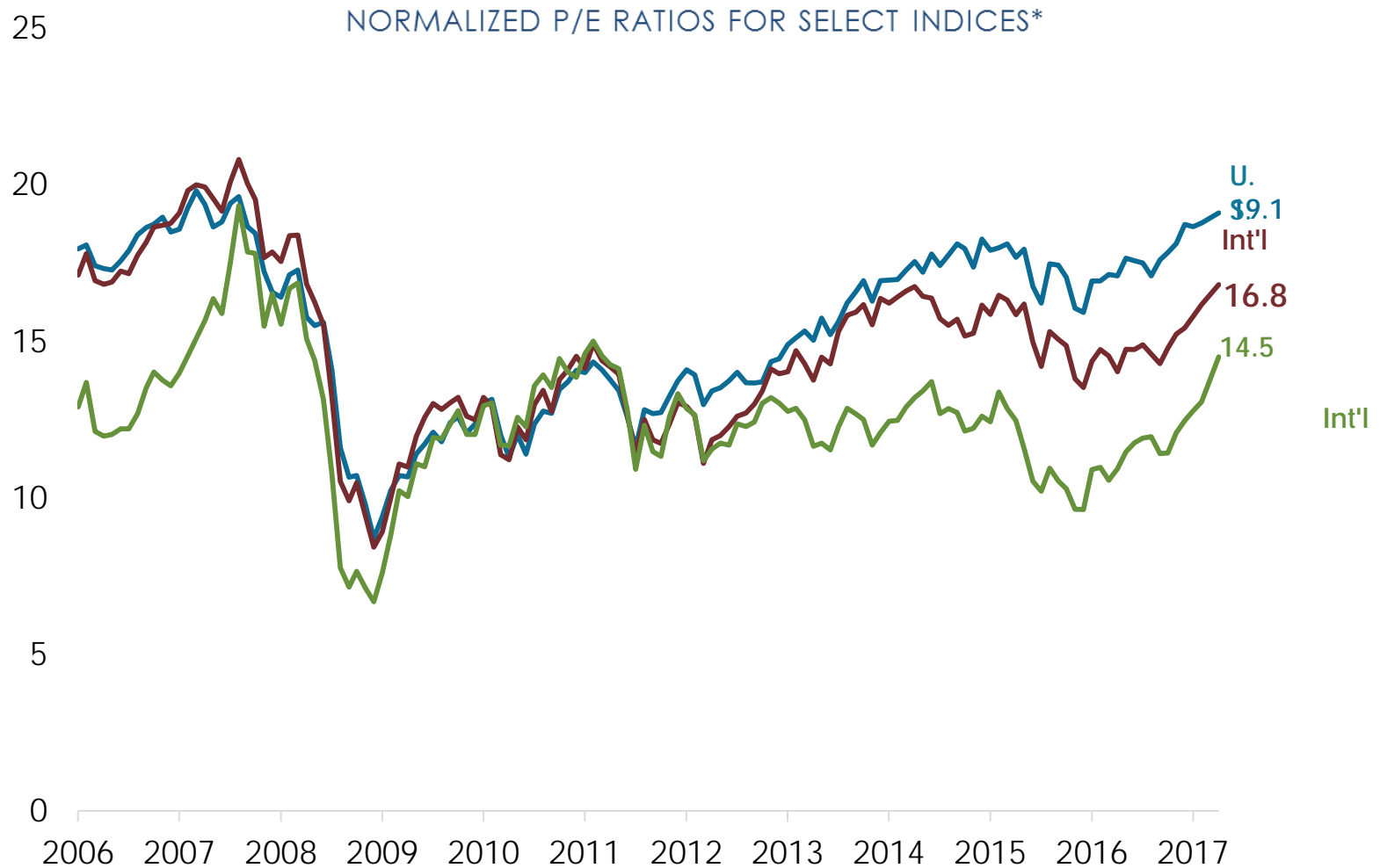


Source: Glenmede

Data as of 6/30/2017

\*Glenmede's Recession model is a tool developed by Glenmede to help estimate the probability of a recession. The model is a well-balanced mix of long-term excess indicators covering manufacturing, employment, and debt balances and near-term leading indicators covering monetary policy, credit markets, business sentiment, and other economic trends. Though created in good faith, there can be no guarantee that these indicators will be accurate.

# NOT ALL MARKETS ARE AS NOTICEABLY OVERVALUED

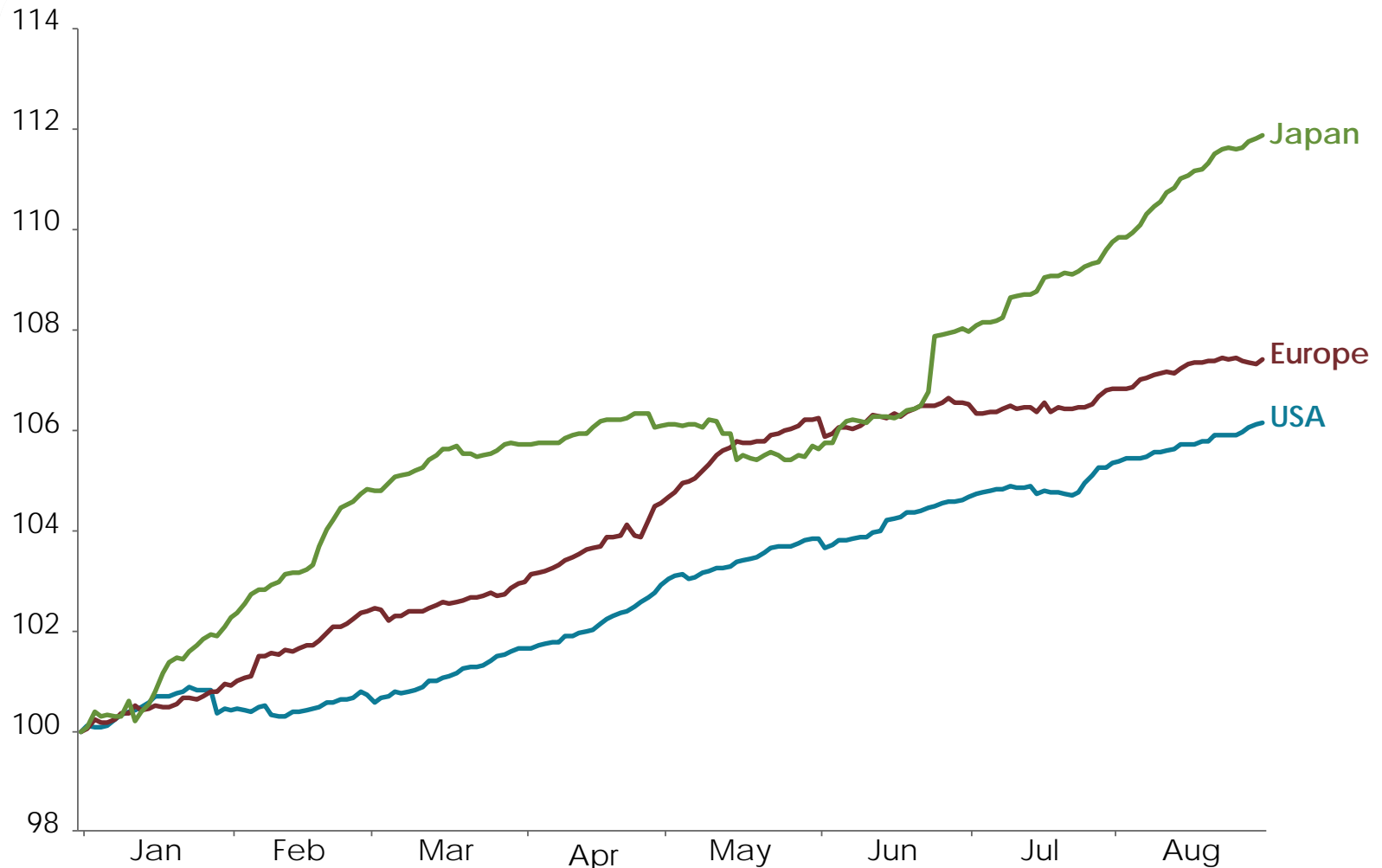


Source: Glenmede, FactSet.  
as of 8/31/2017

Data

Graph shows normalized price to earnings ratio. Normalized means that the earnings are adjusted for seasonality and other atypical occurrences. U.S. is the MSCI USA index. Int'l Developed is the MSCI EAFE index, and Int'l Emerging is the

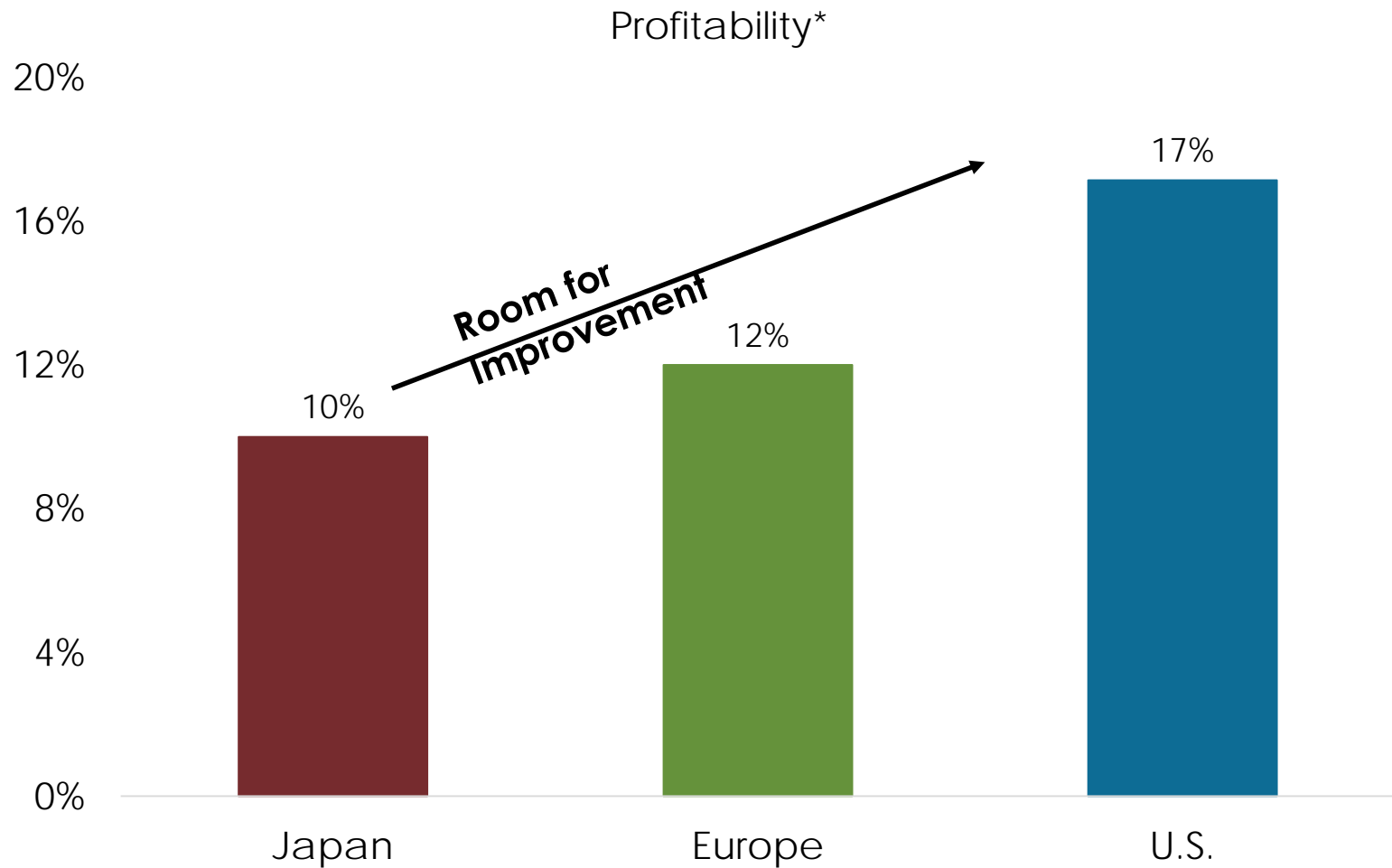
# INTERNATIONAL EQUITIES HAVE FINALLY EXPERIENCED EARNINGS GROWTH



Source: MSCI, FactSet

Next twelve months earnings estimates indexed to 100 in Jan 2017. Earnings shown are those of the MSCI USA, MSCI Euro, and MSCI Japan Indices in US \$, euro, and Japanese Yen, respectively. Data as of 8/31/2017

## INTERNATIONAL PROFITABILITY HAS SIGNIFICANT ROOM TO IMPROVE



Source: MSCI  
as of 8/31/2017

Data

Profitability is measured by return on equity (ROE) for companies in the MSCI Japan, MSCI Europe, and MSCI USA stock market indices.

Past performance is not indicative of future returns.



### **Maintain a full weight to equities**

1. Employ U.S. defensive strategies
2. Don't sell your international stocks
3. Emphasize Japan and the EM Asian Consumer



## Wall of Worry

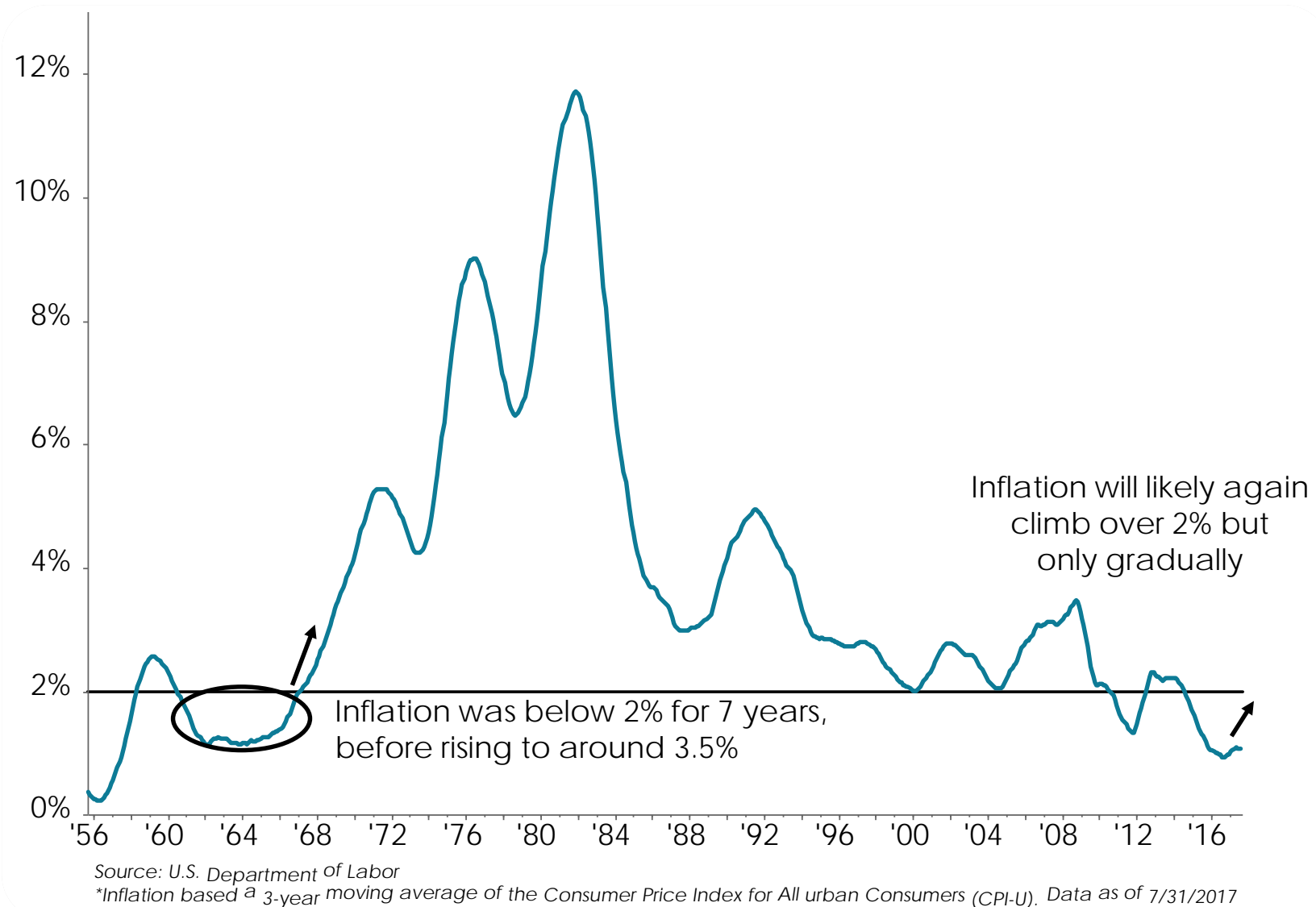
#1 Over-Extended Markets

#2 Deflation / Low Inflation

#3 Tightening Monetary Policy

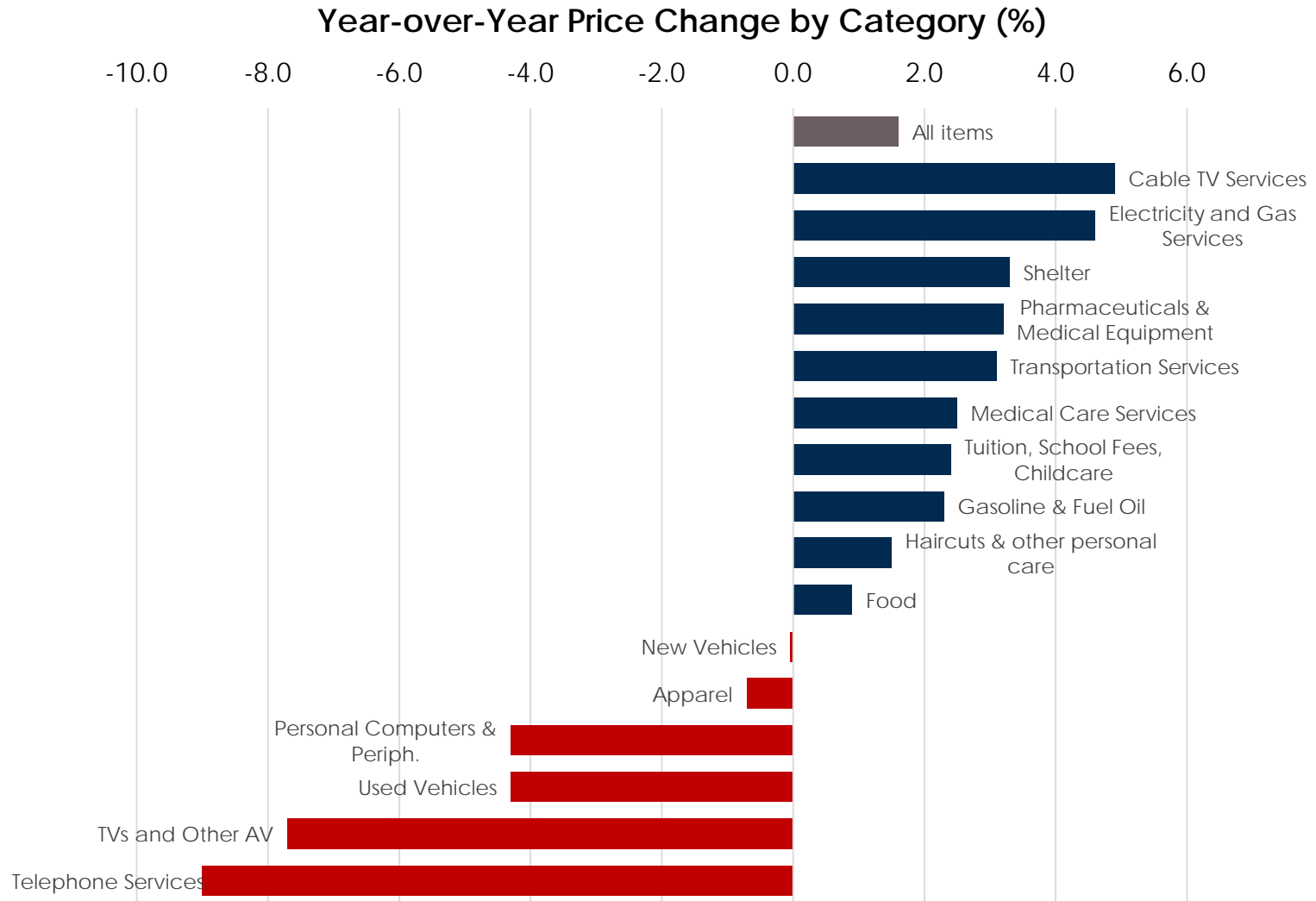
#4 Geopolitical Instability

## U.S. INFLATION HAS CLIMBED OUT OF A LOW PERIOD BEFORE – IN THE 60S



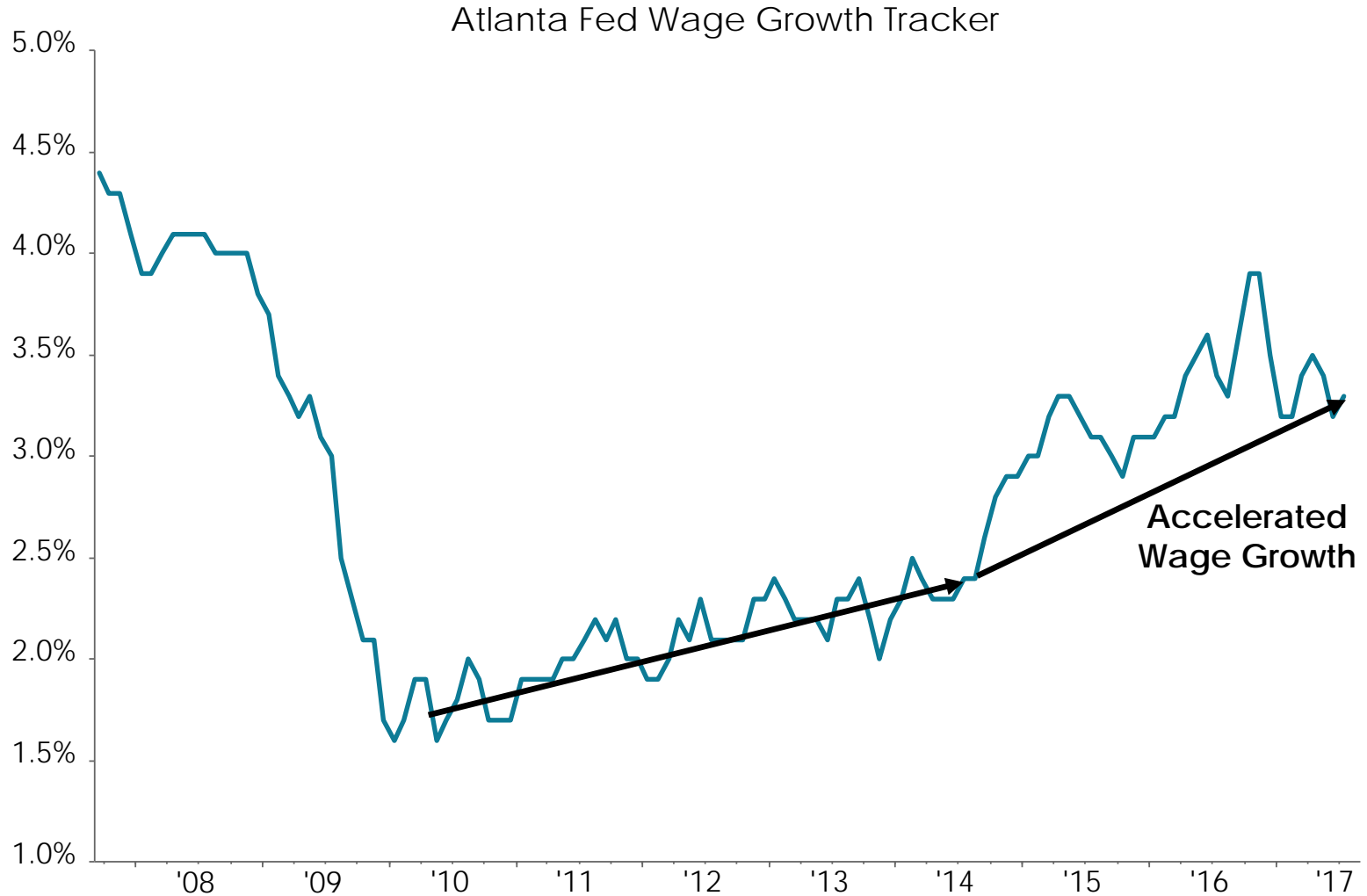


# INFLATION IS NOT AS HOMOGENOUS AS BELIEVED



Source: Bureau of Labor Statistics, Consumer Price Index Report June 2017

# RISING WAGES CREATE BROADER INFLATIONARY PRESSURES

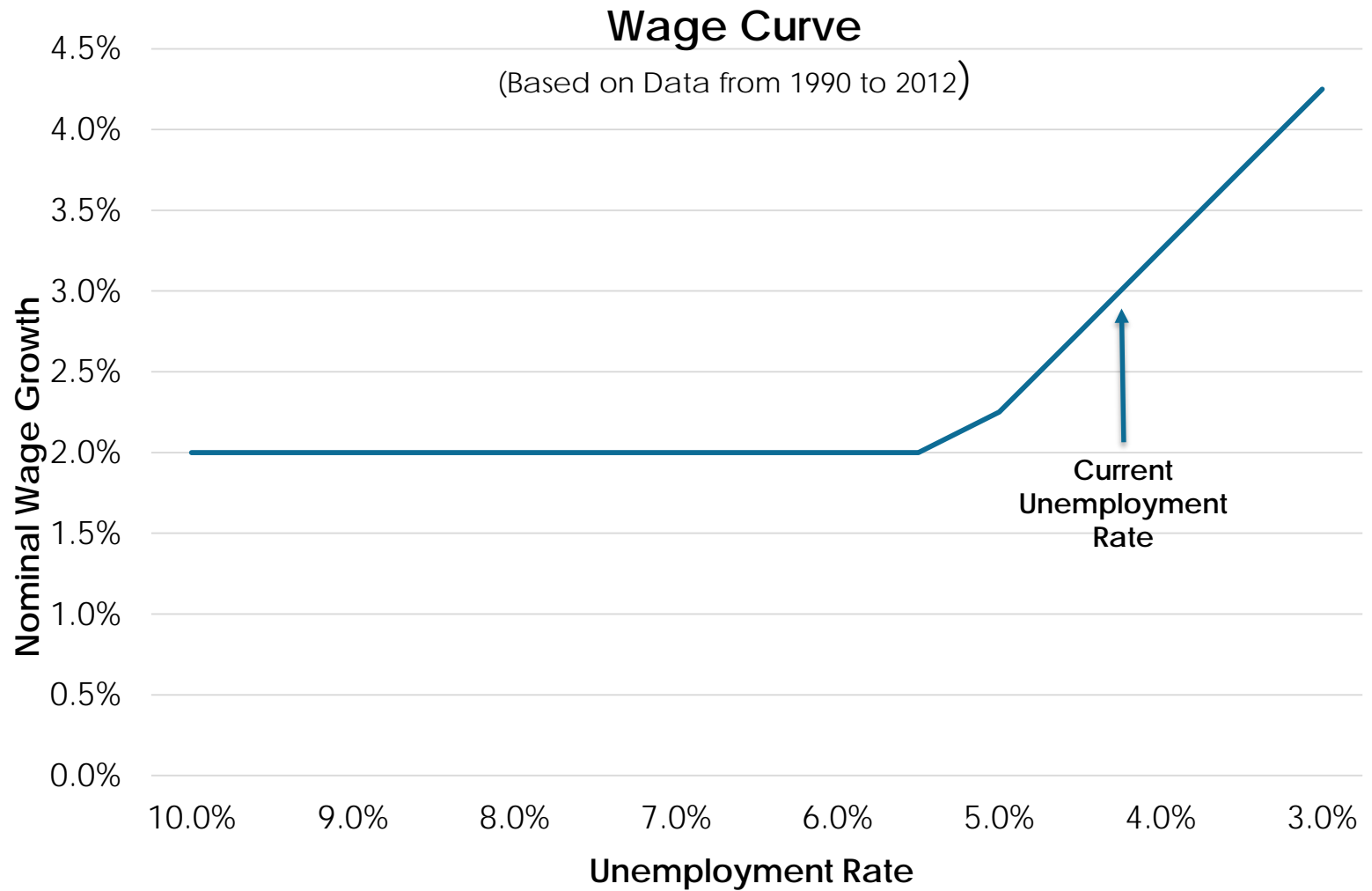


Source: Federal Reserve System

The Federal Reserve Bank of Atlanta's Hourly Wage Tracker is a 3-mo moving average of median wage growth.

Data as of 7/31/2017

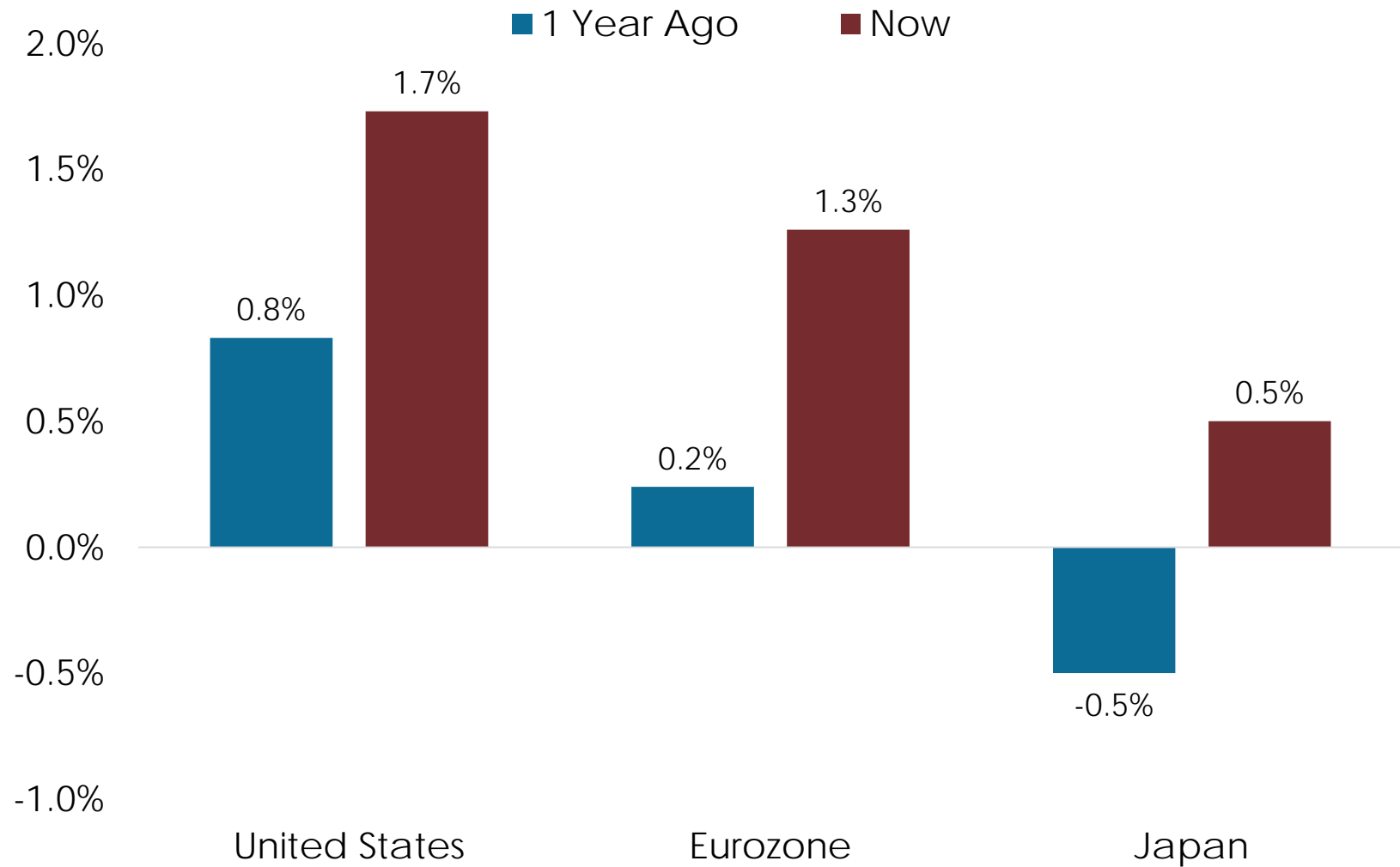
# WAGE GROWTH OFTEN RISES WHEN LABOR MARKETS ARE TIGHT



Source: Empirical Research Partners Analysis.  
Blanchflower, D. and Andrew T. Levin, 2014. "Labor Market Slack and Monetary Policy." NBER Working Paper



## RISING INFLATION IS NOT JUST A U.S. STORY



Source: Factset, Glenmede  
Inflation shown is the year-over-year change in CPI by region as of 7/31/2017.



## Wall of Worry

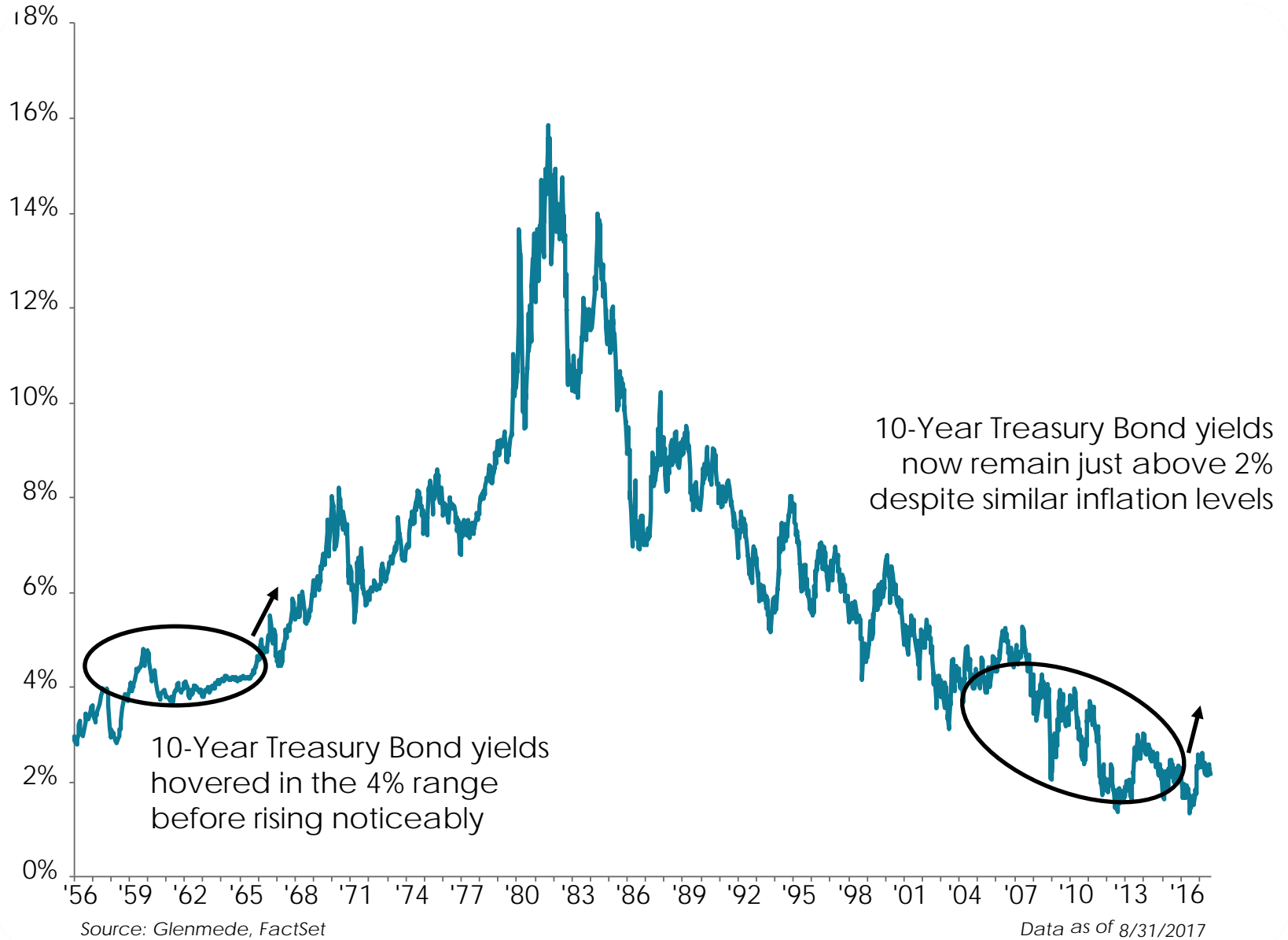
#1 Over-Extended Markets

#2 Deflation / Low Inflation

#3 Tightening Monetary Policy  
(by U.S. Federal Reserve and other central banks)

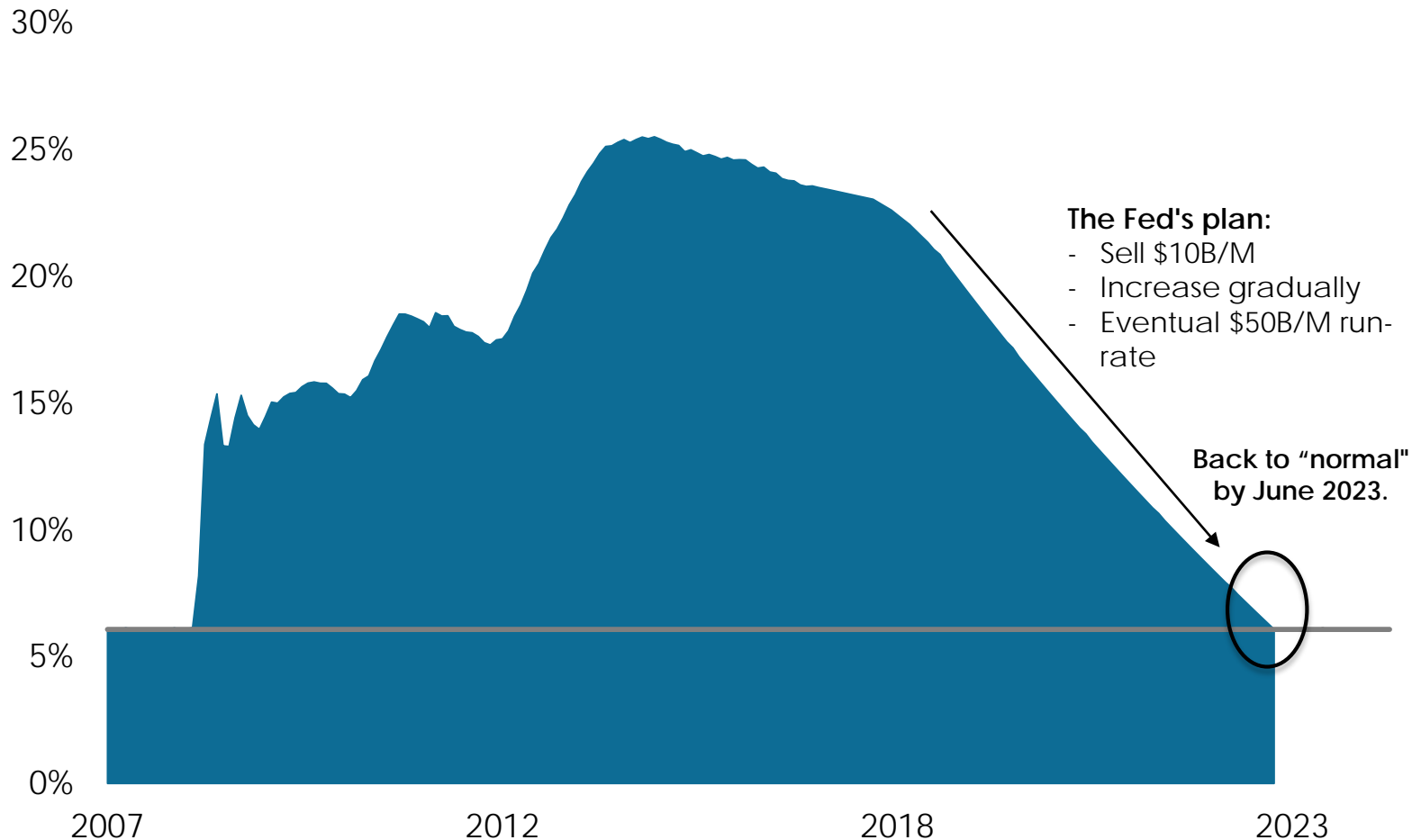
#4 Geopolitical Instability

# INTEREST RATES NEED TO RISE MORE GIVEN THE RISE IN INFLATION



# THE FEDERAL RESERVE IS ALSO LOOKING TO SHRINK ITS BALANCE SHEET

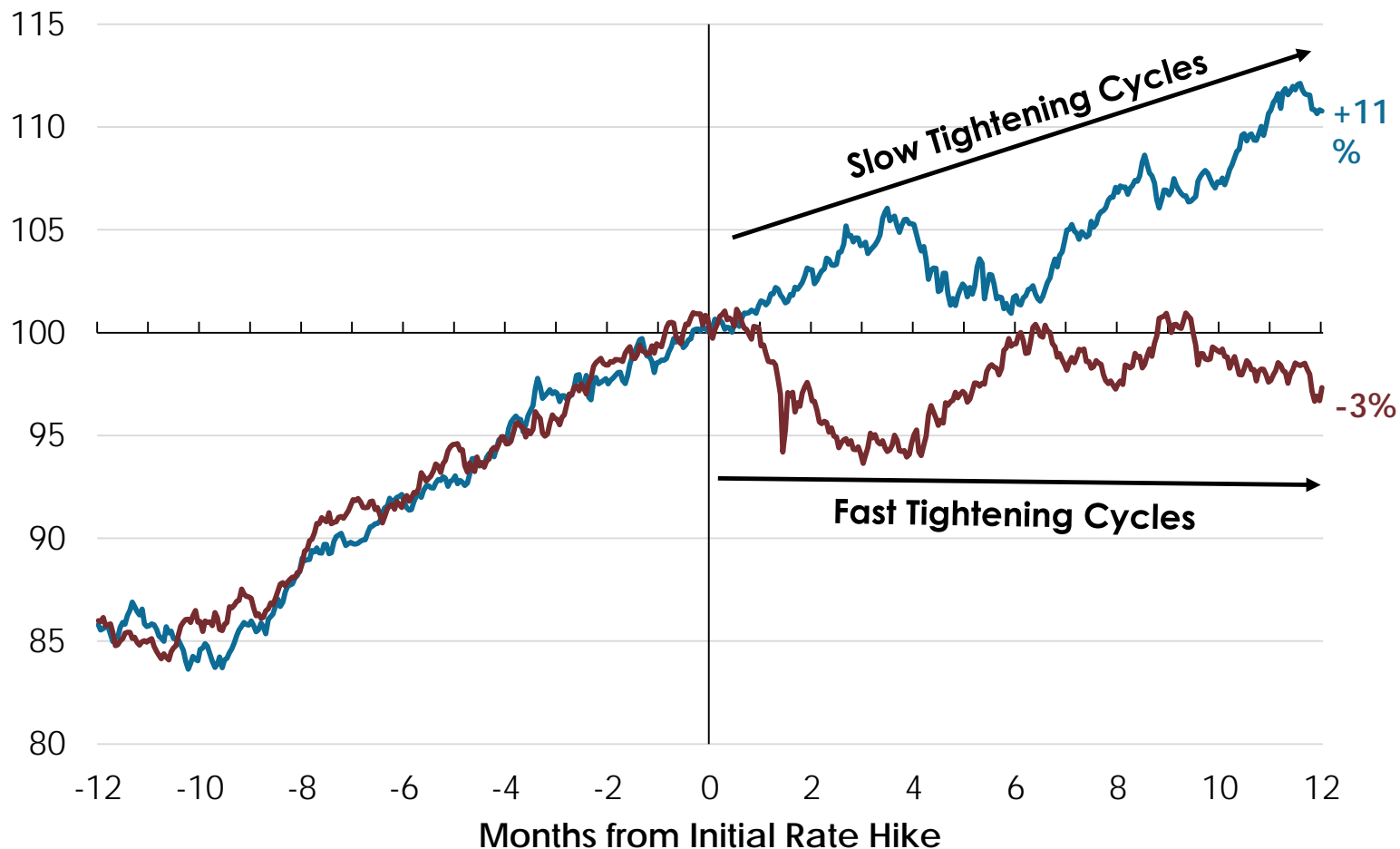
## Fed's Balance Sheet as a % of GDP



Source: FactSet, International Monetary Fund (IMF), Glenmede.

Graph represents the Fed's balance sheet as a percentage of U.S. GDP. Chart assumes the Fed begins trimming their balance sheet according to the plan outlined at the June meeting, starting in December, 2017. Future GDP is represented as projected by the IMF.

### S&P 500 Historical Slow vs. Fast Tightening Cycles

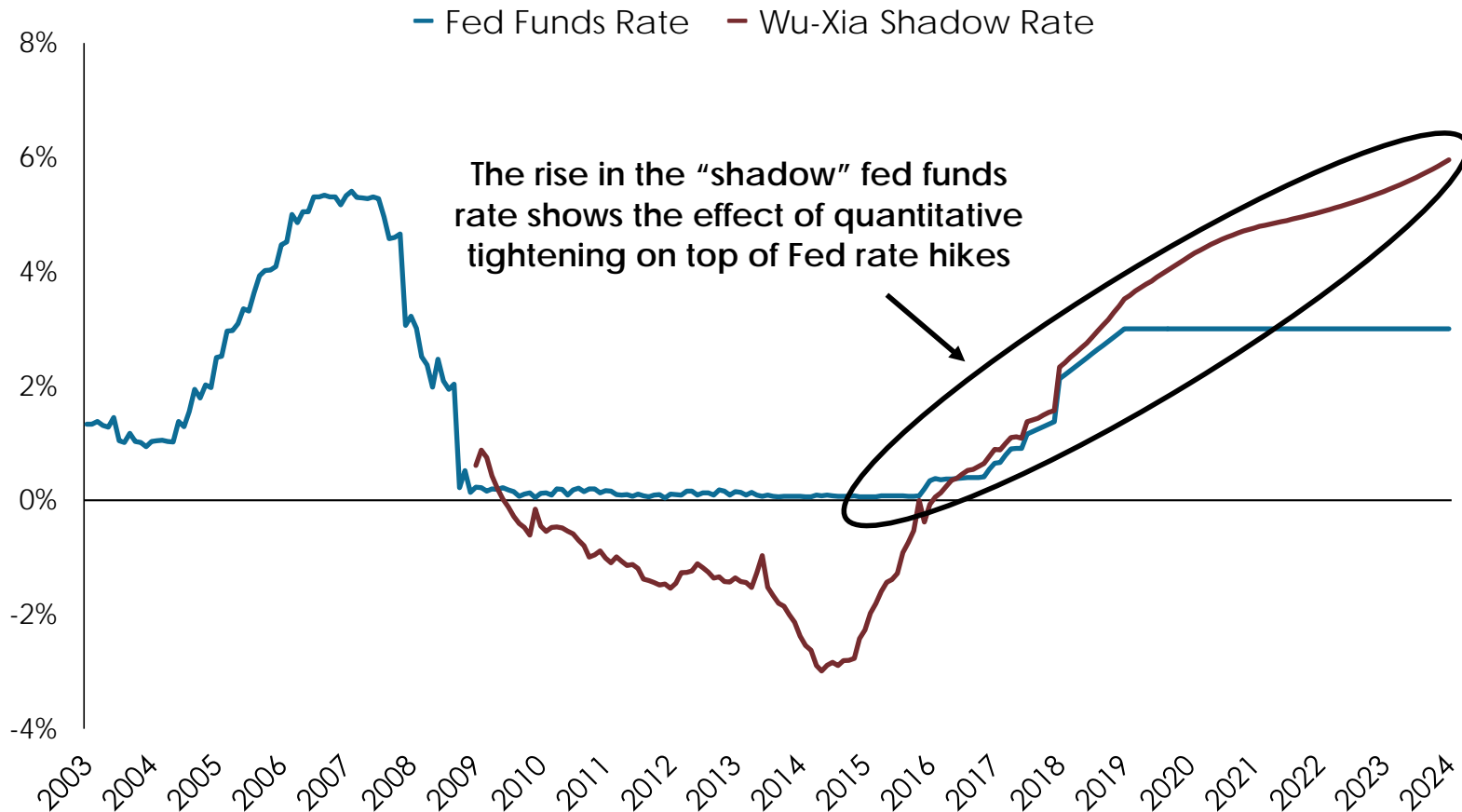


*Slow Tightening Cycles: the average path for the S&P 500 during the five instances of Fed rate hikes that did not increase rates at every meeting (1946, 1955, 1958, 1963, 1977).*

*Fast Tightening Cycles: the average path for the S&P 500 during the seven instances of Fed rate hikes that increased rates at every meeting (1967, 1973, 1980, 1987, 1994, 1999, 2004).*



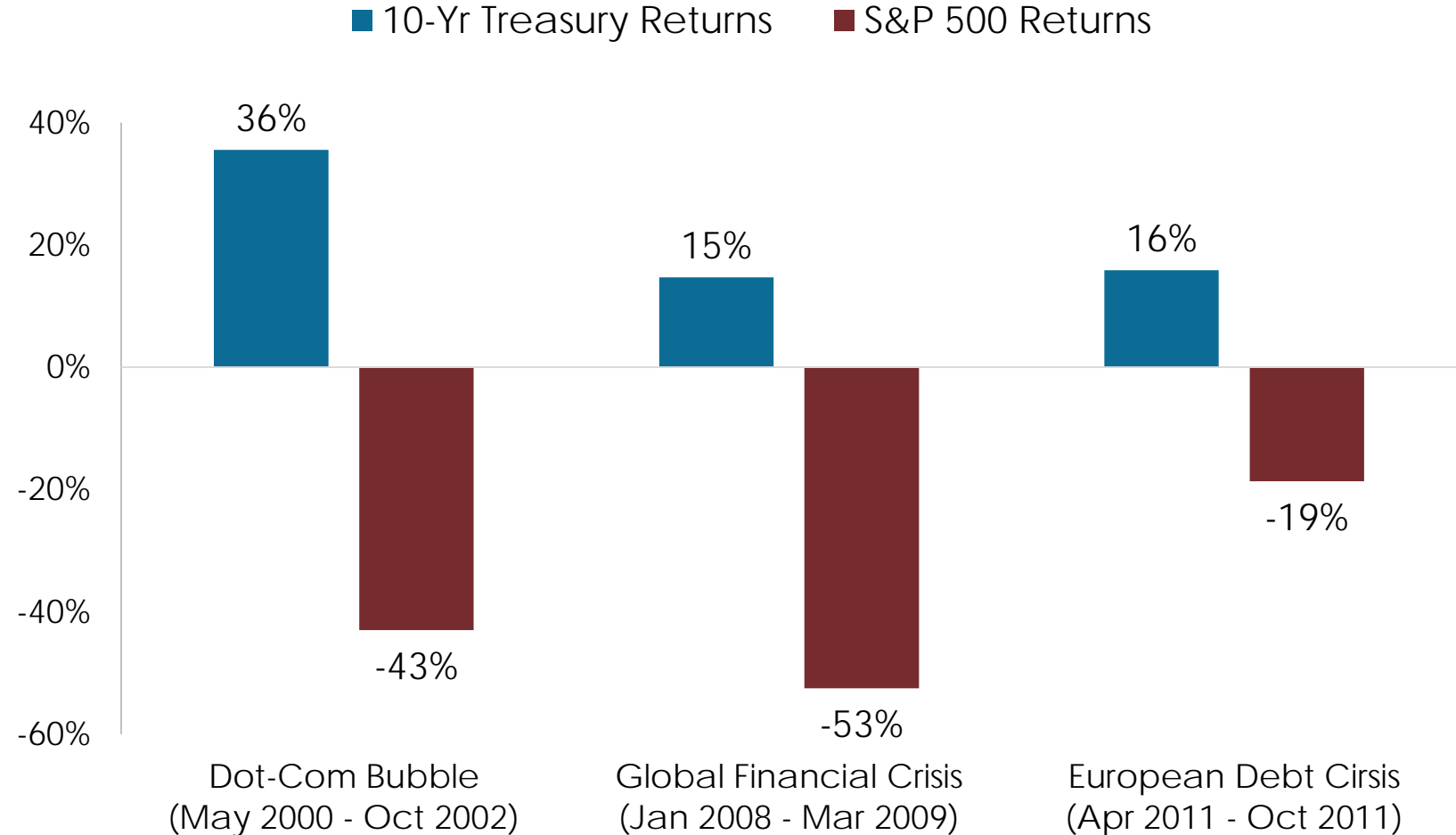
# QUANTITATIVE TIGHTENING: "HOW FAST IS TOO FAST?"



Source: Federal Reserve Bank of Atlanta, Federal Open Market Committee (FOMC), Factset, Glenmede.

\*The Wu-Xia "shadow" federal funds rate is a theoretical short term interest rate meant to provide a better measure of US monetary policy than the Fed Funds rate alone. Interpolated from the Fed Funds futures market, it reflects the combined effect of all monetary policy actions (both interest rate reduction and quantitative easing). Future shadow rate estimates are calculated based off the trend of previous data as provided by Wu-Xia, combined with the Fed dot chart for future rate hikes, and the balance sheet unwinding plan.

## STOCK AND BOND RETURNS DURING PERIODS OF MARKET STRESS



Source: Glenmede

10-Year Treasuries returns are calculated using the Bloomberg Barclays US Treasury Bellwethers (10 Y) Index.

Past performance is not indicative of future returns.

These are unmanaged total return indices with cash flows reinvested. One cannot invest directly in these indices.



### 1. Limit Interest Rate Risk

- Manage duration, & utilize go-anywhere strategies
- But **don't** give up on bonds

### 2. Allocate to real assets

- Commodities
- Commodity-oriented equities (energy stocks & MLPs)
- Real estate



## Wall of Worry

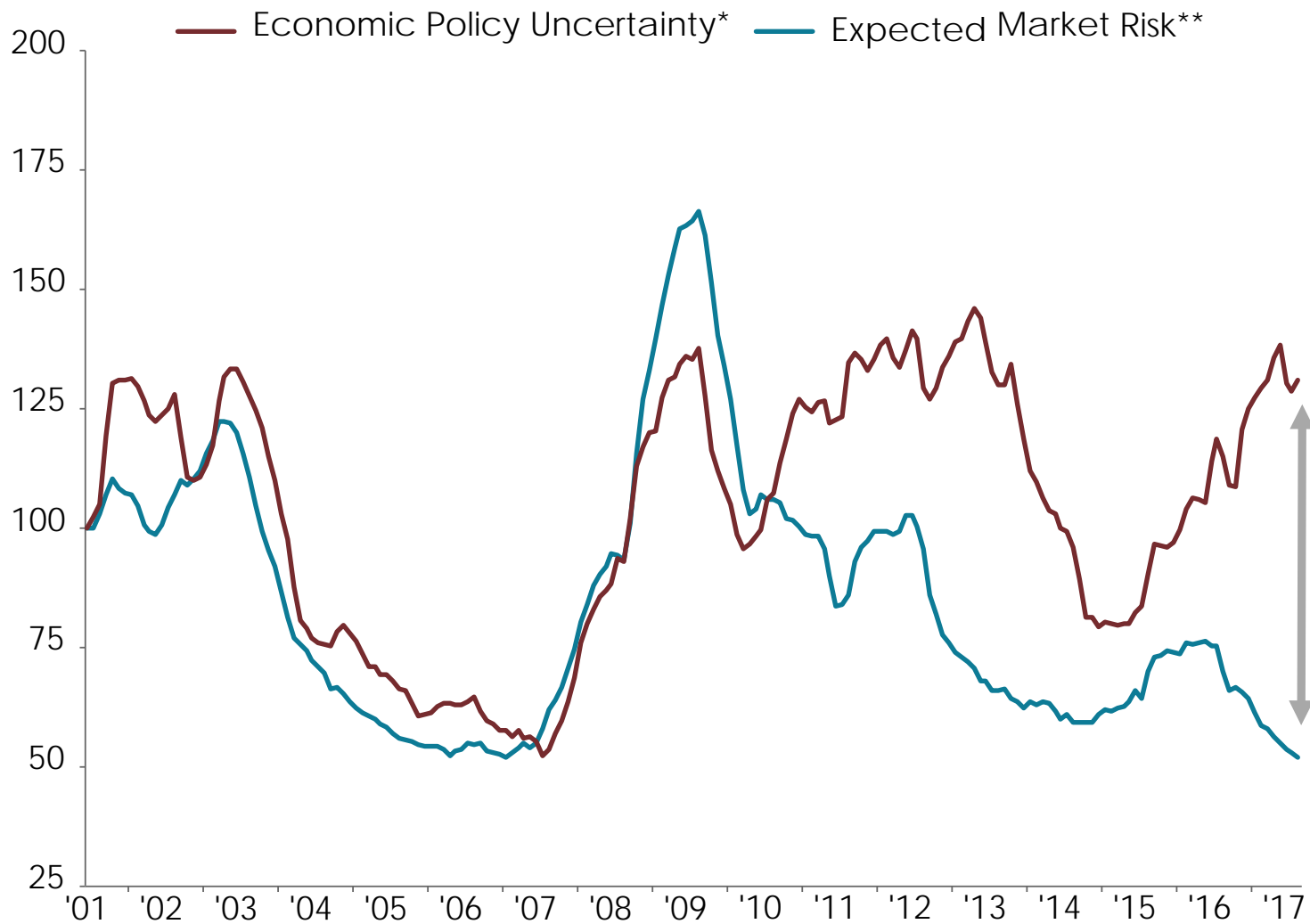
#1 Over-Extended Markets

#2 Deflation / Low Inflation

#3 Tightening Monetary Policy

#4 Geopolitical Instability  
(North Korea, Brexit, U.S. politics, etc.)

# UNCERTAINTY AND MARKET RISK DIVERGE - ARE MARKETS TOO COMPLACENT?



Source: Glenmede, Chicago Board of Options Exchange (CBOE), FactSet

\*Economic Policy Uncertainty is an index of the volume of major news articles discussing political uncertainty.

\*\*Expected Market Risk is the CBOE Volatility Index (VIX), a measure of projected market volatility based on options pricing.

Both indexes are displayed using a 12 month moving average and indexed to 100.

Data as of 8/31/2017

# GEOPOLITICAL RISKS ARE NOT A NEW PHENOMENON



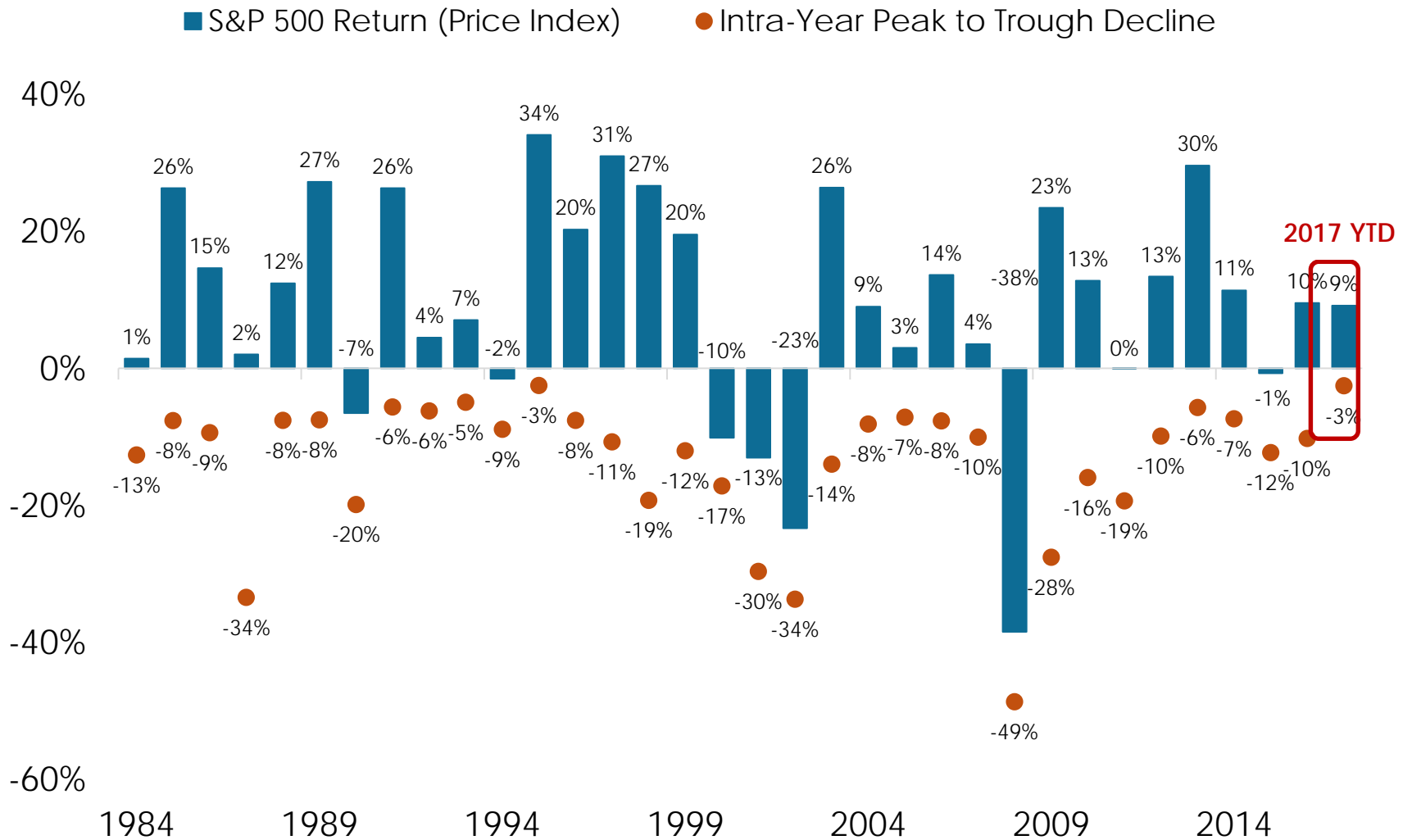
Source: MSCI

\*The MSCI ACWI Index is an unmanaged, market-value weighted index with dividends reinvested, which represents the performance of large and mid-cap companies across developed and emerging market countries around the world. You cannot invest in an index.

Past performance is not indicative of future returns.

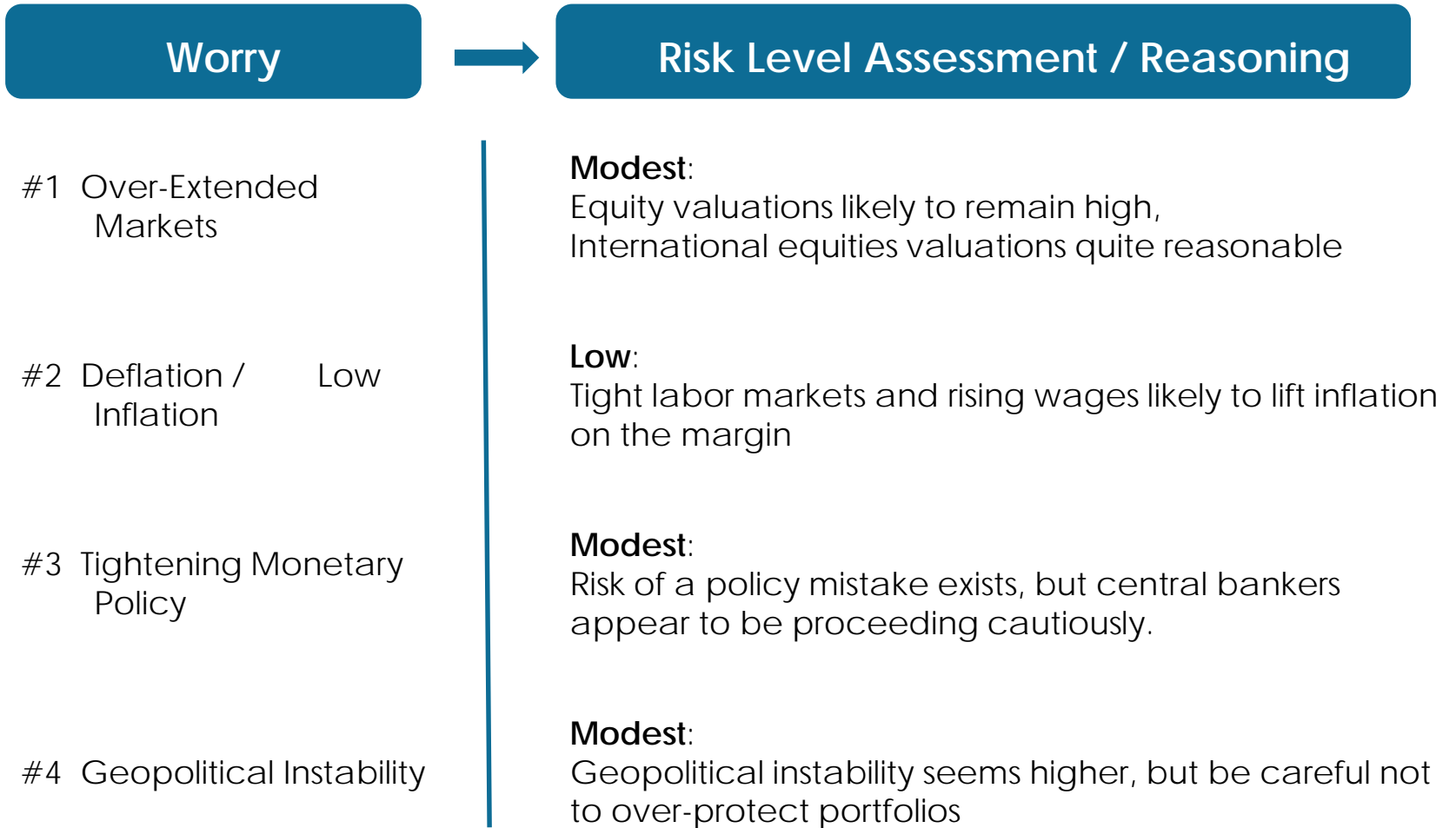
Data as of 8/31/2017

# CORRECTIONS OCCUR QUITE FREQUENTLY, BUT ARE OFTEN TRANSITORY



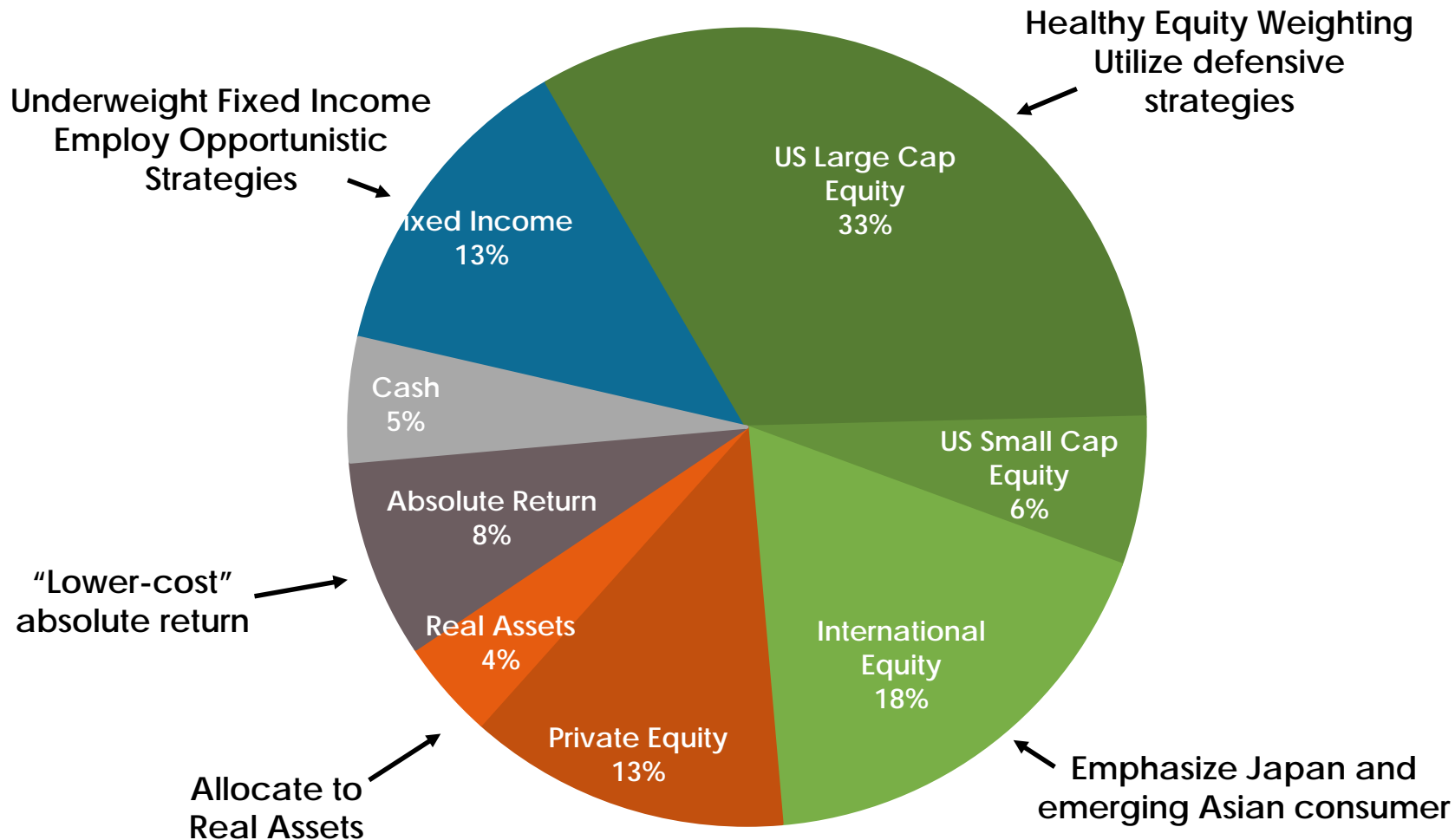
Source: JP Morgan, Factset.

Data





# RECOMMENDATION FOR A MODERATE GROWTH INVESTOR



*This represents our Growth with Moderate Income All Asset with Partnerships model. Not every product is suitable for every investor; decisions about what to invest in are individualized and will depend on facts and circumstances. Alternative funds are typically open only to investors meeting certain minimum qualifications, and there is no assurance that an application to invest will be accepted. Managers generally charge fees for these products in addition to other fees which may be charged by Glenmede. All investment has risk, including risk of the loss of principal. Please discuss all questions you may have regarding matters raised here with your Glenmede representative.*

A man in a dark suit and white shirt is seen from behind, looking out of a large window at a sprawling city skyline at night. The city lights are vibrant, with many buildings illuminated in yellow and white, and some in red and blue. The sky is a deep blue. The man's hands are raised in front of him, palms facing forward, as if he is gesturing or presenting. The overall scene is professional and modern.

The  
University  
of Akron

# 2017 National Tax Conference

*In Honor of Alvin H. Lieberman*

# TAX ASPECTS OF PLANNED GIVING AND DONOR-ADVISED FUNDS

2017 National Tax Conference  
September 28, 2017

## LAURA FINK

Director of Development &  
Professional Advisor Relations  
Akron Community Foundation

## ALEXANDER C. CAMPBELL

Attorney  
Buckingham, Doolittle & Burroughs, LLC



# Agenda

---

Types of Tax Exempt Organizations

Benefits of Charitable Giving

Private Foundation vs. Public Charity vs. Donor  
Advised Fund

Mechanics of DAFs

Center for Family Philanthropy

Ways to fund a DAF

Other Planned Giving Options



# Types of Tax Exempt Organizations

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Public Charity (churches, schools, hospitals, etc.)

Private Foundation

- Private Operating Foundation
- Private Non-Operating Foundation

Social Welfare Organization

Trade Association

Etc.



# Benefits of Charitable Giving

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Charitable contribution deduction

Sale of a closely held business interest

- Compare gift in face of imminent sale of business vs. gift not in face of imminent sale
- Gift followed by redemption

Gift of stock

- C corporation vs. S corporation

Gift of partnership interest

Charitable gifting with retained control

# What is a Private Foundation?

---

Default tax exempt organization (defined by what it is not)

Operating vs. Non-Operating

Family vs. Corporate vs. Independent

Compare to Community Foundation like ACF





**Private  
Foundation**

**VS.**

**Public  
Charity**





# Why a Private Foundation?

---

- Advantages of PF
  - Donor can have legal control over the PF, including over its directors and officers, its charitable grants, and its administration. (Practically, less of a consideration since DAF virtually always follows the donor's wishes as to charitable grants. DAF will retain donor's investment advisor in many cases.)
  - Ability to make program related investments.
- PF can pay reasonable compensation to the donor and his or her family members and affiliated companies for personal services. DAFs cannot.
- PF can operate charitable programs directly and make grants to foreign charities. DAFs ordinarily do not.

# What is a Donor-Advised Fund?

---

A tax-preferred investment account for charitable giving

- Donor receives the maximum charitable deduction allowed by law

An alternative to private foundations

- A similar, but simplified tool for charitable giving – no paperwork for the fundholder
- Like a combined charitable savings and checking account
  - Donor makes a donation to establish the fund, but can wait to make grants to their favorite nonprofits on their own timeline

# Why a Donor-Advised Fund?

---

## Low Cost

- \$5,000 donation (tax deductible) to establish a fund and no out-of-pocket fees to manage

## Streamlined Gift Accounting

- Only need to track contributions to the fund, rather than to each individual charity

## Privacy

- Funds can be named as the donor wishes (after their family or business, or in a more anonymous way) and gifts from the fund can be made anonymously

## Legacy

- Funds can be endowed to grow in perpetuity, so grants can be made in donor's name long after they're gone
- Successor advisors can be named as fund is established to include children in family philanthropy discussions



	Private Foundation	Donor-Advised Fund of ACF
Legal Identity	Separate nonprofit corporation with donor's choice of name	Fund of Akron Community Foundation's with donor's choice of name
Tax Status	Private Foundation	Public Charity
Minimum Size	Generally, \$1 million and up, with \$5-10 million recommended	\$5,000
Taxation of Investment Income	Up to 2% annually	None
Required Payout	5% annually	None
Deductibility of Cash Gifts	Up to 30% of AGI	Up to 50% of AGI
Deductibility of Long-Term Capital Gain Property	Deductible at cost only, except for qualified appreciated securities, which are deductible at fair market value up to 20% AGI	Deductible at fair market value up to 30% of AGI
Administration	Donor responsible for all accounting and record keeping, including detailed IRS annual filing	ACF responsible for all accounting and record keeping; no separate IRS filing required
Grant-making Expertise	Donor must be knowledgeable or obtain professional advice	ACF staff available to research donor interests, advise donor, monitor grants
Control	Private foundation board has control of distributions and responsibility for asset management	Donor advisor(s) recommend grants and investment pool for ACF Board approval
Upfront Costs	Substantial organizational fees and expenses, plus local, state and federal filing fees of \$700	None
Annual Costs	Legal and accounting fees, insurance, possibly staff and office expenses	Administrative fee of 1.25% of assets (or less depending on asset size)

# Excise Taxes

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## Private Foundations

- IRC § 4940 tax on net investment income
- IRC § 4941 tax on self dealing with disqualified persons
- IRC § 4942 minimum annual distributions
- IRC § 4943 excess business holdings prohibition
- IRC § 4944 prohibition on jeopardizing investments

## Donor-Advised Funds

- IRC § 4943 excess business holdings prohibition
- IRC § 4958 automatic excess benefit transactions
  - Slightly different definition of disqualified person and different, less stringent intermediate sanctions regime

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**Both PFs and DAFs subject to unrelated business income rules.**

# Assets to Gift to a DAF

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- Publicly traded securities (including stocks, bonds, mutual fund shares)
- Restricted and controlled stock (appreciated assets)
- Privately-held stock
- Real estate
- Life insurance
- Private foundation grants or terminations
- Bequests
- Named beneficiary of charitable remainder trust

# When is a DAF a Good Idea?

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## When more time is needed

- Any time there is a desire to contribute and get the deduction now but make the actual grant to the final charity at some later date

## To offset a high income year

- Major liquidity event, sale of business, payment of deferred compensation, execution of stock options by front-loading contributions

## When there are appreciated investments

- Stocks, mutual funds, ETFs, real estate, or company stock that are eligible for a charitable deduction at fair market value, eliminating capital gains

## When the donor wants to be anonymous

## When the donor wants to involve family



# Giving through an IRA

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Required minimum distributions cannot be used to establish a DAF but can be used to set up a scholarship or designated fund. Here are some guidelines:

- Donor must be age 70 ½ or older
  - RMDs must be made directly to charity, not included in income
  - Not qualified for a charitable deduction, but lowers AGI
  - Up to \$100,000 can be rolled over per individual (\$200,000 for couple)
  - Made permanent in 2015
- To help reduce income tax burden to decedent, advise clients to leave assets that have tax-free income (Roth IRA, Life Insurance) to family and traditional IRAs and 401k to charity.
  - DAFs can accept donations of assets in an IRA at death



# S Corporation Stock Donations

## HOW IT WORKS



**Contributes S Corp stock to third-party charitable trust.**

Business owner donates \$1M of S Corp stock with a \$200K adjusted basis.

**Third-party charitable trust sells shares.**

Trust sells stock for \$1M.  
Trust pays UBIT at trust rate:  
( $\$800K$  at 15%) = \$120K

**Third-party charitable trust donates net proceeds to ACF.**

Trust receives a 50% AGI deduction, reducing taxes to \$60K. After fees, the business owner's donor-advised fund at ACF receives \$915K.

# Other Planned Giving Options

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Simple Gift

Gift Annuity

Charitable Lead Trust

Charitable Remainder Trust



A person in a dark suit, white shirt, and red and grey striped tie is holding a glowing white orb. The orb is the central focus and contains the text 'Looking to the Future'. The person's hands are positioned around the orb, with the left hand on top and the right hand on the side. The background is dark, making the glowing orb stand out.

Looking to  
the Future

# Conclusions and Time for Questions

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A man in a dark suit and white shirt is seen from behind, looking out over a sprawling city skyline at night. The city is illuminated with warm yellow and orange lights, contrasting with the cool blue tones of the sky and the window panes. The man's hands are raised in front of him, palms facing forward, as if he is gesturing or presenting. The background is a dense urban landscape with numerous skyscrapers and buildings, some of which are brightly lit. The overall atmosphere is professional and forward-looking.

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# Choice of Entity

PRESENTED BY MARK LAPIKAS, CPA, MTAX, MBA

- One of the first decisions a business owner makes is to choose how they should structure their business
- Considerations include:
  - Legal
  - Tax
  - Initial and Maintenance Cost
  - Operational Complexity
  - Future outlook
  - Audit Risk
- How the business is structured will affect subsequent transactions so careful consideration is needed.

# What We Need to Find Out

- Type of business
- Experience of the owners
- Goals and objectives of the owners
- Business plan
- Capital requirements
- Disposition strategy
- Health of the owner and owner's family
- Current tax situation



- State Law
  - Register with the Secretary of State
  - Common choices include:
    - Corporation (Inc)
    - Limited Liability Company (LLC)
    - Limited Liability Partnership (LLP)
- Federal Law
  - File Form SS-4 – “Application for Employer Identification Number (EIN)” to select entity based on state legal structure.

# Common Business Entities

- Sole proprietorship
- Partnership
- C corporation
- S corporation
- LLC

# Sole Proprietorship

- A business conducted by one owner without formal organization of a separate legal entity.
- Both business and personal assets are subject to creditor claims. An owner's liability is unlimited.
- Business activity is reported on Schedule C, E, or F on owners Form 1040.

# Sole Proprietorship (cont.)

- Advantages
  - Easy to form
  - Low cost
  - No formal organizational structure
  - Easy to discontinue
  - Minimal legal restrictions
  - No corporate formation to conduct and document
  - Only one level of tax imposed

# Sole Proprietorship (cont.)

- Disadvantages
  - Unlimited liability
  - Net income is subject to SE tax
  - Retirement contributions for the owner are not a business deduction and therefore subject to SE tax
  - May not bring in new owners or outside capital
  - Limited skills and abilities
  - Lack of business continuity
  - Income tax cannot be deferred by retaining profits

# Partnerships

- An association of two or more people who conduct a business as co-owners.
- Business activity is reported on Form 1065.
- General partners have unlimited liability.
- Limited partners have limited liability.

# Partnership (cont.)

- Advantages
  - Easy to form
  - Low organizational cost
  - Limited organizational structure
  - Combines the skills and financial abilities of several people
  - Special allocations of income and loss are allowed
  - Contributions and distributions of property are usually tax free
  - A step-up in basis of partnership assets is allowed

# Partnerships (cont.)

- Disadvantages
  - Unlimited liability for general partners
  - Difficult to transfer ownership
  - Lack of continuity
  - Difficult to attract outside investment
  - Partners bound by law of agency



- A legal entity separate from its owners (shareholders).
- Limited liability for owners, officers, and directors.
- Business activity is reported on Form 1120.
- Different Types:
  - Private, Public, Closely-Held, Professional Corporations

# Corporations (cont.)

- Advantages
  - Limited liability for shareholders
  - Continuation of enterprise
  - Centralized management
  - Able to attract capital
  - Easy to transfer ownership

- Disadvantages
  - Costly to form and organize
  - Corporate formalities
  - Annual compliance and registration
  - Potential for loss of control

# Limited Liability Companies

- Advantages
  - Limited liability for members
  - Continuation of enterprise
  - Easy to attract new investment
  - Less record keeping than a corporation
  - Flexibility in organizational and management structure

# Entity Comparison – NonTax Differences

<u>Issue</u>	<u>S Corporation</u>	<u>Partnership</u>	<u>LLC/LLP/LLLP</u>	<u>Sole Proprietorship</u>
Limited liability for owners?	Yes, but shareholders usually guarantee corporate debt.	No for general partners, yes for limited partners. Limited partners cannot be actively involved in the business without losing limited liability.	Yes for LLC and LLLP; no for LLP in some states except for other's professional acts—other states provide LLC-type liability limitation for LLPs.	No, liability is unlimited.
Flexible ownership?	No. Limited to 100 shareholders and one class of stock. Types of shareholders are limited.	Yes. Need at least two partners.	Yes. Some states may restrict professionals and other industries from LLC.	N/A—one owner.
Continuity of life?	Yes, but stock ownership must be monitored.	Generally, no.	Generally no, but available in some states.	No.
Multiple classes of ownership?	Common stock (voting and nonvoting).	Yes.	Yes for LLC (managing and nonmanaging); check state law for LLP. Yes for LLLP (general and limited partners).	N/A.

# Single vs Double Taxation

- Single Taxation
  - Sole proprietor, S-corporation, LLC, LP, LLP, LLLP
  - S-corporation which were formerly C-corporations could have double taxation on built-in-gain and AE&P.
- Double Taxation
  - C-corporation earnings are subject to double taxation.
  - Dividends are taxed at 15%-20% (23.8% with NIIT).
  - Corporate tax rates:
    - 15% - \$0 to \$50,000
    - 25% - \$50,000 to \$75,000
    - 34% - \$75,000 to \$100,000
    - 39% - \$100,000 to \$335,000
    - 34% - \$335,000 to \$10,000,000
    - 35% - \$10,000,000 to \$15,000,000

# Ways to Reduce Double Taxation

- Closely held C-corporations:
  - Compensation
  - Fringe Benefits
  - Rent
  - Interest
  - Consulting Agreement
  - Other Deductible Payments

# Check-the-Box Regulations (Reg §301.7701)

- Came into effect on January 1, 1997.
- Elective regime for unincorporated entities to choose how to be taxed for federal income tax purpose.
- If an election is not made, default rules apply:
  - Disregarded = unincorporated with a single member
  - Partnership = unincorporated with multiple members
  - Corporation = incorporated



# Check-the-Box Regulations (cont.)

- Federal tax law is separate from state law.
- If you form an LLC in Ohio, you can follow the default Federal classifications or file:
  - Form 8832 – “Entity Classification Election”
    - Single Owner = LLC taxed as disregarded to an LLC taxed as a corporation.
    - Multiple Owners = LLC taxed as a partnership to an LLC taxed as a corporation.
  - Form 2553 – “Election by a Small Business Corporation”
    - Single Owner = LLC taxed as disregarded to an LLC taxed as an S corporation
    - Multiple Owners = LLC taxed as a partnership to an LLC taxed as an S corporation
    - Note: You can go directly to an S corporation without filing as a corporation (From 8832) first.

- C-Corporation
  - Losses carryforward for 20 years
- S-Corporations/Partnerships
  - Losses pass through to individuals
- If switch from C to S corp, C corp losses can offset built-in gain but will be trapped.

# Capitalization – C corps and S corps

- Shareholder Tax Consequence
  - No gain or loss on the contribution of assets for stock as long as:
    - Property (cash/real/intangible) is exchanged for stock.
    - Transfer must be solely in exchange for stock.
    - Shareholder transferring assets must be in control (80%) of the corporation immediately after the exchange.
      - Contributed appreciated property by a less than 80% partner could result in gain (FMV – Basis).
  - A tax-free contribution of property will result in carryover basis in the stock.
- Corporate Tax Consequence
  - Receipt of property in exchange for stock is not taxable to the corporation.
  - Corporation receives carryover basis in the property + gain recognized by shareholder.

# Capitalization – Partnership

- Partner Tax Consequence

- In general, no gain or loss on the contribution of assets for a partnership interest.
- In general, services provided in exchange for a partnership interest will be taxed.
- Partner's basis in partnership interest equals:
  - Money contributed + partner's adjusted basis in property contributed.

- Partnership Tax Consequence

- No gain or loss is recognized on the contribution of property by a partner in exchange for a partnership interest.
- Partnership's basis in property contributed equals:
  - Money contributed + partner's adjusted basis in property contributed.

# Distributions – Corporations

- Shareholder Tax Consequence
  - Distributions are taxed to a shareholder as a dividend.
  - Ordering rules:
    - 1) Current E&P (Dividend)
    - 2) Accumulated E&P (Dividend)
    - 3) Return of Capital
    - 4) Capital Gain
- Corporate Tax Consequence
  - No gain or loss on distribution of cash to shareholders.
  - If appreciated property is distributed, the corporation must recognize gain as if the property were sold to the shareholder at FMV.

# Distributions – S Corporations

- Shareholder Tax Consequence
  - Ordering rules
    - 1) AAA
    - 2) AE&P
    - 3) Return of Capital
    - 4) Capital Gain
  - Basis
    - + Stock purchase
    - + Cash contributed and FMV of any property contributed
    - + Partner's distributive share of taxable and tax-exempt income
    - + Increase in shareholder loans
    - - Distributions
    - - Partners distributive share of losses
    - - Decrease in shareholder loans
- S Corporation Tax Consequence
  - No gain or loss on distribution of cash to shareholders.
  - If appreciated property is distributed, the corporation must recognize gain as if the property were sold to the shareholder at FMV.

# Distributions – Partnerships

- Partner Tax Consequence
  - Basis:
    - + Cash contributed or FMV of property contributed
    - + Partner's distributive share of taxable and tax-exempt income
    - + Increase in Partner's share of liabilities (recourse/qualified nonrecourse)
    - - Distributions
    - - Partners distributive share of losses
    - - Decrease in Partner's share of liabilities (recourse/qualified nonrecourse)
- Partnership Tax Consequence
  - No gain or loss is recognized to the partnership on a distribution of property or money to a partner.

# Liquidation – Corporations

- Liquidation is a taxable event for both corporation and shareholder.
  - A Corporation may liquidate by:
    - 1) Paying off creditors and distributing assets to the shareholder.
      - Under a plan of liquidation, taxed as having sold assets to the shareholder at FMV.
    - 2) Selling assets, paying creditors, and distributing the remaining cash.
      - Gain on sale of assets is taxed.
      - Taxed at corporate level and shareholder level on distribution.



- Selling-Partner
  - Recognizes ordinary income on hot assets (unrealized receivables/inventory).
  - Recognizes capital gain or loss =
    - Sale Price – Hot Assets – Adjusted Basis of Interest
- Buying-Partner
  - Inherits the selling partners capital account.
  - Likely to be a disparity between inside basis and outside basis due to appreciation/depreciation in value.
    - IRC Section 754 allows adjustments to the inside basis to resolve the disparity.

# Liquidation – Partnership

- Partner
  - Guaranteed payments are treated as ordinary.
  - Payments for Unrealized Receivables are treated as ordinary.
  - Payments for partner's interest are treated as a distribution
    - 1) Return of Capital
    - 2) Capital Gain
- Partnership
  - Terminates if stops doing business as a partnership or if 50% or more of total interest is sold or exchanged within 12 months.
  - If a partnership technically terminates due to an ownership change, the former partnership ceases to exist for tax purpose and a new partnership is formed. EIN is retained. Elections reset.

# Restrictions – C Corporation

- Ownership
  - No restrictions on ownership.
  - No limitation on number of shareholders.
  - Maybe owned by individuals, partnerships, LLCs, corporations, and trusts.
- Capital Structure
  - Can have more than one class of stock.
  - Can have differences in voting rights and distributions.

# Restrictions – S Corporation

- Ownership
  - Restrictions on ownership.
  - No more than 100 shareholders.
  - Only US citizens and residents can own S corporation stock.
- Capital Structure
  - Can have only one class of stock.
  - Can have differences in voting rights.
  - Distributions must be pro rata based on ownership percentage.

# Restrictions – Partnership

- Ownership
  - No restrictions on ownership.
  - No limitation on number of partners.
  - Maybe owned by individuals, partnerships, LLCs, corporations, and trusts.
- Capital Structure
  - Have flexibility to allocate profits, losses, and credits.
    - Allocations must have substantial economic effect.
  - Distributions can be disproportionate.

- C & S Corporations
  - Inherited stock is stepped up to FMV at the date of death.
  - Underlying assets are not affected.
- Partnership
  - IRC Section 754 allows a partnership to adjust the tax basis of partnership assets in the event of a partner sale, exchange, or death.
  - Once the election is in place, it applies to all transfers.

# Employment Taxes

- C-Corporation
  - Owner/employee wages are subject to payroll taxes.
  - Distributions are treated as a taxable dividend.
- S-Corporation
  - Owner/employee wages are subject to payroll taxes.
  - Generally, distributions are tax free.
  - Incentive to minimize wages and increase profit distributions.
- Partnership
  - Partners are subject to self-employment tax on all earnings.

# Payroll Tax Savings

	Self-Employed	Owner Employee
Business income (before salary)	1,000,000	1,000,000
Less: W-2 wages paid to owner	-	(200,000)
Business taxable net income	1,000,000	800,000
Social Security (6.2% * 2 = 12.4%) (Limit is \$127,200)	15,773	15,773
Medicare (1.45% * 2 = 2.9%) (No Limit for SE Income/Limited to W-2 wages)	29,000	5,800
High Income Earners (0.9% over \$200,000 single)	7,200	-
Total payroll tax	51,973	21,573
Payroll tax savings		30,400
Self-Employed = Sole Proprietor, Partnership		
Employee = C-corporation, S-corporation		



# Entity Comparison – Tax Differences

<u>Issue</u>	<u>S Corporation</u>	<u>Partnership</u>	<u>LLC/LLP/LLLP</u>	<u>Sole Proprietorship</u>
Payroll tax/SE tax savings?	Yes, within limits of reasonable compensation.	No.	No.	No.
Tax-free withdrawal of assets?	No.	Yes.	Yes.	Yes.
Special allocation of income or loss?	No.	Yes.	Yes.	N/A.
Owner has tax basis and loss deductions from entity debt?	No, even if owner guarantees debt.	Yes.	Yes.	Yes.
Treatment of gain on sale of ownership interest?	Capital.	May be part ordinary under hot asset rules. (IRC Sec. 751)	May be part ordinary under hot asset rules. (IRC Sec. 751)	May be part ordinary due to recapture items.
Treatment of loss on sale of ownership interest?	Capital unless stock is Section 1244 stock.	No.	Capital.	Generally capital (depends on nature of assets sold).

# Double Taxation on Asset Sale

Below is an example to explain the different tax outcomes between selling a C-corporation vs. S-corporation assuming each business was sold for \$10,000,000:

C corporation	
<u>Corporate - Tax Rates</u>	
Federal Tax Paid at Entity Level	\$ 3,400,000
Income available to distribute as a Dividend	\$ 6,600,000
Tax on Dividends (20% Federal Tax + 3.8% NIIT***)	23.8%
Tax at Individual level on Dividends	\$ 1,570,800
Total Corporate Level Tax	\$ 3,400,000
Total Individual Level Tax	\$ 1,570,800
Total Tax Paid on Sale of a C-corporation for \$10,000,000	\$ 4,970,800
S corporation	
<u>Married - Tax Rates</u>	
Federal Tax Paid at Individual Level	\$ 3,905,231
Tax Savings	\$ 1,065,569

\*\*\*Passive ownership

# Use of Multiple Entities

- C-Corporation
  - Generally, should not hold appreciating assets such as real estate or securities.
  - Getting assets out upon dissolution triggers an entity level tax on appreciation.
  - Corporations are more common for operating businesses.
- LLC/Partnership
  - Generally, more advantageous to hold appreciating assets of a business in an LLC or Partnership
  - Upon death, assets get stepped up to FMV.

- C-Corporation
  - In general, can have any year-end.
    - Tax return due 3.5 months after fiscal year-end.
- S-Corporation and Partnerships
  - IRC Section 444 allows a taxpayer to elect a 9/30, 10/31, or 11/30 fiscal year-end.
    - IRC Section 7519 requires an entity make a tax deposit.
    - Tax return due 2.5 months after fiscal year-end.

# Audit Risk – 2015 Statistics

- Total returns filed = 192,936,878
- Total returns audited = 1,166,379
- Break down of audit risk:
  - Large Corporations = 9.5% (6,453 returns)
  - Small Corporations = 0.8% (14,136 returns)
  - Partnerships = 0.4% (14,645 returns)
  - S Corporations = 0.3% (15,869 returns)
  - Individuals = 0.7% (1,034,955 returns)

Note: Large corporation is over \$250 million in assets.

# New Partnership Audit Regime - 1/1/18

- Audit adjustments will be made at the partnership level.
  - The partnership is required to pay the tax, interest, and penalties.
    - Can make an election to pass through the audit adjustments to the partners to pay the tax, interest, and penalties.
    - Tax to be collected at 39.6%.
  - There is no small partnership exception to the general rule.
- Tax Matters Partner (TMP) will be replaced by a Partnership Representative (PR).
  - PR is the only person who can act on behalf of partnership.
  - PR can bind all partners with respect to action taken during audit.
  - PR need not be a partner but must have presence in the US.

# Partnership Audit Regime – 1/1/18 (cont.)

- If ownership changes occur, additional tax from audit changes may not be shared based on the ownership of the entity for the year being audited.
  - The new law permits elections which will place the tax burden on the owners for the year under audit.
  - If an “opt out” election is not filed with the tax return under audit, the PR can make a “push out” election at the end of the audit process which would make the partners responsible for any tax due.

# Partnership Audit Regime – 1/1/18 (cont.)

- Consider changes to partnership agreements, operating agreements, buy-sell agreements, etc.
  - Agreements might require the partnership file the “opt out” election annually.
  - Agreements might address the selection of a PR and the scope of a PR’s authority such as duties to keep owners informed and consideration regarding a “push out” election.
  - Agreements might address how current/former owners share any tax obligation for years under audit.
  - Language related to distributions for taxes may need adjusted.



# Trump – Proposed Tax Reform

- Lower corporate tax rate to 15%.
- Pass-through entities to be taxed at 15% on income retained in the business.
  - A second layer of tax would be imposed on distributions.
- Eliminate corporate alternative minimum tax (AMT).
- One-time reduced corporate tax rate on repatriated money.

A man in a dark suit is seen from behind, looking out over a city skyline at night. The city lights are blurred and overlaid with glowing, ethereal digital effects that resemble data or light trails. The overall scene is vibrant and futuristic.

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# Navigating the New Disguised Sale Landscape

Paul H. Speyer, JD, LLM

MALONEY + NOVOTNY

# Timeline of the Regulations

January 30, 2014

- Proposed Regulations Issued

October 5, 2016 -

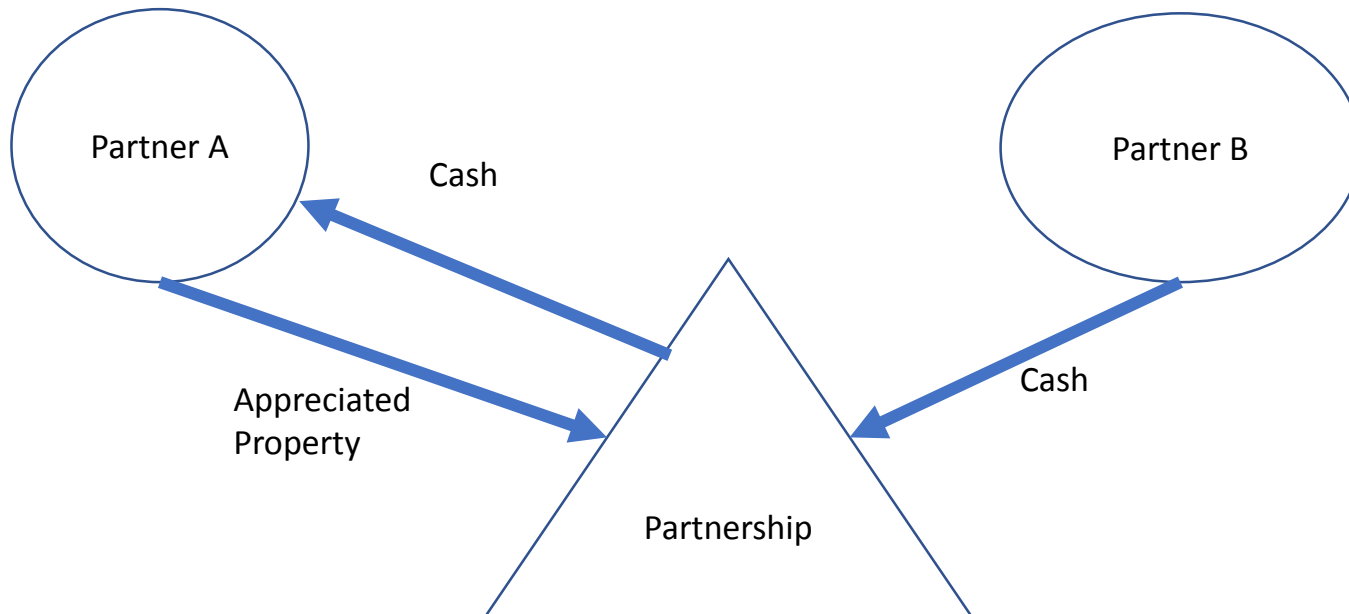
- Final (T.D. 9787) Section 707
- Temporary (T.D. 9788) Section 707, Section 752
- Proposed (REG-12855-15) Section 752

# Disguised Sales in General

- Generally, no gain or loss is recognized when money or unencumbered property is contributed to a partnership.
- IRC Sec. 707(a)(2)(B): Treatment of certain property transfers. If
  - i. there is a direct or indirect transfer of money or other property by a partner to a partnership,
  - ii. there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and
  - iii. the transfers described in (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property,then the transactions will be treated as occurring between the parties (either the partner and the partnership or two or more partners) acting other than in their capacity as members of the partnership.

# Classic Example

- Partner contributes appreciated property to partnership
- Partnership distributes cash to the contributing partner



# Forms of a Disguised Sale

- Partner to a Partnership
- Partnership to the Partner
- Partner to Partner

# General Rule [Reg. 1.707-3(b)(1)]

A transfer of property (other than money or debt obligations) from a partner to a partnership coupled with a transfer of money or other consideration from the partnership to the contributing partner (or vice versa) constitutes a sale if both of the following criteria are met:

- a. The money or other consideration would not have been transferred but for the property transfer.
- b. If the transfers are not simultaneous, the subsequent transfer (of either money or property) is made without regard to the results of LLC operations.



# The Two-Year Rule (Reg. 1.707-3(c)(1) and (d))

- Transfers made within a two-year period are presumed to be a sale, and transfers made more than two years apart are presumed not to be a sale
- When the transfers of property and consideration are not simultaneous, the sale date is deemed to be the date on which the property is transferred

# Recognizing When a Disguised Sale Takes Place [Reg. 1.707-3(b)(2)] (1 of 2)

- i. That the timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer;
- ii. That the transferor has a legally enforceable right to the subsequent transfer;
- iii. That the partner's right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured;
- iv. That any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration;
- v. That any person has loaned or has agreed to loan the partnership the money or other consideration required to enable the partnership to make the transfer, taking into account whether any such lending obligation is subject to contingencies related

# Recognizing When a Disguised Sale Takes Place [Reg. 1.707-3(b)(2)] (2 of 2)

- vi. That the partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt (considering such factors as whether any person has agreed to guarantee or otherwise assume personal liability for that debt);
- vii. That the partnership holds money or other liquid assets, beyond the reasonable needs of the business, that are expected to be available to make the transfer (taking into account the income that will be earned from those assets);
- viii. That partnership distributions, allocations or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property;
- ix. That the transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits; and
- x. That the partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner.

# Allocation of Liabilities

- Generally, recourse liabilities are allocated to the partner or partners that bear the economic risk of loss for such liability, to the extent the partner or partners bear the economic risk of loss.
- Nonrecourse liabilities, for general liability allocation purposes (but, as described below, not for disguised sale purposes), are allocated according to a 3-tier waterfall:
  - First tier: an amount equal to a partner's share of the "partnership minimum gain" attributable to that liability is allocated to the partner (very generally, the amount by which a nonrecourse liability exceeds the book basis of an encumbered property).
  - Second tier: then, an amount equal to the partner's share of the pre-contribution built in gain that would be allocated to such partner under Section 704(c) if the property subject to the nonrecourse liability were sold in full satisfaction of the liability and for no other consideration.
  - Third tier: any remaining "excess nonrecourse liabilities" are allocated in accordance with the partner's share of partnership profits.

# Exceptions to Disguised Sale Rules Under Old (Pre-2016) Regulations

- Qualified Liability Exclusion
- Debt-Financed Distribution Exception
- Preformation Expenditure Exception

# Treatment of Liabilities in a Disguised Sale

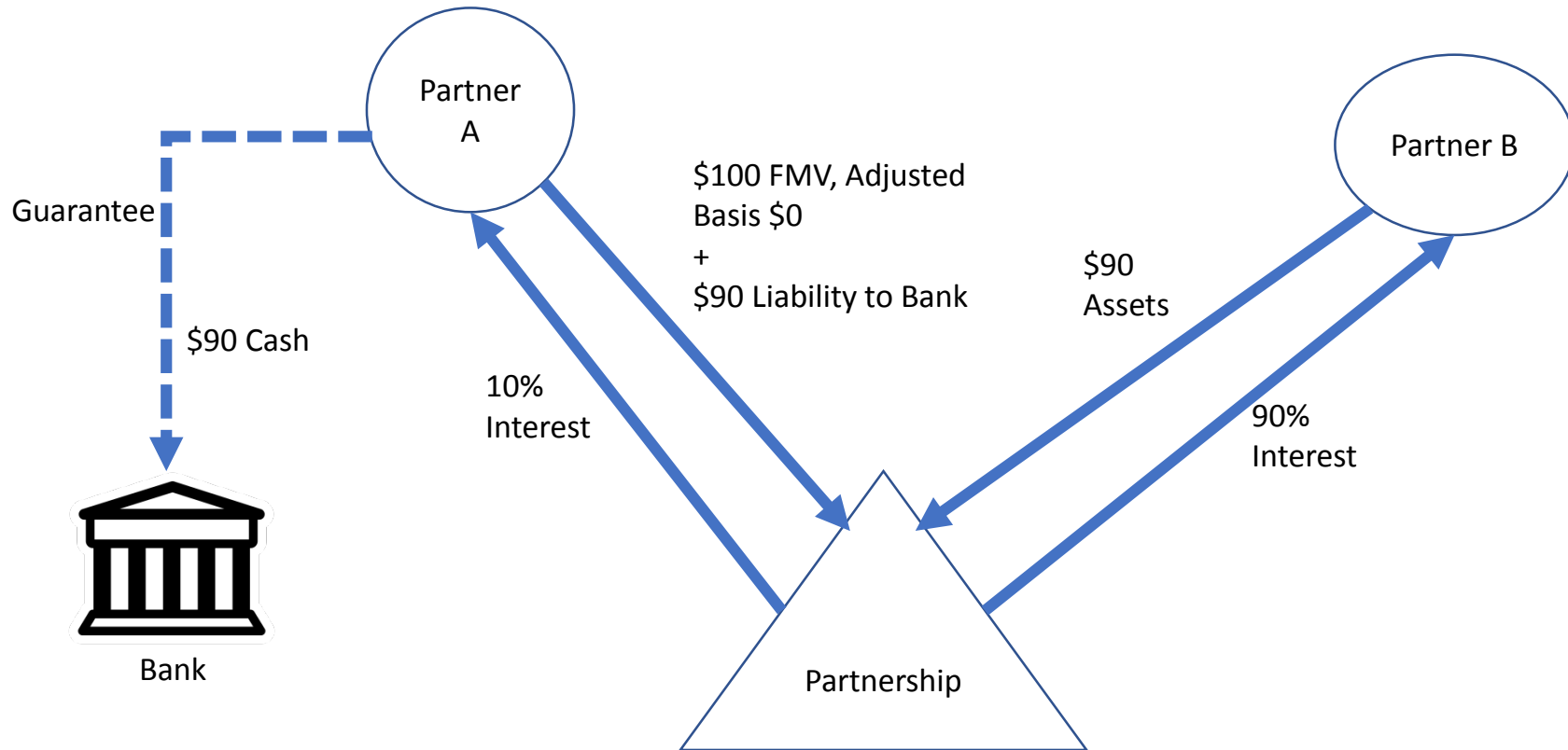
- Non-Qualified Liabilities → Consideration
- Qualified Liabilities → Only Consideration if the transfer of property would have been treated as a disguised sale *without* taking into account the transferred debt (when cash or other property changes hands)

# Qualified Liabilities

## [Reg. 1.707-5(a)(6)]

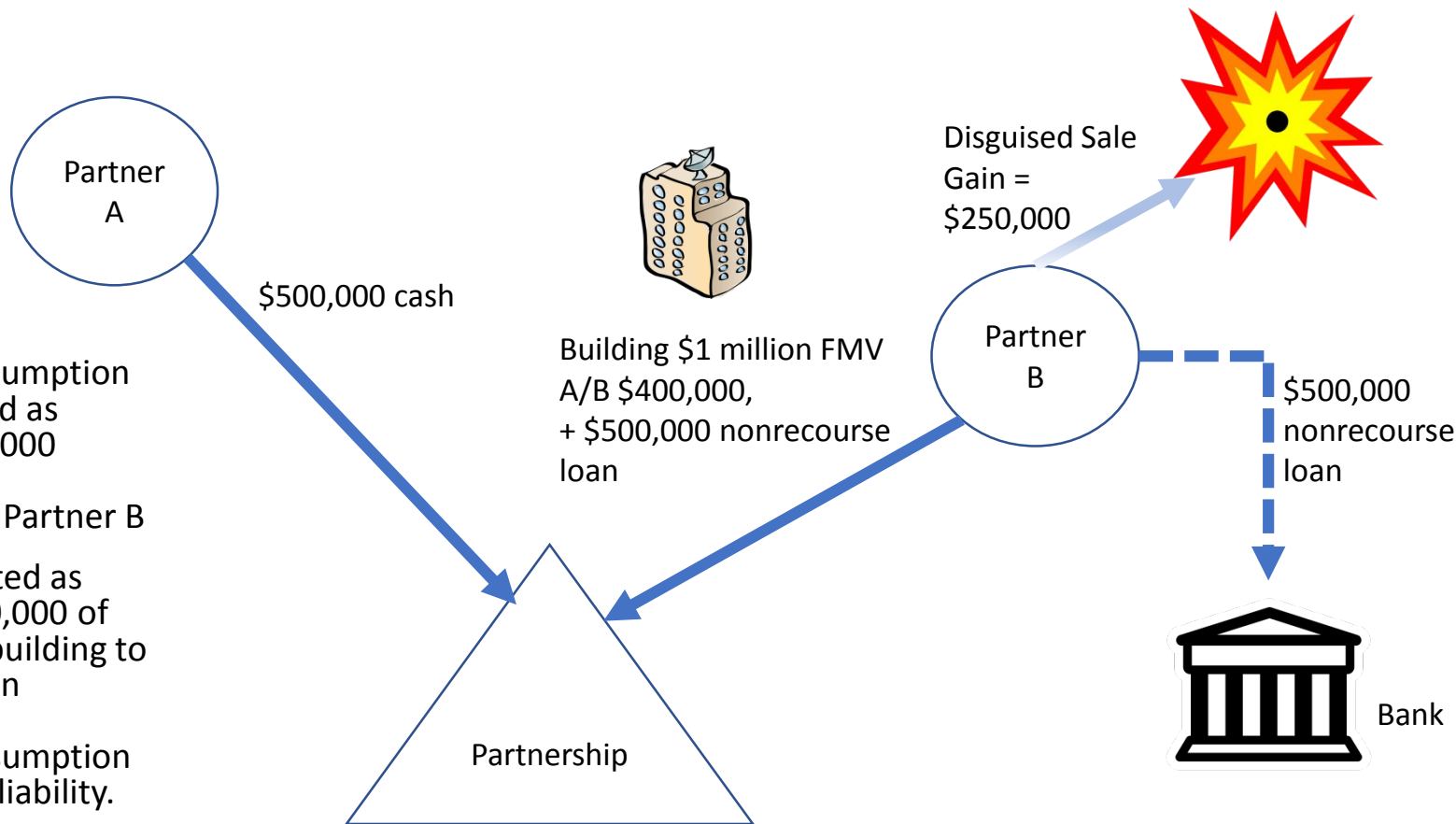
- a. Debt incurred more than two years before the transfer (or agreement to transfer) that has encumbered the transferred property throughout the two-year period.
- b. Debt incurred within two years before the transfer (or agreement to transfer) but not incurred in anticipation of the transfer. Such debt must have encumbered the property since it was incurred.
- c. Debt incurred to acquire or improve the property (under the tracing rules of Temp. Reg. 1.163-8T).
- d. A liability incurred in the ordinary course of a trade or business operated in connection with the property (but only if substantially all the assets related to that trade or business are transferred).
- e. For transactions where all the transfers occur after October 4, 2016 [see Reg. 1.707-9(a)(1)] a debt that was not incurred in anticipation of the transfer but was incurred in connection with a trade or business in which the property was used or held but only if all the assets related to the trade or business (other than assets that are not material to its continuation) are transferred.

# Qualified Liabilities: Example 1





# Qualified Liabilities: Example 2



- Partnership's assumption of liability treated as transfer of \$250,000 disguised sale consideration to Partner B
- Partner B is treated as having sold \$250,000 of the FMV of the building to the partnership in exchange for the partnership's assumption of the \$250,000 liability.

# Qualified Liabilities Exception (Continued)

Reg. 1.707-5(a)(5)(iii)

De minimis Exception: The partnership's assumption of or taking property subject to a qualified liability is not treated as a transfer of consideration made pursuant to the sale, if the total amount of all liabilities other than qualified liabilities that the partnership assumes or takes subject to is the lesser of 10 percent of the total amount of all qualified liabilities the partnership assumes or takes subject to, or \$1,000,000.

# Debt-Financed Distribution Exception

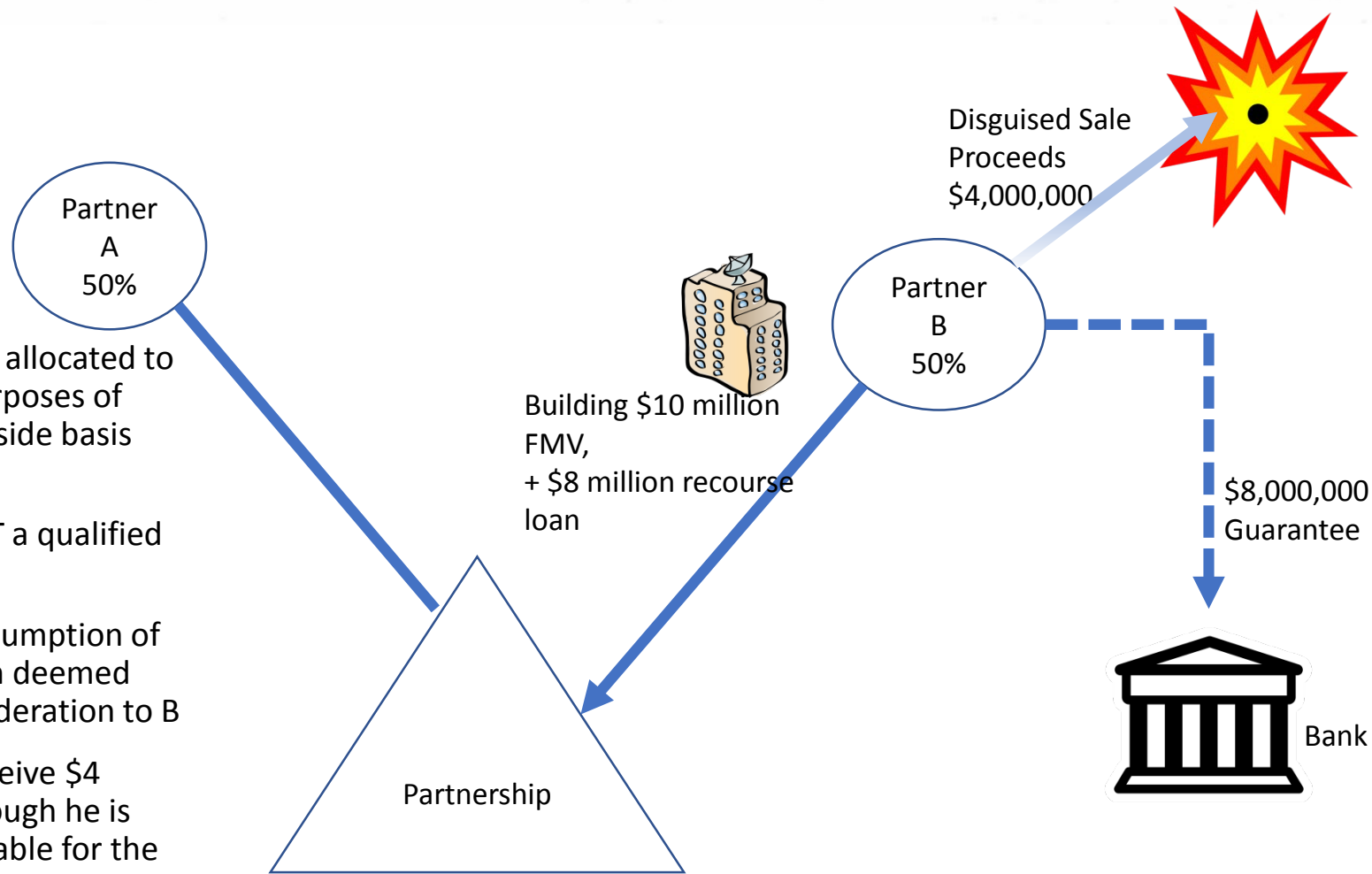
- Exception may be available when a partnership distribution that would otherwise be considered disguised sales proceeds paid to a contributing partner under the disguised sale rules, is financed by partnership debt [ Reg. 1.707-5(b)].
- The exempt amount equals the contributing partner's percentage share of the partnership debt that financed the distribution (determined under the Section 752 liability sharing rules) multiplied by the amount of the debt that is allocable to the distribution received by the contributing partner (determined under the debt tracing rules found in Temp. Reg. 1.163-8T).
- Only available for distributions made within 90 days of the date the partnership incurs the liability

# New Rules Pertaining to Debt-Financed Distribution Exception

- Determination of Share of Liabilities under Section 707
  - Same percentage used to determine partner's share of partnership's excess nonrecourse liabilities [Reg. 1.707-5T(a)(2)(i)]
  - Applies regardless of whether liability is recourse or nonrecourse
  - For purposes of the disguised sale rules, a partner's share of partnership excess nonrecourse liabilities will be based on the partner's share of partnership profits [Section 1.752-3(a)(3)]
- Qualified Liability Ordering Rule
  - An amount excludable as a debt-financed distribution is determined prior to applying the preformation expenditure exception under section 1.707-4

# Example: Partnership's Assumption of Recourse Liability

- Entire \$8 million allocated to Partner B for purposes of determining outside basis BUT...
- \$8 million is NOT a qualified liability.
- Partnership's assumption of liability results in deemed transfer of consideration to B
- B deemed to receive \$4 million, even though he is still personally liable for the entire \$8 million



# Preformation Expenditure Exception

- The disguised sale rules do not apply to reimbursement of the partnership's preformation expenses if the distribution reimburses a partner for expenses incurred during the two-year period preceding the transfer, and the capital expenditures were incurred with respect to one of the following [Reg. 1.707-4(d)]:
  - a. Organization and syndication costs of the partnership.
  - b. Contributed property-but only in an amount that does not exceed 20% of the FMV of the property at the time of contribution. (The 20% limitation does not apply if the FMV of the contributed property does not exceed 120% of the partner's adjusted basis in the property on the contribution date.)

# New Regulations – Preformation Expenditures Exception

## 20%-of-FMV Limit Clarified [Reg. 1.707-4(d)(1)(ii)(B)]:

Applies on property-by-property basis, except that partners can aggregate any of the contributed property to the extent that ALL of the following are true:

- a. The total FMV of such aggregated property (of which no single property's FMV exceeds 1% of the aggregate FMV) is not greater than \$1,000,000 (or if less, 10% of the FMV all property, excluding money and marketable securities, transferred by the partner to the partnership).
- b. The partner uses a reasonable aggregation method that is consistently applied.
- c. Such aggregation of property is not part of a plan, a principal purpose of which is to avoid the disguised sale rules.

# New Regulations – Preformation Expenditures Exception (Continued)

## Step-in-the-Shoes Transaction [Reg. 1.707-4(d)(2)]:

- A partner who acquires property from a person in a nonrecognition transaction described in IRC Sec. 351, 381(a), 721, or 731 steps in the shoes of that person for applying the capital expenditure reimbursement exception



# New Regulations – Preformation Expenditures Exception (Continued)

## Tiered Partnerships [Reg. 1.707-4(d)(3)]:

An upper-tier partnership is eligible to apply the preformation expenditure exception to capital expenditures incurred by another person when:

1. A person incurred eligible capital expenditures with respect to property;
2. Such property is contributed by the person who incurred the capital expenditures to a partnership (lower-tier partnership); and
3. Within two years from the date the capital expenditures were originally incurred, the person transfers an interest in the lower-tier partnership to another partnership (upper-tier partnership).

# New Regulations – Preformation Expenditures Exception (Continued)

## Form 8275 Disclosure:

Required whenever consideration is distributed to a partner within two years of such partner's contribution of property to the partnership, unless the consideration is either:

- i. A guaranteed payment for capital,
- ii. A reasonable preferred return, or
- iii. An operating cash flow distribution

## Disguised Sale Consequences Resulting from Temporary 752 Regulations

- Example: Partner A owns 10% of Partnership and has a basis in his partnership interest of \$70. Partnership has one nonrecourse liability of \$1,000, \$400 of which is allocated to Partner X because Partner X has undertaken a BDPO. Assume Partnership refinances the debt with \$1,000 of new debt (to which same BDPO applies), and assume that the seven-year transition rule discussed above does not apply (e.g., because the refinancing took place more than seven years after the promulgation of the regulations).
- Result: Partner A's BDPO is disregarded, meaning that Partner A's share of the new liability is only \$100 (10% of \$1,000). This causes Partner A to receive a \$300 deemed distribution, triggering \$230 of gain.

# Temporary 752 Regulations: Bottom Dollar Payment Obligations (BDPOs)

[Reg. 1.752-2T(b)(3)(ii)(C)(1)]

- Any payment obligation other than one in which the partner (or a related person) is or would be liable up to the full amount of such obligor's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied.
  - Includes tiered partnerships, intermediaries, senior and subordinate liabilities and other obligations involving multiple liabilities if the liabilities were incurred as part of a common plan to avoid having at least one of the liabilities be treated as a bottom-dollar payment obligation

# Example: Bottom Dollar Payment Obligation (BDPO)

- Guarantor executes a Bottom Dollar Guarantee of \$300 of an Obligor's \$3,000 loan.
- If the Obligor repays \$300 or more of the \$3,000 it owes, the Guarantor has no liability.
- If the Obligor repays \$250 of the \$3,000 it owes, the Guarantor has an obligation to pay \$50.
- If the Obligor repays \$0 of the \$3,000 it owes, the Guarantor has an obligation to pay \$300.

# Temporary 752 Regulations: Exceptions

- **Capped Obligations:** a maximum amount is placed on the obligation
- **Vertical Slice Guarantees:** the obligation is stated as a fixed percentage (less than 100%) of every dollar of the partnership liability to which such obligation relates
- **Joint and several liability:** The rules also provide an exception for a right of proportionate contribution between co-obligors that are jointly and severally liable for the payment obligation.
- **90/10 exception:** If an indemnity, reimbursement agreement or similar arrangement creates a bottom-dollar payment obligation, the obligation may still be recognized as a payment obligation if, taking the indemnity, reimbursement agreement or similar arrangement into account, the partner or related person remains liable for at least 90% of such obligor's initial payment obligation

# Temporary 752 Regulations: Timing

- Effective Immediately for New Obligations on or after October 5, 2016
- Grandfather Rule for liabilities incurred/assumed and payment obligations undertaken prior to Oct. 5, 2016, and/or liabilities/obligations incurred pursuant to a written binding contract in effect prior to Oct. 5, 2016
- Seven-Year Transition Period for partners whose allocable share of partnership liabilities exceeds the partner's adjusted basis in the partnership on October 5, 2016. The amount of partnership liabilities subject to this relief will be reduced as the partner's negative tax capital is reduced

# Disguised Sale Regulations

- Treas. Reg. § 1.707-2 – Disguised payments for services [Reserved]
- Treas. Reg. § 1.707-3 – General rules related to disguised sales of property by partners to partnerships
- Treas. Reg. § 1.707-4 – Rules related to guaranteed payments; preferred returns, operating cash flow distributions, and reimbursements of preformation expenditures
- Treas. Reg. § 1.707-5 – Rules related to liabilities
- Treas. Reg. § 1.707-6 – General rules related to disguised sales of property by partnerships to partners
- Treas. Reg. § 1.707-7 – Disguised sales of partnership interests [Reserved]
- Treas. Reg. § 1.707-8 – Disclosure rules



# QUESTIONS

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A man in a dark suit and white shirt is seen from behind, looking out over a sprawling city skyline at night. His hands are raised in front of him, palms facing forward, as if he is in awe or surprise. The city lights are vibrant, with many buildings illuminated in yellow and white, and some in red and blue. The sky is a deep blue, and the overall atmosphere is one of a high-stakes, professional environment.

The  
University  
of Akron

# 2017 National Tax Conference

*In Honor of Alvin H. Lieberman*

University of Akron  
National Tax Conference

Federal Tax Legislative & Regulatory  
Outlook

September 28, 2017

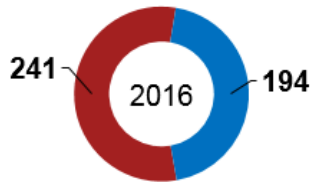
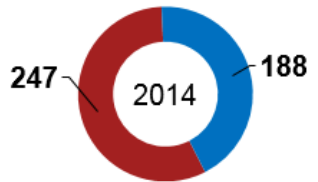
Tim Gerspacher  
Lead Tax Partner - Cleveland

Jeff Barringer  
Principle, Personal Financial Services – Midwest  
Market

# 2016 election results – Republican sweep provides opening for comprehensive tax reform

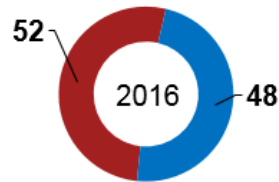
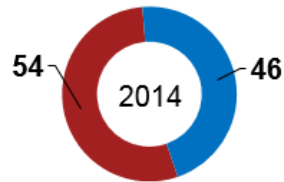
## 2016 Elections – final results

### US House



	2014	2016
Republicans	247	241
Democrats	188	194
<b>2016 Net change</b>		<b>House Ds +6</b>

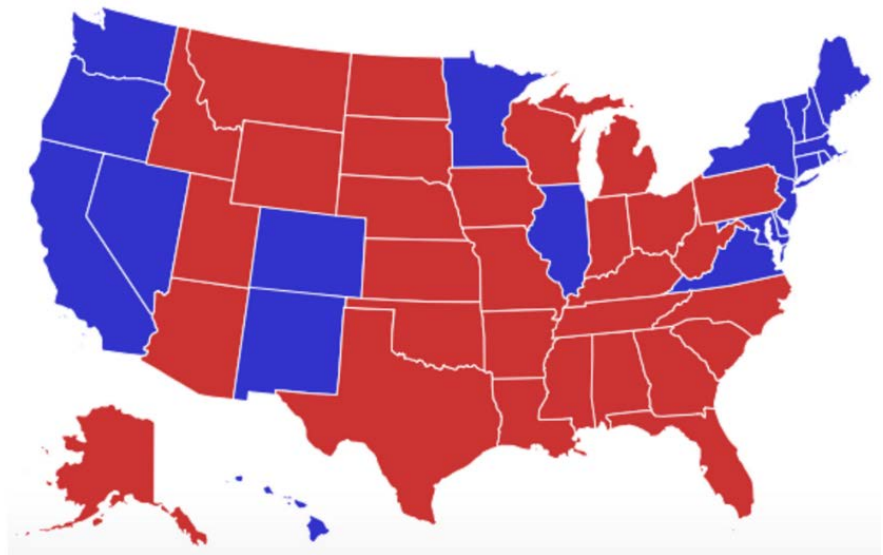
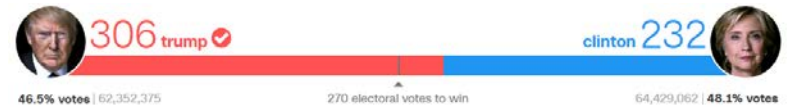
### US Senate



	2014
Republicans	54
Democrats*	46
<b>2016 Net change</b>	<b>Senate D</b>

\* Includes two Independents: Senators Bernie Sanders (I-VT) and Angus King (I-ME)

■ Republicans    ■ Democrats



# Key tax policymakers in the 115th congress

## Administration



**President Trump**

## US House of Representatives



**Speaker Ryan**



**Minority Leader  
Pelosi**



**Majority Leader  
McConnell**



**Minority Leader  
Schumer**

## Treasury



**Treasury Secretary  
Mnuchin**

## House Ways and Means Committee



**Chairman Brady**



**Ranking Member  
Neal**

## Senate Finance Committee



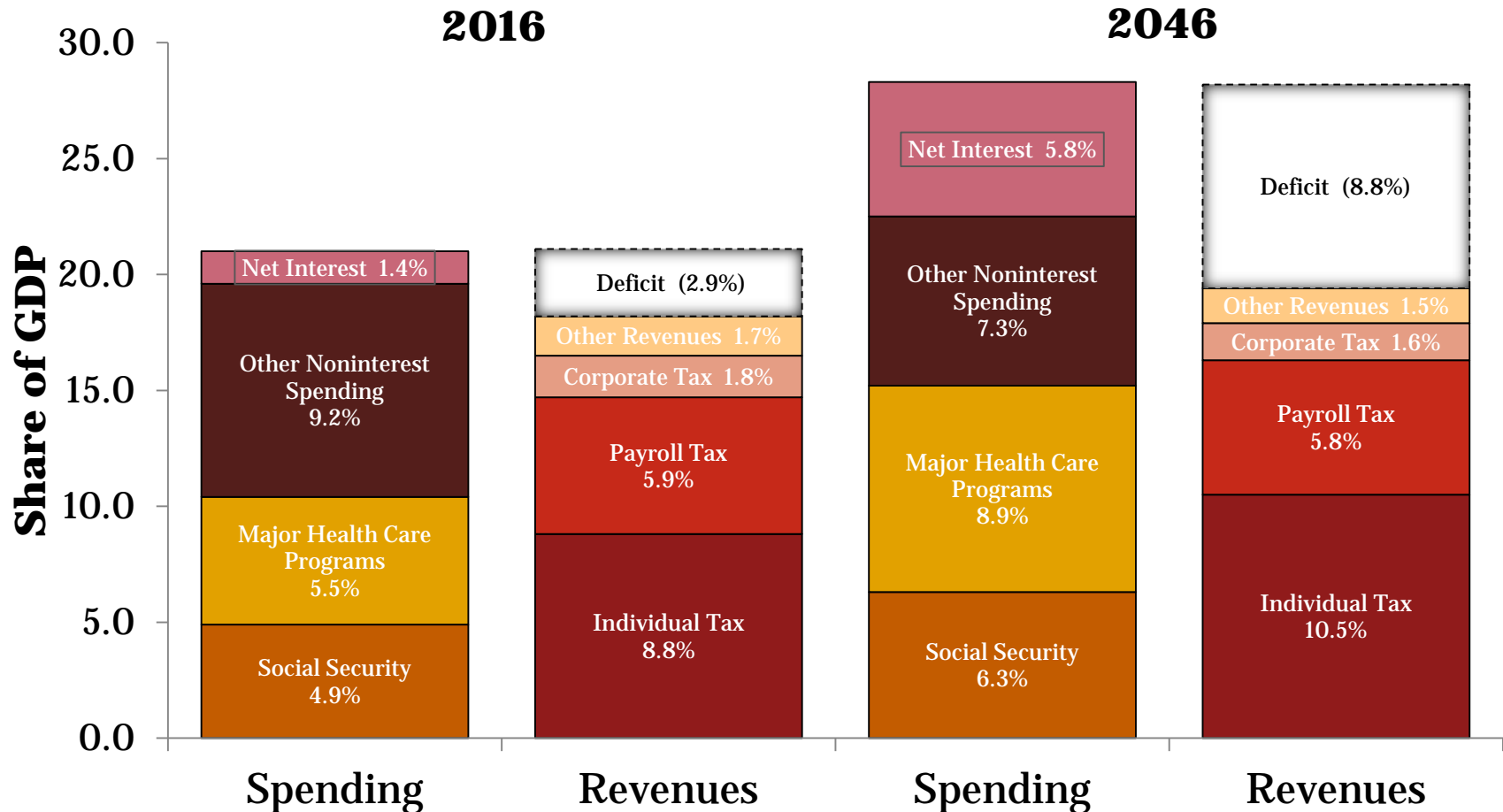
**Chairman Hatch**



**Ranking Member  
Wyden**

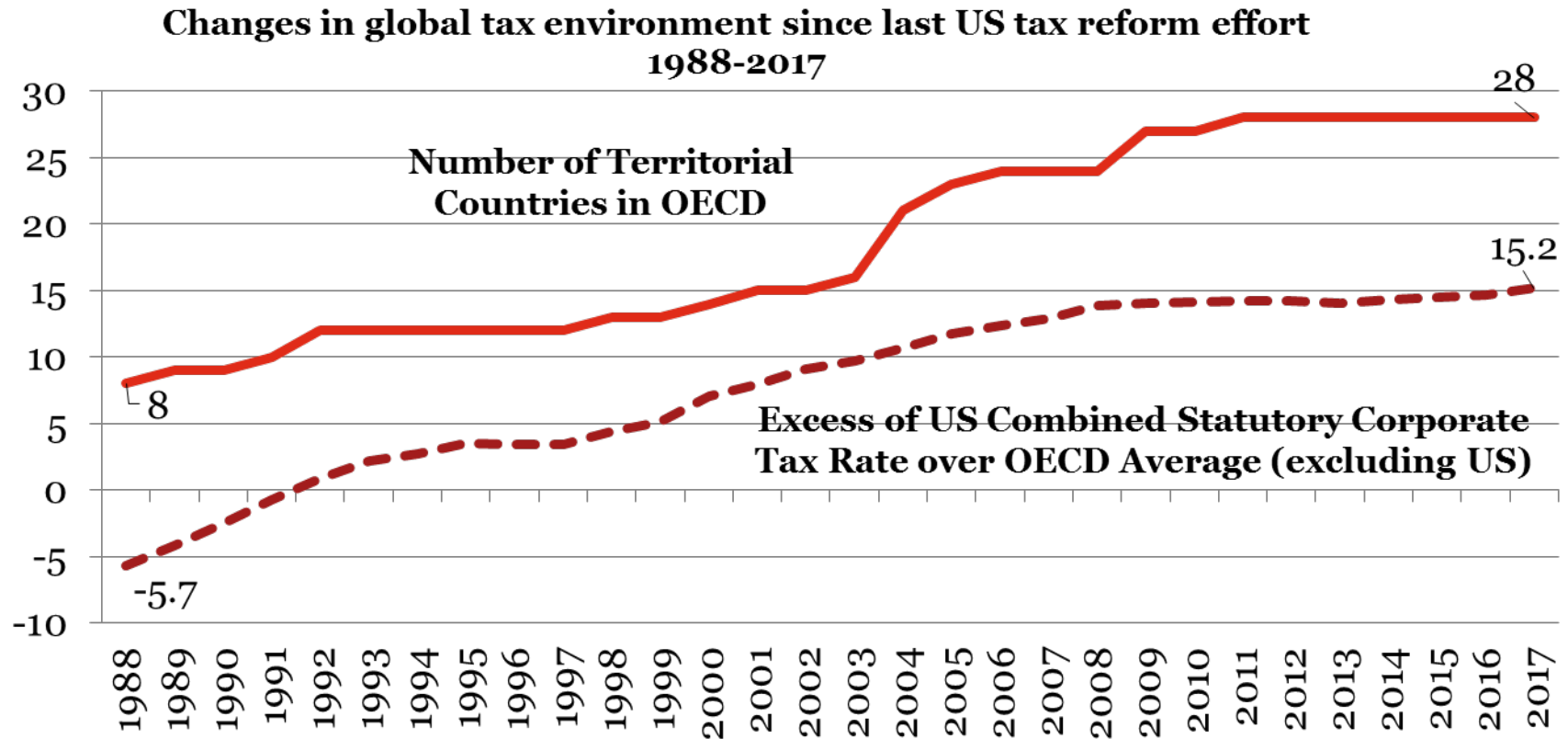
# Worsening federal budget outlook favors difficult revenue-neutral tax reform over simply cutting taxes

## Spending and revenues as a percentage of GDP



Source: Congressional Budget Office, *The 2016 Long-Term Budget Outlook* (July 2016).

# ***Business tax reform is an economic imperative ...***



Sources: "Evolution of Territorial Tax Systems in the OECD," April 2, 2013; OECD Tax Database, "Part II. Taxation of Corporate and Capital Income. Table II. 1. Corporate income tax rate: Combined Central and Subcentral".

# Trump's top priorities for the FY 2018 budget include reform of healthcare, tax and immigration

## The Trump administration's eight pillars of reform



### Health reform

- Trump's plan suggests repealing Obamacare and replacing it "with a framework that restores choice and competition"



### Regulatory rollback

- Trump's plan calls for aggressive elimination of outdated federal regulation



### Tax reform

- The budget claims to simplify the tax system so individuals and corporations can spend less time filling out taxes



### Energy development

- The budget puts a focus on developing and cultivating U.S. energy resources to strengthen national security and lower the price of electricity and transportation fuel



### Reduction in federal spending

- In the budget Trump calls on Congress to "scrutinize every dollar the federal government spends"



### Welfare reform

- Trump's welfare reform aims to ensure able-bodied adults are not "discouraged from working, which takes away scarce resources from those in real need"



### Immigration reform

- The budget proposes reforming immigration "to reduce burdens on taxpayers ... and focus federal funds on underserved and disadvantaged citizens"



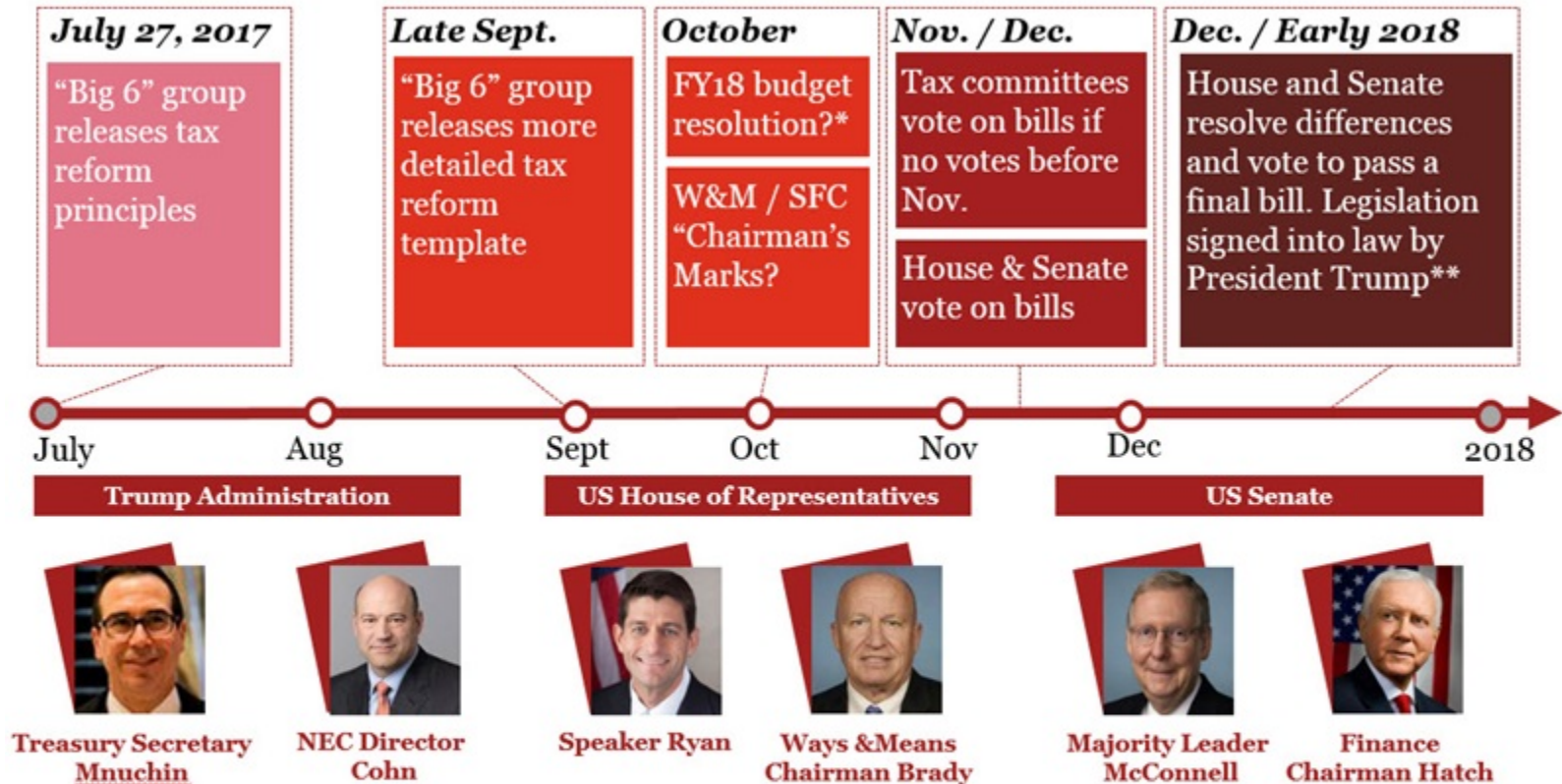
### Education reform

- The education reform suggested in the budget is aimed to "return decision regarding education back to the state and local levels"

Source: "A new foundation for American greatness," Office of Management and Budget, May 23, 2017.



# Trump's top priorities for the FY 2018 budget include reform of healthcare, tax and immigration



\*Budget resolution approved by both House and Senate is critical – without first passing, Republicans would not be able to use budget reconciliation (which allows them to avoid Democratic filibuster in the Senate).

\*\*If House & Senate pass tax bills by end of 2017, potential to reconcile any differences and pass a unified bill either by the end of calendar year 2017 or in early 2018. Whether the ultimate tax reform signing ceremony occurs around Thanksgiving or early 2018, we expect the effective date generally to be 1/1/2018.

# ***Comprehensive tax reform is top priority for Republican-controlled White House and Congress***



- Achieving first priority – health care – unsuccessful even with GOP control
- Other priorities, investigations, and tweets are competing for attention
- Administration and Republican Congressional leaders communicated key tax reform priorities in July 27 joint statement:
  - Make taxes “simpler, fairer, and lower” for American families
  - “Lower rates for all American businesses”
  - Provide “unprecedented capital expensing”
  - Encourage companies to “bring back jobs and profits trapped overseas”
  - Place a “priority on permanence” of tax reforms
- Need “tax reform budget” to facilitate passage of tax reform legislation



**Donald J. Trump**  @realDonaldTrump · Sep 8

Republicans must start the Tax Reform/Tax Cut legislation ASAP. Don't wait until the end of September. Needed now more than ever. Hurry!



11K



20K



78K



## ***Base-broadening options for tax reform***

<b>Top 5 corporate tax expenditures</b>	<b>5-year amount (\$ billions)</b>
Deferral of active income of controlled foreign corporations	\$563.6
Deduction for income attributable to domestic production activities	\$61.5
Deferral of gain on like-kind exchanges	\$57.4
Exclusion of interest on public purpose State & local tax-exempt bonds	\$50.5
Tax credit for low-income housing	\$41.2
<b>Top 5 individual tax expenditures</b>	<b>5-year amount (\$ billions)</b>
Exclusion of employer contributions for health care, health insurance premiums, and long-term care insurance premiums	\$769.8
Reduced rate on capital gains and dividends	\$689.6
Exclusion of retirement contributions and earnings (Keogh, defined benefit plans, defined contribution plans, and IRAs)	\$504.8
Mortgage interest deduction	\$419.8
Earned income tax credit	\$371.4

# How does failed ACA repeal-and-replace effort affect tax reform?

Select Tax Provisions of American Health Care Act as passed by the House	Effective Date	10-Year Revenue Cost (in billions)
Repeal 3.8% net investment income tax for taxpayers with AGI in excess of \$200,000/\$250,000	2017	172.2
Repeal annual fee on health insurance providers	2017	144.7
Set AGI floor on itemized medical expenses to 5.8% for all taxpayers	2017	125.7
Repeal 40% excise tax ("Cadillac tax") on certain high-cost employer-provided health care	2020 – 2025	65.9
Repeal 0.9% HI surtax on earned income in excess of \$200,000/\$250,000	2023	58.5
Repeal annual fee on manufacturers and importers of branded drugs	2017	28.5
Repeal 2.3% excise tax on manufacturers and importers of certain medical devices	2017	19.6
Repeal limitations on health FSA contributions in cafeteria plans	2017	19.4
Increase maximum HSA contribution limit to amount of deductible and out-of-pocket limitation	2018	18.6
Repeal exclusion of over-the-counter medicines from definition of qualified medical expenses	2017	5.6
Reinstate deduction for expenses allocable to Medicare Part D subsidy	2017	1.8

Source: Joint Committee on Taxation (JCX-27-17).

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# ***Budget resolution critical to passing tax reform under budget reconciliation protections***

## **House Budget Committee on July 19, 2017 approves FY 2018 budget resolution with budget reconciliation instructions**

- Directs Ways and Means Committee to report deficit-neutral tax reform legislation
- Also directs 11 authorizing committees including Ways and Means to report legislation that produces at least \$203 billion in mandatory savings and reforms over 10 years
- Sets nonbinding deadline of October 6, 2017 for reconciliation legislation
- Includes nonbinding statement of tax reform policy that expresses support for
  - Substantially lowering tax rates for individuals
  - Repealing the Alternative Minimum Tax
  - Reducing the corporate tax rate, and
  - Transitions to a more competitive system of international taxation

## **Prospects for House passage uncertain due to objections from House GOP Freedom Caucus members and moderate House Republicans**

## **Senate approval of FY 2018 budget may require revisions to gain support of at least 50 Republican Senators and Vice President Pence's tie-breaking vote**

# ***Legislative paths available for tax reform in 2017***

## **Regular legislative process**

<b>Benefits</b>	<ul style="list-style-type: none"><li>• Legislation can be enacted permanently</li><li>• No artificial restrictions on which measures can be included</li></ul>
<b>Limitations</b>	<ul style="list-style-type: none"><li>• 60 votes needed at every step in the Senate (i.e., to begin debate, vote on amendments, vote on passage, to conference, etc).</li></ul>

## **Budget reconciliation process**

<b>Benefits</b>	<ul style="list-style-type: none"><li>• Requires only simple majority vote at every step in the Senate (no filibuster allowed)</li><li>• Expedited consideration (time limits for amendments and overall debate)</li></ul>
<b>Limitations</b>	<ul style="list-style-type: none"><li>• Legislation that increases the deficit outside of the budget window (typically 10 years) is subject to automatic sunset or other measures to avoid long term deficit effect</li><li>• 60-vote Senate super-majority required to waive deficit rule</li><li>• Senate rules also require reconciliation to be used only to enact measures that have a fiscal effect on the federal budget</li></ul>

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## ***“Big 6” Joint statement on tax reform***

**July 27, 2017 Joint statement on tax reform issued by House Speaker Paul Ryan, Senate Majority Leader McConnell, Treasury Secretary Steven Mnuchin, National Economic Council Gary Cohn, House Ways and Means Chairman Kevin Brady, and Senate Finance Committee Chairman Orrin Hatch:**

- Tax relief for American families “to be at the heart of our plan,” with focus on making taxes “simpler, fairer, and lower”
- Reduce business tax rates “as much as possible”
- Allow “unprecedented capital expensing”
- Create international tax system to “bring back jobs and profits trapped overseas”
  - Language consistent with past expressions of support for territorial taxation with one-time mandatory repatriation tax
- “Place a priority on permanence” of tax reform
  - Statement does not require reforms to be revenue neutral
- House Blueprint border adjusted tax “set aside ... in order to advance tax reform”
- House and Senate tax committees to move tax reform legislation “through the committees this fall, under regular order, followed by consideration on the House and Senate floors”

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## ***Key take-aways from Big 6 statement***

1. BAT officially dead
2. Key priorities are lower rates and accelerated expensing
3. Permanence (read: revenue neutrality) is a priority but no longer a requirement
4. Indirect reference to territorial



# Recent tax reform proposals

President Donald Trump (4/26/17 outline)	House GOP 2016 tax reform 'Blueprint'	Senate Finance Committee	Dave Camp 2014 HR 1
<ul style="list-style-type: none"> <li>• Lower individual tax rates, with three brackets: 10%, 25% and 35%</li> <li>• 20% top tax rate on long-term capital gains and dividends, with repeal of ACA 3.8% net investment tax</li> <li>• 15% business tax rate</li> <li>• Territorial international tax system</li> <li>• One-time deemed repatriation tax (unspecified rate)</li> </ul>	<ul style="list-style-type: none"> <li>• Lower individual tax rates, with three brackets: 12%, 25% and 33%</li> <li>• 50% exclusion for capital gains, dividends and interest (16.5% top rate)</li> <li>• 20% corporate tax rate, with 25% rate for pass-through businesses</li> <li>• 100% expensing for equipment and real property</li> <li>• No deduction for business net interest expense</li> <li>• Border-adjustable destination-based cash-flow system</li> <li>• 100% territorial dividend exemption</li> <li>• Deemed repatriation tax: 8.75% cash / 3.5% other</li> </ul>	<ul style="list-style-type: none"> <li>• Senate Finance Committee Chairman Orrin Hatch (R-UT) and his staff have been working on a detailed corporate integration proposal that could be considered as part of reform efforts</li> <li>• Finance Committee Ranking Member Ron Wyden (D-OR) has released detailed statutory tax reform discussion drafts addressing cost recovery rules and the tax treatment of derivatives. Senator Wyden also is working on legislation to address corporate 'inversions'</li> <li>• Senate Finance Committee member Ben Cardin (D-MD) has proposed a 10% credit invoice, border adjustable VAT, a corporate rate of 17%, a top individual rate of 28%, and exemption of most individuals from income tax</li> </ul>	<ul style="list-style-type: none"> <li>• Lower individual tax rates, with three brackets: 10%, 25% and 35%</li> <li>• 20% top tax rate on long-term capital gains and dividends (did not address ACA 3.8% net investment tax)</li> <li>• 25% business tax rate (phased-in over five years)</li> <li>• Replace current accelerated cost recovery rules with alternative depreciation system</li> <li>• 95% territorial dividend exemption</li> <li>• Deemed repatriation tax: 8.75% cash / 3.5% other</li> <li>• Base erosion measures including 15% minimum tax on foreign market intangible income and thin cap rules</li> </ul>

# *Where to set the dials on tax reform?*



**Tax cuts vs. tax reform**



**Lower rates vs. broader base**



**Border adjustment vs. minimum tax**



**Taxing income vs. consumption**



**Full expensing vs. interest deductibility**



**Corporate vs. individual**



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## ***2017 Congressional calendar – key dates and deadlines***

FAA and Children’s Health Insurance Program (CHIP) authorization expire	September 30
Federal government’s FY 2018 begins and “sequestration” discretionary spending caps reinstated	October 1
Columbus Day Recess	October 9 – 13 (S); October 16 – 20 (H)
Thanksgiving Recess	November 20 – 24
Temporary FY 2018 government funding “Continuing Resolution” (CR) and statutory debt limit suspension expires*	December 8
Target adjournment	December 15
Medical device excise tax suspension expires; oil spill liability trust fund financing rate expires	December 31

\* Treasury Department retains ability to use “extraordinary measures” to meet government obligations and prevent default.

# ***President Trump's core tax reform principles***



## ***Four principles for reform announced on 8-30-2017***

- “Need a tax code that is simple, fair, and easy to understand”
- “Need a competitive tax code that creates more jobs and higher wages”
- “Tax relief for middle-class families” is “crucial”
- “Bring back trillions of dollars of wealth that’s parked overseas”

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## ***Earlier tax reform principles announced on 4-26-2017***

### **Individuals**

- Reduce individual rate brackets from 7 to 3 (10%, 25%, 35%)
- Maximum 20% tax rate on long-term capital gains and dividends, with repeal of 3.8% ACA net investment income tax
- Double the standard deduction
- Eliminate targeted tax breaks for wealthiest taxpayers
- Protect home ownership and charitable gift deductions
- Tax relief for child and dependent care expenses
- Eliminate estate tax and AMT

### **Businesses**

- 15% business tax rate
- Eliminate tax breaks for special interests
- Territorial international tax system
- One-time repatriation tax on overseas corporate profits (unspecified rate)

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# ***House Republican Blueprint outlines goals for comprehensive ‘pro-growth’ tax reform***

- **Cut business tax rates and limit disparity between corporate and pass-through rates**
  - 20% top corporate tax rate
  - 25% top rate for pass-through business income
- Reduce top individual tax rate to 33%
  - 50% exclusion for capital gains, dividends and interest (16.5% top individual rate)
  - Eliminates most individual itemized deductions; retains deductions for charitable contributions and mortgage interest; also retains education and retirement savings incentives (with unspecified modifications)
- **100% expensing** for equipment and real property (excluding land)
- No deduction for business net interest expense
- **Border adjustable destination-based cash-flow system:** no deduction for cost of imported goods and services; no tax on receipts from exported goods and services
- **Territorial tax system**, with 100-percent dividend exemption
- **Mandatory ‘deemed’ repatriation**
  - 8.75% for cash / cash equivalents and 3.5% for other accumulated foreign earnings, payable over eight years
- Repeals corporate and individual AMT
- House Ways and Means Committee to provide special rules for banks, insurance, and leasing

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# ***House Republican Blueprint***

## **Business taxation – International income provisions**

- Dividends from foreign subsidiaries would be exempt
  - No limitation would be imposed on the deduction of domestic expenses allocable to exempt dividends
  - Presumably no credit or deduction would be allowed for foreign taxes related to exempt dividends
- Subpart F would be repealed except for FPHCI
- The treatment of foreign branch income is not discussed
- Tax on accumulated deferred foreign E&P
  - Taxed at an effective rate of 8.75% to the extent held in cash and equivalents and 3.5% otherwise. Payment of tax spread over 8 years
  - No details are provided regarding the definition of cash equivalents or whether: tax is limited to post 1986 E&P, deficits may be netted, and applicability to non-controlled foreign corporations

# Recent GOP tax reform proposals

## Corporate provisions

Proposal	Current Law	Camp 2014 tax reform act (H.R. 1)	House GOP 2016 tax reform 'Blueprint'	President Trump campaign proposals
<b>Corporate tax rates</b>	35% rate	25% rate (phased in over 5 years)	20% rate	15% rate
<b>Border adjustments</b>	(No provision)	(No provision)	–'Destination-based cash-flow' –Border adjustments –Exempt exports & tax imports	(Not stated)
<b>International tax regime</b>	–'Worldwide' system –Foreign tax credits to mitigate double taxation	–'Territorial' system –95% foreign dividend exemption	–'Territorial' system –100% dividend exemption system	(Not stated)
<b>Cost recovery (full expensing)</b>	Expense investment over the investment's applicable life under MACRS or ADS	–Repeal MACRS –Implement ADS type system, with inflation	Full expensing for investments (tangible & intangible) excluding land	Manufacturers may elect full expensing for investments (revocable within the first 3 years), but...
<b>Business interest expense</b>	Deductible as incurred	Limit for thin capitalization	–Deductible only against net interest income –Special rules for financial services	...if electing full expensing for investments must forego interest expense deductions
<b>Repatriation 'toll tax'</b>	Currently no provision. Previously untaxed foreign earnings: –35% corporate rate when repatriated	Previously untaxed foreign earnings: –8.75% cash & cash-equivalents –3.5% non-cash assets over 8 years	Previously untaxed foreign earnings: –8.75% cash & cash-equivalents –3.5% non-cash assets over 8 years	Previously untaxed foreign earnings: –Subject to US income tax at 10% rate

# Recent *GOP* tax reform proposals

## *Corporate provisions*

Proposal	Current Law	Camp 2014 tax reform act (H.R. 1)	House GOP 2016 tax reform 'Blueprint'	President Trump campaign proposals
<b>Pass-through entities</b>	Income is passed through to the owners to be taxed at the individual rates (see below)	(No change)	25% maximum (combined entity and individual)	15% maximum (within individual income tax regime)
<b>Carried interest</b>	Taxed at capital gains rates	Taxed at ordinary rates for partnerships engaged in certain stated trades or businesses	(Not stated)	Taxed at ordinary rates
<b>Anti-base erosion regime (Subpart F)</b>	Subpart F anti-deferral regime includes CFC's insurance income, foreign base company income, among others	Subpart F generally maintained; New tax on 'intangible' income: 15% for foreign market sales, 25% for US market sales	Subpart F reduced to foreign personal holding company income provisions	(Not stated)
<b>Domestic production</b>	Deduction up to 9% of qualified income for items manufactured, produced, grown, or extracted in US	Phase out and repeal Section 199 deduction	Repeal Section 199 deduction	Repeal Section 199 deduction
<b>R&amp;D</b>	Regular credit – 20%	Make alternative simplified credit permanent	Business credit to encourage research and development	Maintains R&D credit
<b>AMT</b>	AMT imposed on indiv., estates, trusts (up to 28%) & corps (20%) on tentative min tax liability in excess of regular tax liability	Repeal corporate and individual AMT	Repeal corporate and individual AMT	Repeal corporate and individual AMT



# Recent *GOP* tax reform proposals

## *Individual Provisions*

Proposal	Current Law	Camp 2014 tax reform act (H.R. 1)	House GOP 2016 tax reform 'Blueprint'	President Trump campaign proposals
<b>Individual rates</b>	Seven rate brackets (10%, 15%, 25%, 28%, 33%, 35%, and 39.6%)	Three rate brackets (10%, 25%, 35%)	Three rate brackets (12%, 25%, 33%)	Three rate brackets (12%, 25%, 33%)
<b>Capital gain/ QDI rates (Individuals)</b>	Maximum 20% rate for long-term capital gains and QDI	Tax as ordinary income with 40% exclusion	Tax as ordinary income with 50% exclusion; exclusion also applies to interest	Maximum 20% rate
<b>Individual – standard deduction</b>	\$6,300 for single filers/ \$12,600 joint returns (2016)	\$22,000 joint returns/ \$11,000 other tax payers	\$18,000 for single filers with a child/\$24,000 for joint returns/\$12,000 for other tax payers	\$15,000 for single filers/ \$30,000 joint returns
<b>Individual – itemized deductions</b>	Itemized deductions phase out begins at \$311,300 for joint filers and \$259,400 for single filers (2016)	Itemized deductions would look similar to current law with several stated exceptions	Eliminates most itemized deductions; retains mortgage interest and charitable contributions deductions; retains education and retirement incentives (w/ unspecified modifications)	Cap itemized deductions at \$200,000 for joint filers and \$100,000 for single filers
<b>Estate tax</b>	Maximum 40% rate for taxable estates exceeding \$5.45 million (2016 indexed amount)	(No provision)	Repeal estate tax	Repeal estate tax



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## ***Potential tax regulatory relief is under review (Notice 2017-38)***

### **8 regulations determined to “impose undue financial burden” and/or “add undue complexity”**

- Treatment of certain interests in corporations as stock or indebtedness (Sec. 385)
- Income and currency gain or loss (Sec. 987)
- Treatment of certain transfers of property to foreign corporations (Sec. 367)
- Liabilities recognized as recourse partnership liabilities (Sec. 752)
- Restrictions on liquidation of an interest for estate, gift, and generation-skipping transfer taxes (Sec. 2704)
- Certain transfers of property to RICs and REITs (Sec. 337(d))
- Definition of political subdivision (Sec. 103)
- Participation of certain persons in a summons interview (Sec. 7602)

### **Comments requested by Aug. 7 on whether regulations should be rescinded or modified (and how)**

### **Final Treasury report recommending specific actions to mitigate regulatory burden is due in September**

A man in a dark suit and white shirt is seen from behind, looking out a large window at a vibrant city skyline at night. The city lights are a mix of warm yellows and oranges and cool blues. The man's hands are raised in a gesture of appreciation or gratitude, with some light trails around them. The overall mood is professional and appreciative.

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# 2017 National Tax Conference

*In Honor of Alvin H. Lieberman*

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