CPE

Quarterly Federal Tax Update – Second Quarter 2016

QUARTERLY FEDERAL TAX UPDATE – SECOND QUARTER 2016

TITLE:

Quarterly Federal Tax Update—Second Quarter 2016

FIELD OF STUDY:

Taxation

COURSE DESCRIPTION:

This course provides various tax update items and other federal tax highlights.

OBJECTIVE:

Understand key recent developments that will affect many tax practitioners and their clients.

TARGET PARTICIPANTS:

CPAs in industry and public practice

Quarterly Federal Tax Update—Second Quarter 2016

Highlights For Various Types of Taxpayers

- Regulation of Preparers Dropped from Bill
- TEFRA Audit Rules Repealed and Replaced
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- Partnership Ownership of Disregarded Entity Results in SE Tax
- Cuban Taxes Now Eligible for Foreign Tax Credit
- Tax Consequences of Partner Guarantee of Qualified Nonrecourse Financing
- New Form 3115 Released
- IRS Issues New List of Automatic Consent Changes
- Designated Private Delivery Service Rules
- IRS Announces Adjustments for Premium Tax Credit

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Key Tax Developments Affecting Various Types of Taxpayers

Legislative Developments

Regulation of Preparers Dropped from Bill

The Senate Finance Committee announced on April 18, 2016, that Chairman Orrin Hatch's (R-Utah) mark of an identity theft refund fraud bill removed a proposal to legislatively override *Loving v. IRS*, 742 F.3d 1013 (D.C. Cir., 2014). The *Loving* case derailed the IRS's effort to broadly regulate all preparers of federal tax returns, holding that the act of preparing and filing tax returns does not constitute "practice before" the IRS, and therefore, the IRS exceeded its authority to regulate such activities. The deleted provisions would have operated as a legislative repeal of the D.C. Circuit's decision in *Loving*.

TEFRA Audit Rules Repealed and Replaced

The Bipartisan Budget Act of 2015[1] (BBA) amends IRC Sections 6221 through 6241 with respect to returns filed for partnership taxable years beginning after December 31, 2017. As a result, the returns filed for partnership taxable years beginning after 2016 are subject to a centralized system for audit, adjustment, and collection of tax that applies to all partnerships, except those eligible partnerships that have filed a valid election out.

Under the centralized system, the audit of a partnership takes place at the partnership level. Any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year, and any partner's distributive share thereof, generally are determined at the partnership level. Any tax attributable to these items generally is assessed and collected at the partnership level.

The applicability of any penalty, addition to tax, or additional amount that relates to an adjustment of any item of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year or to any partner's distributive share thereof, is determined at the partnership level. Unlike prior law, distinctions between partnership items and affected items are no longer made. An underpayment of tax determined as a result of an examination of a taxable year is "imputed" to the year during which the adjustment is finally determined, and generally is assessed against and collected from the partnership with respect to that year rather than the reviewed year (an *imputed underpayment*).

Under the centralized system, a partnership may seek modification of the imputed underpayment amount by providing the IRS with specified information about the tax status of partners and about the nature and amount of items of income or gain, by means of reviewed-year partners filing amended returns with payment, or on the basis of other factors in regulations or guidance.

A partnership may elect an alternative to partnership payment of the imputed underpayment in which each reviewed-year partner is furnished a statement of the partner's share of the adjustments (similar to Schedule K–1) and each such reviewed-year partner increases its tax for the year the statement is furnished.

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[1] Pub. L. 114-74.

If the partnership disagrees with the computation of the imputed underpayment during an administrative proceeding, it may seek modification of the computation. Modification procedures permit redetermination of the imputed underpayment: (1) to take into account amounts paid with amended returns filed by reviewed-year partners; (2) to disregard the portion allocable to a tax-exempt partner; and (3) to take into account a rate of tax lower than the highest tax rate for individuals or corporations for the reviewed year.

The centralized system is applicable to any partnership unless it meets eligibility requirements and has made a valid election out for a taxable year. A partnership may elect out of the centralized system (and it and its partners are governed by the current rules for deficiency proceedings) for a partnership taxable year if it meets eligibility requirements. One of the eligibility requirements is that for the taxable year, the partnership is required to furnish 100 or fewer statements under IRC Section 6031(b) (Schedules K–1) with respect to its partners.

A further eligibility requirement for a partnership to make the election is that each of its partners is (1) an individual; (2) a deceased partner's estate; (3) a C corporation; (4) a foreign entity that would be required to be treated as a C corporation if it were a domestic entity; or (5) an S corporation (provided special rules are met). A partnership with a foreign entity as a partner can meet this eligibility requirement if, under the rules of IRC Section 7701, the foreign entity would be taxable as a C corporation if it were domestic; that is, the foreign entity has elected to be, or is, treated as a per se corporation under the check-the-box rules. A C corporation partner that is a regulated investment company (RIC) or a real estate investment trust (REIT) does not prevent the partnership from being able to elect out, provided the applicable requirements are met.

Regulations Issued and Proposed

Low-Income Housing Credit Utility Allowance Regulations Issued

The IRS has issued new final and temporary regulations at Reg. Section 1.42-10; Reg. Section 1.42-10T; and Reg. Section 1.42-12. The new final regulations adopt the 2012 proposed regulations with certain amendments, and the temporary regulations extend those rules to the provision of energy that the building owner acquires directly from renewable sources and then provides to low-income tenants.

IRC Section 42(f) provides that a low-income housing credit is allowed annually over a 10-year credit period beginning with the tax year a qualified low-income building is placed in service (or, if elected, the next tax year). The amount of the credit for any tax year in the credit period equals the applicable percentage of the qualified basis of each *qualified low-income building*. A qualified low-income building is any building that is, at all times during a statutorily prescribed period, part of a "qualified low-income housing project," which in turn is defined as any project for residential rental housing if the project meets one of the following tests elected by the taxpayer: (1) at least 20 percent of the residential units in the project are "rent-restricted" and occupied by individuals whose income is 50 percent or less of area median gross income; or (2) at least 40 percent of the residential units in the project are "rent-restricted" and occupied by individuals whose income is 60 percent or less of area median gross income.

In order to qualify as a rent-restricted unit, gross rent for the unit must not exceed 30 percent of the applicable income limitation. If any utilities are paid directly by the tenant, a *utility allowance* must be included in gross rent. Rules for determining the applicable utility allowance are provided in Reg. Section 1.42-10(b) and depend on whether (1) the building receives rental assistance from the Rural Housing

Service (RHS); (2) the building has any tenant that receives RHS rental assistance payments; (3) the rents and utility allowances of the building are reviewed by the Department of Housing and Urban Development (HUD); or (4) none of the foregoing descriptions apply.

Partnership Ownership of Disregarded Entity Results in SE Tax

The Treasury Department and the IRS issued temporary regulations (Temp. Reg. Section 301.7701-2T) on May 4, 2016 to clarify that the rule that a disregarded entity is treated as a corporation for employment tax purposes *does not* apply to the self-employment tax treatment of any individuals who are partners in a partnership that owns a disregarded entity. The rule that the entity is disregarded for self-employment tax purposes applies to partners in the same way that it applies to a sole proprietor owner. Accordingly, the partners are subject to the same self-employment tax rules as partners in a partnership that do not own a disregarded entity.

IRS Rulings and Guidance

Cuban Taxes Now Eligible for Foreign Tax Credit

IRC Section 901(j)(1) imposes restrictions in the case of income and taxes attributable to certain countries. That section denies the credit for taxes paid or accrued (or deemed paid or accrued) to any country described in IRC Section 901(j)(2)(A) if the taxes are with respect to income attributable to a period during which IRC Section 901(j) applies. In addition, IRC Section 952(a)(5) provides that subpart F income includes income derived by a controlled foreign corporation from any foreign country during any period which IRC Section 901(j) applies to that foreign country.

Based on the certification by the Secretary of State, Rev. Rul. 2016-08 states that Cuba ceased to be described in IRC Section 901(j)(2)(A) as of December 21, 2015.

Tax Consequences of Partner Guarantee of Qualified Nonrecourse Financing

In Chief Counsel Advice 201606027, the IRS addressed four specific issues regarding the tax consequences of a partner guarantee of qualified non-recourse financing. The issues and the IRS analysis are set forth below.

1. If one partner guarantees a partnership's obligation to satisfy a promissory note in the event of, among other events, the partnership admitting in writing that it is insolvent or unable to pay its debts when due, or its voluntary bankruptcy or acquiescence in an involuntary bankruptcy, does this guarantee preclude the promissory note from qualifying as a nonrecourse obligation of the partnership under IRC Section 752 and regulations promulgated thereunder?

Analysis

If a partner guarantees an obligation of the partnership and the guarantee is sufficient to cause the guaranteeing partner to bear the economic risk of loss for that obligation, the guaranteed debt is properly treated as recourse financing for purposes of applying the basis allocation rules of IRC Section 752.

2. If the partnership's sole business activity involves acquiring existing hotels, renovating them, installing personal property appropriate to improve the properties' utility as hotels, and holding

and maintaining the premises, but does not include the hotels' day-to-day operations, does this business activity qualify as an *activity of holding real property* within the meaning of IRC Section 465(b)(6)(A)?

Analysis

Where the partnership's sole business activity includes acquiring existing hotels, renovating them, installing personal property appropriate to improve the properties' utility as hotels, and holding and maintaining the premises, but does not include the hotels' day-to-day operations, the partnership is engaged in an *activity of holding real property* within the meaning of IRC Section 465(b)(6)(A).

3. If a partner guarantees partnership debt that otherwise had met the requirements of qualified nonrecourse financing within the meaning of IRC Section 465(b)(6), are the other non-guarantor partners entitled to treat the obligation as qualified nonrecourse financing or otherwise at risk with respect to the guaranteed obligation?

Analysis

When an individual partner guarantees a partnership obligation, the amount of the guaranteed debt no longer meets the definition of *qualified nonrecourse financing* under IRC Section 465(b)(6)(B), and the amount of the guaranteed debt will no longer be includible in the at-risk amount of the other non-guaranteeing partners, if the guarantee is bona fide and enforceable by creditors of the partnership under local law.

4. If the partnership operating agreement provides that, in the event that the guaranteeing partner makes a payment under a guarantee, the guaranteeing partner has the right to call for the non-guaranteeing partners to make capital contributions and, if they fail to do so, treat ratable portions of the payment as loans to those partners, adjust their fractional interests in the partnership, or enter into a subsequent allocation agreement under which the risk of the guarantee would be shared among the partners, is this provision sufficient to make the non-guaranteeing partners personally liable with respect to the guaranteed obligation for the purposes of IRC Sections 752 and 465?

Analysis

To the extent the guaranteeing partner has the right under the partnership operating agreement to call for the non-guaranteeing partners to make capital contributions and, if they fail to do so, treat ratable portions of the payment as loans to those partners, adjust their fractional interests in the partnership, or enter into a subsequent allocation agreement under which the risk of the guarantee would be shared among the partners, this right generally will not be sufficient to make the non-guaranteeing partners personally liable with respect to the guaranteed obligation for the purposes of Sections 752 and 465.

New Form 3115 Released

The IRS has revised Form 3115, *Application for Change in Accounting Method*, and the corresponding instructions as of December, 2015. *See* IRS Ann. 2016-14. Under IRC Section 446(e), taxpayers must obtain the IRS's consent before changing a method of accounting for federal income tax purposes. In most cases, a taxpayer that wishes to change its method of accounting must apply and secure the prior consent of the IRS (*advance* or *non-automatic* consent). For some accounting method changes, the IRS provides an automatic procedure for obtaining its consent to the change. In general, a taxpayer uses Form 3115 for an accounting method change.

Beginning in January 2016, the duplicate copy of Form 3115 for an automatic change request is filed with the IRS in Covington, Kentucky. The address of the IRS office in Covington, Kentucky, is: Internal Revenue Service, 201 West Rivercenter Blvd., PIN Team Mail Stop 97, Covington, KY 41011-1424.

Taxpayers may download the December 2015 Form 3115 and its instructions from the IRS website, www.irs.gov/formspubs, or order them from the IRS website www.irs.gov/orderforms. Accounting period changes are made on Form 1128, *Application To Adopt, Change, or Retain a Tax Year.*

IRS Issues New List of Automatic Consent Changes

On May 5, 2016 the IRS issued Rev. Proc. 2016-29 containing an updated list of changes to which automatic consent applies. This updated list applies for a change to any tax year ending on or after September 30, 2015.

Among the more significant changes are those related to the procedures relating to changes from an impermissible to a permissible method of depreciation or amortization. Under Section 6.01 of Rev. Proc. 2016-29, a taxpayer may generally make a change from an impermissible method of depreciation or amortization to a permissible one using the automatic consent procedures. If the item of property is placed in service in the taxable year immediately preceding the year of change (1-year depreciable property), the taxpayer may make the change by filing a Form 3115 with the return and indicate the IRC Section 481 adjustment. Alternatively, the taxpayer may change from the impermissible method to the permissible method of determining depreciation for a 1-year depreciable property by filing an amended federal tax return for the property's placed-in-service year prior to the date the taxpayer files its federal tax return for the taxable year succeeding the placed-in-service year.

Rev. Proc. 2016-29 provides that this streamlined procedure cannot be made for any property for which the taxpayer has claimed a federal income tax credit (that is, the rehabilitation credit under IRC Section 47). Likewise, the Rev. Proc. 2016-29 automatic consent procedures do not apply to changes from an impermissible to permissible depreciation method related to (1) property held by a tax-exempt organization; (2) property subject to the income-forecast method under IRC Section 167(g); (3) any change in method of accounting involving a change from deducting the cost or other basis of any property as an expense to capitalizing and depreciating the cost or other basis, or vice versa; and (4) any change in method of accounting involving a change from one permissible method of accounting for the property to another permissible method of accounting for the property, among other situations. Instead, a change from an impermissible to a permissible method of depreciation in these situations must be made under the non-automatic change procedures.

Designated Private Delivery Service Rules

Effective April 11, 2016, the IRS is adding eight new delivery services to the list of designated delivery services. DHL Express: DHL Express 9:00, DHL Express 10:30, DHL Express 12:00, DHL Express Worldwide, DHL Express Envelope, DHL Import Express 10:30, DHL Import Express 12:00, and DHL Import Express Worldwide.[2]

[2] Notice 2016-30.

Thus, the 23 current designated PDSs are as follows:

1. DHL Express 9:00
2. DHL Express 10:30
3. DHL Express 12:00
4. DHL Express Worldwide
5. DHL Express Envelope
6. DHL Import Express 10:30
7. DHL Import Express 12:00
8. DHL Import Express Worldwide
9. FedEx First Overnight
10. FedEx Priority Overnight
11. FedEx Standard Overnight
12. FedEx 2 Day
13. FedEx International Next Flight Out
14. FedEx International Priority
15. FedEx International First
16. FedEx International Economy
17. UPS Next Day Air Early AM
18. UPS Next Day Air
19. UPS Next Day Air Saver
20. UPS 2nd Day Air
21. UPS 2nd Day Air A.M.
22. UPS Worldwide Express Plus
23. UPS Worldwide Express

This list of designated PDSs will remain in effect until further notice. The IRS will publish a subsequent notice setting forth a new list only if a designated PDS (or service) is added to, or removed from, the current list.

IRS Announces Adjustments for Premium Tax Credit

IRC Section 36B provides that certain taxpayers are allowed a refundable premium tax credit to assist in the purchase of health insurance through an Exchange. A taxpayer's premium tax credit is calculated as the lesser of (1) the premiums due or (2) the excess of the premium for the second lowest cost silver plan over the taxpayer's contribution amount. The *contribution amount* is the product of the taxpayer's household income multiplied by an *applicable percentage*. The applicable percentages are contained in a table under IRC Section 36B(b)(3)(A)(i). For tax years beginning in 2015 and thereafter, the percentages in the table must be adjusted for inflation. The applicable percentage within an income category increases on a sliding scale in a linear manner from the initial to final percentages.

A taxpayer is eligible for the premium tax credit if they meet all of the following requirements:

- Their household income falls between 100 percent and 400 percent of the poverty level.
- They do not file a Married Filing Separately tax return.
- They cannot be claimed as a dependent by another person.
- In the same month—a coverage month—the taxpayer, or a family member
  - enrolls in coverage through a Health Insurance Marketplace.
  - is not able to get affordable coverage through an eligible employer-sponsored plan that provides minimum value.

- is not eligible for coverage through a government program, like Medicaid, Medicare, CHIP or TRICARE.
- pays the share of premiums not covered by advance credit payments.

IRC Section 5000A provides that each individual must (1) have minimum essential coverage for each month; (2) qualify for an exemption; or (3) make a penalty payment when filing his or her federal income tax return (the so-called "individual mandate"). However, an individual is exempt from the individual mandate for a month if the individual's required contribution for minimum essential coverage exceeds 8 percent of the individual's household income. For plan years beginning after 2014, the required contribution percentage must be adjusted for inflation.

Under IRC Section 36B, the "applicable percentage" is the percentage of household income an individual eligible for the premium tax credit is required to pay for premiums. The applicable percentage varied based on how much above the poverty line the household income is, and is phased out within ranges.

On April 11, 2016 the IRS issued Rev. Proc. 2016-24 announcing the 2017 adjustments to both the applicable percentages for purposes of the premium tax credit and the percentage of household income related to exemption from the individual mandate. For tax years beginning in 2017, the Applicable Percentage Table for purposes of IRC Section 36B(b)(3)(A)(i) is adjusted as follows:

Household income as a percentage of the federal poverty line is

- less than 133 percent, then the initial percentage is 2.04 percent and the final percentage is 2.04 percent;
- at least 133 percent but less than 150 percent, 3.06 percent and 4.08 percent;
- at least 150 percent but less than 200 percent, 4.08 percent and 6.43 percent;
- at least 200 percent but less than 250 percent, 6.43 percent and 8.21 percent;
- at least 250 percent but less than 300 percent, 8.21 percent and 9.69 percent; and
- at least 300 percent but not more than 400 percent, 9.69 percent and 9.69 percent.

The IRC Section 5000A required contribution percentage (the percentage of household income at which a required premium contribution is deemed to be unaffordable) is 8.16 percent for 2017 (up from 8.13 percent for 2016).

Key Tax Developments Affecting Individual Taxpayers

Legislative Developments

Partnership Interests Created by Gift

The Bipartisan Budget Act of 2015[3] (BBA) amends IRC Sections 704(e) and 761(b) to clarify that, in the case of a capital interest in a partnership in which capital is a material income-producing factor, the determination of whether a person is a partner with respect to the interest is made without regard to whether the interest was derived by gift from any other person. Specifically, the amendment strikes paragraph (1) of IRC Section 704(e) (the family partnership rule) and modifies the definition of partner in IRC Section 761 to eliminate any argument that the provision provides an alternative test as to whether the holder of a capital interest is a partner with respect to that interest, or whether the interest constitutes a capital interest in a partnership.

The provision is intended to retain the present-law determination of which person (for example, the donor or the donee) is a partner. The provision is not intended to change the principle that the real owner of a capital interest is to be taxed on the income from the interest, regardless of the motivation behind or the means of the transfer of the interest. Thus, as under present law, the fact that an individual received such a partnership interest by gift from a family member does not determine whether that individual is (or is not) a partner.

The BBA places the new provision in Section 761, relating to definitions, rather than Section 704, relating to a partner's distributive share.

Regulations Issued and Proposed

Inherited Property Consistent Basis Rules

IRC Section 6035 now requires executors of estates that are required to file an estate tax return to furnish a statement identifying the value of each interest in such property, as reported on the estate tax return, to the IRS and to each person acquiring any interest in property included in the decedent's gross estate for federal estate tax purposes. This requirement applies only to property included in the decedent's gross estate for federal estate tax purposes that increases the federal estate tax liability payable by the decedent's estate. If any federal estate tax liability is incurred, all of the property in the gross estate is deemed to increase the federal estate tax liability and is subject to the consistency requirement. However, excluded from the reporting requirement is property that qualifies for a charitable or marital deduction, because such property does not increase the federal estate tax liability. In addition, the proposed regulations exclude any tangible personal property for which an appraisal is not required.

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[3] Pub. L. 114-74.

For purposes of IRC Section 6035, the term *information return* means Form 8971, *Information Regarding Beneficiaries Acquiring Property from a Decedent*. Notwithstanding Reg. Section 20.2010-2(a)(1) (which provides that an estate that elects portability will be considered to be required to file a return) the executor does not have to file or furnish Form 8971 if the executor is not required to file an estate tax return for the estate, even if the executor does file such a return to make a generation-skipping transfer tax exemption allocation or election, to make the portability election, or to make a protective filing to avoid any penalty if an asset value is later determined to cause a return to be required or otherwise.[4]

Each beneficiary (including a beneficiary who is also the executor) who receives property to be reported on Form 8971 must receive a copy of the statement reporting the property distributable to that beneficiary. If the beneficiary is a trust, estate, or business entity, the executor is to furnish the entity's statement to the trustee, executor, or to the business entity itself, and not to the beneficiaries of the trust or estate or to the owners of the business entity. The proposed regulations also set out rules for circumstances where the executor has not determined what property will be used to satisfy the interest of each beneficiary and where a beneficiary cannot be located.

The proposed regulations generally require a supplemental Form 8971 upon a change to the information required to be reported on the information return or a statement that causes the information as reported to be incorrect or incomplete. Such changes include, for example, the discovery of property that should have been, but was not, reported on the federal estate tax return, a change in the value of property pursuant to an examination or litigation, or, subject to exceptions, a change in the identity of the beneficiary to whom the property is to be distributed.

A taxpayer's initial basis in property acquired from a decedent may not exceed the final value of the property. The final value is the value reported on the federal estate tax return once the period of limitations on assessment for adjusting or contesting that value has expired. If no final value has been determined when the taxpayer's basis in the property becomes relevant for federal tax purposes (for example, when it is needed to calculate depreciation or amortization, or gain or loss on disposition of the property) the taxpayer may use the value reported on the statement required by IRC Section 6035(a).

The IRS, of course, may specify a value for the property by determining a value in the course of carrying out its audit responsibilities. If the IRS determines a value different from the value reported, the final value is the value determined by IRS once that value can no longer be contested by the estate. If the value determined or specified by IRS is timely contested by the estate, the final value is the value determined in an agreement that is binding on all parties, or the value determined by a court once the court's determination is final.[5]

Proposed Regulation Section 1.1014-10(c)(2) provides that the recipient of property to which the consistency requirement applies may not, before the final value of that property has been determined, claim a basis that is in excess of the value reported on the statement furnished to the recipient. As noted above, however, basis cannot exceed the property's final value. Therefore, the proposed regulations provide that, if the final value is determined before the period of limitation on assessment expires for any federal income tax return of the recipient on which the taxpayer's basis is relevant, and the final value differs from the initial basis claimed with respect to that return, a deficiency and an underpayment may result.

The basis limitation rule applies regardless of whether the owner on the date of the sale, exchange, or disposition is the same taxpayer who acquired the property from the decedent or as a result of the

[4] Prop. Reg. Section 1.6035-1(a)(2).

[5] Prop. Reg. Section 1.1014-10(c)(1).

decedent's death.[6] "The property" for this purpose includes any other property, the basis of which is determined in whole or in part by reference to the basis of the property acquired from the estate or as a result of the death of the decedent (for example, as the result of a like-kind exchange or involuntary conversion).

The proposed regulations provide that the existence of recourse or non-recourse debt secured by property at the time of the decedent's death does not affect the property's basis, whether the gross value of the property and the outstanding debt are reported separately on the estate tax

Where there is property that is discovered after the filing of the federal estate tax return or that is otherwise omitted from that return, and that property would have generated a federal estate tax liability if it had been reported on the estate tax return, two different results are possible. If the executor does not report the after-discovered or omitted property on an initial or supplemental federal estate tax return filed prior to the expiration of the period of limitation on assessment, the final value of that unreported property is zero. If the executor, prior to the expiration of the period of limitation on assessment, files with the IRS an initial or supplemental estate tax return reporting the property, the final value of the after-discovered or omitted property is determined in accordance with such filing. If no federal estate tax return was filed, the final value of all property includible in the gross estate subject to the consistent basis requirement is zero.

These temporary and proposed reliance regulations are found in T.D. 9757; Reg. Section 1.6035-2T; Prop Reg Section 1.1014-10; Prop Reg Section 1.6035-1; Prop Reg Section 1.6035-2; Prop Reg Section 1.6662-8; Prop Reg Section 301.6721-1; and Prop Reg Section 301.6722-1.

IRS Rulings and Guidance

Filing Requirement Thresholds

Filing requirement thresholds are based on the personal exemption and standard deduction available to a particular taxpayer. The following table summarizes the basic 2016 filing thresholds:

	Personal Exemption	Basic Standard Deduction	Filing Threshold
Single	$4,050	$6,300	$10,350
Married-Joint	$8,100	$12,600	$20,700
Married-Separate	$4,050	$6,300	$10,350
Head of Household	$4,050	$9,300	$13,350

[6] Prop. Reg. Section 1.1014-10(a)(1).

Personal Exemption Amounts

Generally, there is allowed a personal exemption for the taxpayer, the taxpayer's spouse (if filing a married-joint return), and any dependents of the taxpayer for the taxable year. The 2016 personal exemption amount is $4,050, up from $4,000 for 2015.

Not all taxpayers will be able to take the full amount of this exemption. The amount begins to *phaseout* once the taxpayer's AGI reaches a certain level. For most taxpayers, the personal exemption is reduced by 2 percent for each $2,500 (or any fractional portion of $2,500) by which the taxpayer's AGI exceeds a threshold amount based on the taxpayer's filing status. For taxpayers filing married-separate returns the 2 percent reduction applies for each $1,250 (or any fractional portion of $1,250) by which the taxpayer's AGI exceeds the threshold amount.

The chart below summarizes these threshold and complete phase-out amounts for 2016 personal exemptions:

Filing Status	Phaseout Begins	Phaseout Complete
Married Filing Jointly	$311,300	$433,800
Qualifying Widow(er)	$311,300	$433,800
Head of Household	$285,350	$407,850
Single	$259,400	$381,900
Married Filing Separately	$155,650	$216,900

Note that an individual who can be claimed as a dependent by another taxpayer is not entitled to a personal exemption on his or her own return, even if the other taxpayer does not actually claim the dependency exemption or would not derive any benefit from doing so due to the PEP.

Standard Deduction Amounts

The standard deduction is composed of the *basic* standard deduction and an *additional* standard deduction for taxpayers who are age 65 or older, blind, or both. The amount of the basic standard deduction depends on the taxpayer's filing status. For the 2016 tax year, the basic standard deduction for single taxpayers as well as those filing married-separate returns (subject to the requirement for such taxpayers to itemize as discussed above) is $6,300. Taxpayers who qualify for the head-of-household filing status get a standard deduction of $9,300. Married taxpayers who file married-joint returns are allowed a standard deduction of $12,600 on their 2016 joint return.

For tax year 2016, the basic standard deduction of individuals who can be claimed as dependents by another taxpayer is limited to the greater of (1) $1,050 or (2) $350 plus the individual's earned income for the year (limited to a maximum of $6,300).

For those taxpayers filing single or head-of-household returns for 2016, the additional standard deduction is $1,550. The amount of the additional standard deduction for married taxpayers (whether filing married-joint or married separate) is $1,250. Remember that an additional standard deduction is allowed for each taxpayer (that is, both spouses on a married-joint return) who has attained the age of 65 by the end of the tax year and for each taxpayer who is blind.

Tax Brackets

Tax brackets for individuals are adjusted annually for inflation. The 2016 tax brackets for individuals are as follows:

Rate	Single	Married Joint	Head of Household
10%	$0 to $9,275	$0 to $18,550	$0 to $13,250
15%	$9,275 to $37,650	$18,550 to $75,300	$13,250 to $50,400
25%	$37,650 to $91,150	$75,300 to $151,900	$50,400 to $130,150
28%	$91,150 to $190,150	$151,900 to $231,450	$130,150 to $210,800
33%	$190,150 to $413,350	$231,450 to $413,350	$210,800 to $413,350
35%	$413,350 to $415,050	$413,350 to $466,950	$413,350 to $441,000
39.6%	$415,050+	$466,950+	$441,000+

Kiddie Tax

A parent may elect to include a child's gross income in the parent's gross income and to calculate the *kiddie tax*. One of the requirements for the parental election is that a child's gross income is more than an inflation-adjusted amount, but less than 10 times that amount. For 2016 the amount is $1,050, the same as the basic standard deduction of individuals who can be claimed as dependents by another taxpayer. Thus for 2016, a child's gross income must be more than $1,050 but less than $10,500 for a parent to make the election to include a child's gross income in the parent's gross income.

Adoption Credit

For 2016, the credit allowed for an adoption of a child with special needs is $13,460. The maximum credit allowed for other adoptions is the amount of qualified adoption expenses up to $13,460. The available adoption credit begins to phase out under for taxpayers with modified adjusted gross income in excess of $201,920 and is completely phased out for taxpayers with modified adjusted gross income of $241,920 or more.

Adoption Assistance Programs

Corresponding to the adoption credit is a gross income exclusion for employer-provided adoption assistance. Parallel to the adoption credit for 2016, the amount that can be excluded from an employee's gross income for the adoption of a child with special needs is $13,460. The maximum amount that can be excluded from an employee's gross income for the amounts paid or expenses incurred by an employer for qualified adoption expenses furnished pursuant to an adoption assistance program for other adoptions by the employee is $13,460. These amounts begin to phase out for taxpayers with modified adjusted gross income in excess of $201,920 and are completely phased out for taxpayers with modified adjusted gross income of $241,920 or more.

Child Tax Credit

For tax years through 2017, the value used in to determine the amount of child tax credit that may be refundable under IRC Section 24 is $3,000. This amount is not adjusted annually, but will remain the same through 2017.

American Opportunity and Lifetime Learning Credits

The American Opportunity Credit (Hope Scholarship Credit) under IRC Section 25A(b)(1) is an amount equal to 100 percent of qualified tuition and related expenses not in excess of $2,000 plus 25 percent of those expenses in excess of $2,000, but not in excess of $4,000. Accordingly, the maximum American Opportunity Credit allowable for 2016 is $2,500.

A taxpayer's modified adjusted gross income in excess of $80,000 ($160,000 for a joint return) is used to determine the reduction under in the amount of the American Opportunity Credit otherwise allowable. A taxpayer's modified adjusted gross income in excess of $55,000 ($110,000 for a joint return) is used to determine the reduction in the amount of the Lifetime Learning Credit otherwise allowable under IRC Section 25A(a)(2).

Earned Income Credit

For 2016, the following amounts are used to determine the earned income credit under IRC Section 32(b). The *earned income amount* is the amount of earned income at or above which the maximum amount of the earned income credit is allowed. The *threshold phaseout amount* is the amount of adjusted gross income (or, if greater, earned income) above which the maximum amount of the credit begins to phase out. The *completed phaseout amount* is the amount of adjusted gross income (or, if greater, earned income) at or above which no credit is allowed.

	Number of Qualifying Children			
Item	1	2	3+	0
Earned Income Amount	$ 9,920	$ 13,930	$ 13,930	$ 6,610
Maximum Credit	3,373	5,572	6,269	506
Threshold Phaseout (Single, HofH)	18,190	18,190	18,190	8,270
Complete Phaseout (Single, HofH)	39,296	44,648	47,955	14,880
Threshold Phaseout (MFJ)	23,740	23,740	23,740	13,820
Complete Phaseout (MFJ)	44,846	50,198	53,505	20,430

The instructions for Form 1040 provide tables showing the amount of the earned income credit for each type of taxpayer. For 2016, the earned income tax credit is not allowed if the aggregate amount of certain investment income exceeds $3,400.

Exemption Amounts for Alternative Minimum Tax

For taxable years beginning in 2016, the AMT exemption amounts are as follows:

Joint Returns or Surviving Spouses	$83,800
Unmarried Individuals (other than Surviving Spouses)	$53,900
Married Individuals Filing Separate Returns	$41,900
Estates and Trusts	$23,900

The excess taxable income above which the 28 percent tax rate applies is

Married Individuals Filing Separate Returns	$93,150
Joint Returns, Unmarried Individuals (other than Surviving Spouses), and Estates and Trusts	$186,300

The amounts used to determine the phaseout of the exemption amounts are:

Joint Returns or Surviving Spouses	$159,700
Unmarried Individuals (other than Surviving Spouses)	$119,700
Married Filing Separate Returns + Estates and Trusts	$79,850

Alternative Minimum Tax Exemption for a Child Subject to the Kiddie Tax.

For a child to whom the kiddie tax applies, the 2016 exemption amount for purposes of the alternative minimum tax may not exceed the sum of (1) the child's earned income for the taxable year, plus (2) $7,400.

Cafeteria Plans

For the taxable years beginning in 2016, the dollar limitation on voluntary employee salary reductions for contributions to health flexible spending arrangements is $2,550.

Qualified Transportation Fringe Benefit

The 2016 monthly limitation regarding the aggregate fringe benefit exclusion amount for transportation in a commuter highway vehicle and any transit pass would have been $130 without extended legislation, with the monthly limitation regarding the fringe benefit exclusion amount for qualified parking being $255. Note that retroactive parity between the two amounts was established via the PATH Act so that the $255 limitation applies to both.

Income from United States Savings Bonds for Taxpayers Who Pay Qualified Higher Education Expenses

For taxable years beginning in 2016, the exclusion regarding income from United States savings bonds for taxpayers who pay qualified higher education expenses begins to phase out for modified adjusted gross income above $116,300 for joint returns and $77,550 for all other returns. The exclusion is completely phased out for modified adjusted gross income of $146,300 or more for joint returns and $92,550 or more for all other returns.

Eligible Long-Term Care Premiums

For 2016, the limitations regarding eligible long-term care premiums includible in the term *medical care*, are as follows:

Attained Age Before the Close of Year	Limitation on Premiums
40 or less	$390
More than 40 but not more than 50	$730
More than 50 but not more than 60	$1,460
More than 60 but not more than 70	$3,900
More than 70	$4,870

Medical Savings Accounts

For self-only coverage in 2016, the term *high deductible health plan* means a health plan that has an annual deductible that is not less than $2,250 and not more than $3,350, and under which the annual out-of-pocket expenses required to be paid (other than for premiums) for covered benefits do not exceed $4,450.

For family coverage in 2016, the term *high deductible health plan* means a health plan that has an annual deductible that is not less than $4,450 and not more than $6,700, and under which the annual out-of-pocket expenses required to be paid (other than for premiums) for covered benefits do not exceed $8,150.

Interest on Education Loans

The $2,500 maximum deduction for interest paid on qualified education loans begins to phase out for taxpayers with modified adjusted gross income in excess of $65,000 ($130,000 for joint returns) in 2016 and is completely phased out for taxpayers with modified adjusted gross income of $80,000 or more ($160,000 or more for joint returns).

Foreign Earned Income Exclusion

The foreign earned income exclusion amount for 2016 is $101,300.

Unified Credit Against Estate Tax

For an estate of any decedent dying during calendar year 2016, the basic exclusion amount is $5,450,000 for determining the amount of the unified credit against estate tax.

Valuation of Qualified Real Property in Decedent's Gross Estate

For an estate of a decedent dying in calendar year 2016, if the executor elects to use the special use valuation method for qualified real property, the aggregate decrease in the value of qualified real property resulting from the election cannot exceed $1,110,000.

Annual Exclusion for Gifts

For 2016, the first $14,000 of gifts to any person (other than gifts of future interests in property) are not included in the total amount of taxable gifts made during that year.

The first $148,000 of gifts to a spouse who is not a citizen of the United States (other than gifts of future interests in property) are not included in the total amount of taxable gifts.

Interest on a Certain Portion of the Estate Tax Payable in Installments

When an extension of time is allowed for payment of estate tax where the estate consists largely of interest in closely held business, the interest on a portion of the tax is 2 percent. For an estate of a decedent dying in calendar year 2016, the dollar amount used to determine the *2 percent portion* of the estate tax for purposes of calculating interest is $1,480,000.

Energy Conservation Subsidies Excluded From Income

In PLR 201607004, the IRS responded to the following circumstances regarding the exclusion under IRC Section 136(a). A state's statutes established a specific organization to support state environmental and economic development objectives through clean energy finance and investment. The organization oversees two subsidies (Subsidy A and Subsidy B) under its program. The subsidies are available to residential homeowners whose homes are within the service territories of state's utilities (Utility A and Utility B).

Pursuant to the state statutes, the program is funded by a surcharge on state ratepayer's electricity bills. These surcharges are collected by Utility A and Utility B and the utilities remit the collected surcharges to the organization, which maintains the funds in a separate account. From the funds, the organization pays eligible contractors who install the residential photovoltaic systems for the residential system owners and apply for the subsidies.

The organization screens and evaluates every application for eligible contractors and approves only ones meeting its criteria. The organization also screens residential photovoltaic system owners to qualify for the subsidies. All system owners under the program are required to use eligible contractors to install the residential photovoltaic systems. The organization enters into a contract with an eligible contractor to comply with all of the terms and conditions for receiving the subsidies. Upon the installation of a system that satisfies certain criteria, an eligible contractor receives a payment from the organization to be applied as a reduction in the total price of the system.

Under this program, the organization calculates the subsidy amount based on the photovoltaic system's specifications, size and efficiency, all of which have a direct impact on the cost of the system. The size of the system is intended to generate only the amount of energy to sufficiently service the electrical needs of the system owner to minimize excessive net metering and ensure that eligible contractors do not recommend a system that would be too large for a system owner.

Pursuant to the contract with the organization, eligible contractors must incorporate into their contracts with the system owners certain terms and conditions imposed by the organization. As a condition of receiving the subsidies, the organization is entitled to any renewable energy credits and any other tradable energy or environmental related commodity produced or created by the photovoltaic systems. System owners are also required to install a revenue-grade electric meter monitoring system to monitor the production of renewable energy credits. Unlike Subsidy B, Subsidy A requires system owners to meet an energy production target for the first 30-day period to confirm that the system is in operation.

The IRS found that the statutory requirements for the exclusion of the above described subsidies made by the organization from the gross income of the residential photovoltaic system owners are satisfied in the instant circumstances. The payments are made for purposes, and within the limitations, described in IRC Section 136(c)(1). Under the legislative scheme enacted by the state as administered through the organization, the described payments are made "directly or indirectly" by Utility A and Utility B satisfying the terms of IRC Section 136(c)(2)(B), through the organization, to the residential customers.

The IRS concluded, therefore, that the above described subsidies made by the organization are excludable from the gross incomes of the residential photovoltaic system owners for federal income tax purposes.

Value of Identity Protection Services Excluded From Income

In Announcement 2016-2 the IRS indicated that it was expanding its position that identity protection services are tax-free when provided to consumers, whether those services are provided before or after a data breach. Announcement 2016-2 does not apply to cash received in lieu of identity protection services. This announcement also does not apply to proceeds received under an identity theft insurance policy.

2016 Inflation-Adjusted Amounts for HSAs and High-Deductible Health Plans

Individuals who participate in a health plan with a high deductible are permitted a deduction for contributions to HSAs set up to help pay their medical expenses.[7] The contribution deduction limit is subject to an annual inflation adjustment. For 2016, the annual limit on deductible contributions is $3,350

[7] IRC Section 223.

for individuals with self-only coverage (unchanged from 2015) and $6,750 for family coverage ($100 higher than for 2015).

To be eligible to contribute to an HSA, an individual must participate in a "high deductible health plan," which is a health plan with an annual deductible that is not less than a certain limit each year and for which the annual out-of-pocket expenses, including deductibles, co-payments, and other amounts, but excluding premiums, does not exceed a certain limit each year. These limits are also subject to annual inflation adjustments. For 2016, the lower limit on the annual deductible under a high-deductible plan is $1,300 for self-only coverage and $2,600 for family coverage, the same as for 2015. The upper limit for out-of-pocket expenses is $6,550 for self-only coverage and $13,100 for family coverage, both slightly higher than for 2015.

Regulations Issued and Proposed

Proposed Section 385 Debt/Equity Regulations

Prop. Reg. Section 1.385-1; Prop. Reg. Section 1.385-2; Prop. Reg. Section 1.385-3; and Prop. Reg. Section 1.385-4, generally apply to expanded group indebtedness ("EGI"), defined as an instrument in which both the issuer and holder are members of the same "expanded group." The definition of "expanded group" starts with the "affiliate group" described under IRC Section 1504(a), subject specific modifications. Unlike an affiliated group, an expanded group may include foreign corporations and indirectly (in addition to directly) held interests in another corporation, including a corporation held through a partnership. The proposed regulations adopt the constructive ownership rules of IRC Section 304(c)(3). Furthermore, the proposed regulations modify the "vote *and* value" definition under IRC Section 1504(a)(2)(A) to "vote *or* value." The proposed regulations also expand the population of an EGI as compared to an affiliated group by using a 50 percent threshold for relatedness, rather than an 80 percent threshold.

Subject to certain exceptions, the proposed regulations may treat the following related-party transactions involving indebtedness as stock:

- Distributions of debt instruments by corporations to their related corporate shareholders;
- Issuances of debt instruments by corporations in exchange for stock of an affiliate (including "hook stock" issued by their related corporate shareholders);
- Certain issuances of debt instruments as consideration in an exchange pursuant to an internal asset reorganization (for example, a IRC Section 368(a)(1)(D); reorganization); and
- A related-party debt instrument that is issued with a principal purpose of funding certain distributions and acquisitions and may involve (1) a distribution of cash or other property to a related corporate shareholder, (2) an acquisition of affiliate stock from an affiliate, and (iii) certain acquisitions of property from an affiliate pursuant to an internal asset reorganization.

Adjustment to Calculating NOL Limitations

On April 26, 2016 the IRS issued final regulations that modify the method to be used to adjust the applicable federal rate ("AFR") that determines certain rates under IRC Sections 382 and 1288.[8] These adjustments were considered necessary after the IRS concluded that the rates being used were inconsistent with express intention of Congress that rates be lower than federal long-term rate. The proposed regulations issued in 2015 are adopted without significant change.

These regulations that provide method to be used to determine the long-term tax-exempt rate and the adjusted federal long-term rate under IRC Section 382. As such, the regulations affect the determination of the limitations under IRC Sections 382 and 383 on the use of certain operating loss carryforwards, tax credits, and other attributes of corporations following ownership changes.

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[8] TD 9763.

The regulations provide the new method by which the Treasury Department and the IRS will determine the adjusted AFRs the long-term tax-exempt rate and the adjusted federal long-term rate under IRC Section 382 to take into account differences between rates on long-term taxable and tax-exempt obligations.

IRS RULINGS AND GUIDANCE

IRS Reverses Position on Effect of Nonrecourse Carve-Outs

By definition, a partnership nonrecourse liability is a liability for which none of the partners bears the economic risk of loss. Nonrecourse liabilities are allocated to the partners in a different manner than recourse liabilities under IRC Section 752. Furthermore, nonrecourse liabilities are not counted in a partner's "at-risk" amount unless the liability constitutes qualified nonrecourse financing under IRC Section 465(b)(6). In determining whether a guarantee results in economic risk of loss to the guarantor, obligations that are conditioned on contingencies unlikely to occur are disregarded.

Including "nonrecourse carve-out" provisions in guarantees of partnership nonrecourse obligations is a fairly common practice throughout the commercial real estate finance industry. These nonrecourse carve-outs typically provide that the guarantee does not take effect unless one or more of the following events occur: (1) the borrower fails to obtain the lender's consent before obtaining subordinate financing or transfer of the secured property; (2) the borrower files a voluntary bankruptcy petition; (3) any person in control of the borrower files an involuntary bankruptcy petition against the borrower; (4) any person in control of the borrower solicits other creditors of the borrower to file an involuntary bankruptcy petition against the borrower; (5) the borrower consents to or otherwise acquiesces or joins in an involuntary bankruptcy or insolvency proceeding; (6) any person in control of the borrower consents to the appointment of a receiver or custodian of assets; or (7) the borrower makes an assignment for the benefit of creditors, or admits in writing or in any legal proceeding that it is insolvent or unable to pay its debts as they come due.

The IRS had previously taken the position that the presence of nonrecourse carve-outs results in a risk of economic loss to the guarantor, causing the obligation to be regarded as a recourse liability for basis and at-risk purposes (see CCA 201606027).

The IRS has now reversed itself and concluded that such nonrecourse carve-out events will *not* cause the obligation to fail to qualify as a nonrecourse liability of the partnership under IRC Section 752, or as qualified nonrecourse financing for purposes of IRC Section 465(b)(6), until one of those events actually occurs and causes the guarantor to become personally liable for the partnership debt under local law. Legal Advice Issued by Associate Chief Counsel 2016-001.

2016 Vehicle Depreciation Limits

Tables 1 through 4 of Rev. Proc. 2016-23 provide depreciation limitations for passenger automobiles placed in service during calendar year 2016.

Table 1: Depreciation Limits for Passenger Automobiles (Not Trucks or Vans) Placed in Service in 2016 With Bonus Depreciation

Tax Year	Amount
1st	$ 11,160
2nd	5,100
3rd	3,050
Each succeeding	1,875

Table 2: Depreciation Limits for Trucks and Vans Placed in Service in 2016 With Bonus Depreciation

Tax Year	Amount
1st	$ 11,560
2nd	5,700
3rd	3,350
Each succeeding	2,075

Table 3: Depreciation Limits for Passenger Automobiles (Not Trucks or Vans) Placed in Service in 2016 Without Bonus Depreciation

Tax Year	Amount
1st	$ 3,160
2nd	5,100
3rd	3,050
Each succeeding	1,875

Table 4: Depreciation Limits for Trucks and Vans Placed in Service in 2016 Without Bonus Depreciation	
Tax Year	**Amount**
1st	$ 3,560
2nd	5,700
3rd	3,350
Each succeeding	2,075

IRC Section 280F(c) requires a reduction in the deduction allowed to the lessee of a leased passenger automobile. The reduction must be substantially equivalent to the limitations on the depreciation deductions imposed on owners of passenger automobiles. This reduction requires a lessee to include in gross income an amount determined by applying a formula to the amount obtained from a table. Table 5 of Rev. Proc. 2016-23 applies to lessees of passenger automobiles that are not trucks and vans and Table 6 applies to lessees of trucks and vans. Each table shows inclusion amounts for a range of fair market values for each taxable year after the passenger automobile is first leased.

2016 Maximums for Cents-Per-Mile Valuation and Fleet Averaging

Notice 2016-12 provides that the maximum value of employer-provided vehicles first made available to employees for personal use in calendar year 2016 for which the vehicle cents-per- mile valuation rule may be applicable is $15,900 for a passenger automobile and $17,700 for a truck or van.

The maximum value of employer-provided vehicles first made available to employees for personal use in calendar year 2016 for which the fleet-average valuation rule may be applicable is $21,200 for a passenger automobile and $23,100 for a truck or van.

Inflation Adjusted Section 179 Limitation

The PATH Act amended IRC Sections 179(b)(1) and (2) to provide that the dollar limitation for the aggregate cost of Section 179 property that a taxpayer may elect to expense is $500,000, and that dollar amount is reduced by the amount by which the cost of all Section 179 property placed in service during the taxable year exceeds $2,000,000. For taxable years beginning in 2016, these amounts are adjusted for inflation. In Rev. Proc. 2016-14 the IRS announced that the $500,000 limitation is reduced (but not below zero) by the amount the cost of Section 179 property placed in service during the 2016 taxable year exceeds $2,010,000.

Amount Paid to Settle Fraudulent Conveyance Claim Not Deductible

In Chief Counsel Advice 201552028 the IRS concluded that amounts paid in settlement of a fraudulent conveyance claim were capitalizable as amounts paid to defend or perfect title to real or personal property, and thus could not be deducted as incurred.

Fraudulent conveyance claims have their origin in a defense of title to real or personal property, Chief Counsel observed, because they seek to restore improperly transferred property back to the transferor. Therefore, the dispute in each claim is over ownership of, or title to, property.

Where a settlement payment has its origin in a fraudulent conveyance claim the essence of the action is a claim for the return of property or a payment in lieu thereof. Part of the controversy settled in the case being considered by Chief Counsel was over a dispute regarding ownership of property. Amounts paid in settlement of such claims are capital in nature. Therefore, amounts attributable to the four fraudulent conveyance claims are not deductible under IRC Section 162.

Failure of Internal Controls Leads to Nondeductible Expense

In a case where a disregarded entity's executives and employees intentionally falsified its books and records and the taxpayer failed to implement adequate internal accounting and financial controls designed to detect and prevent such corruption-related violations, including Foreign Corrupt Practices Act violations, the Office of Chief Counsel determined in Chief Counsel Advice 201619008 that IRC Section 162(f) prohibited deduction for amount paid as disgorgement to Securities and Exchange Commission.

Chief Counsel clarified that, although the issue under IRC Section 162(f) is often referred to as whether a payment is *punitive* or *compensatory*, the scope of that section is not restricted to payments that are punitive in the narrow sense that they are imposed solely as retribution for past wrongdoing. The scope of punitive in this context includes the purpose of enforcing the law by deterring the proscribed conduct in the future.

For purposes of IRC Section 162(f), Chief Counsel observed that disgorgement in federal securities law cases can be primarily compensatory or primarily punitive for federal tax law purposes depending on the facts and circumstances of a particular case. The fact that disgorgement goes to a fund does not always mean that it is primarily compensatory. Disgorgement can be primarily punitive for tax purposes in some cases, where it serves primarily to prevent wrongdoers from profiting from their illegal conduct and deters subsequent illegal conduct.

In the instant case, the Chief Counsel concluded that there was nothing indicating that the purpose of the disgorgement payment was to compensate the United States Government or some non-governmental party for its specific losses caused by the taxpayer's violations of the FCPA. Consequently, Chief Counsel found that the disgorgement payment is not deductible pursuant to IRC Section 162(f) because the payment was primarily punitive. Similarly, a deduction for a loss under IRC Section 165 would be prohibited.

Matching Contributions Held to be Not Deductible

In PLR 201616002, the IRS addressed a situation involving a corporation prohibited by the Federal Election Campaign Act (FECA) from contributing to federal election campaigns. Consistent with the FECA, the taxpayer established a political action committee (PAC), which was funded by employees of the taxpayer and its subsidiaries. The PAC was a political organization exempt from taxation under IRC Section 527. The PAC's purpose, as stated in its charter, was to "disburse funds to candidates" for public office.

To incentivize employee contributions to the PAC, the corporation matched each of these contributions with a contribution in the name of the employee to one or more charities selected by the employee. The corporation requested a ruling that it may deduct its matching contributions as ordinary and necessary business expenses under IRC Section 162.

The IRS concluded that the contributions to the PAC and corporation's matching contributions were inextricably linked. They noted that the contributions to the PAC were a prerequisite for the corporation's matching contributions. Moreover, the corporation's matching contributions were specifically intended to incentivize contributions to the PAC. Applying IRC Section 162(e)(1)(B), the regulations, and case law, the IRS concluded that the corporation's matching contributions were "in connection with" a political campaign on behalf of a candidate for public office, and therefore not deductible under IRC Section 162.

Recognition of Gift Card Income

In PLR 201610017 (TAM) the IRS addressed a situation in which a company (Company) is a multinational e-commerce and physical retailer of products with operations in several countries. During the tax years at issue, Company operated retail stores and associated commercial websites under various brand names from which customers could purchase its products.

Company also offers an assortment of related services including delivery, installation, and repair. For example, if a customer purchases an item online or at its retail store, the customer can also pay an additional fee to have Company deliver, install, or repair that item. These services are related to its core businesses.

Company also sells services unrelated to its core business. For example, customers can purchase repair services for items not purchased from Company, can hire Company to install new items that the customer did not purchase from Company, or can hire Company to install items without having purchased any related items from Company. These services are unrelated to its core businesses.

Company also sells extended warranties and service contracts related to its core business. The warranty or service plans are sold on behalf of a third party. Company earns a commission for every extended warranty or service contract it sold and recognized these commissions as commission revenue. The third party determines whether to hire Company or another to perform the repair. If Company performs the repair, the third party will reimburse Company for the cost of the repair.

Company sells gift cards to customers, which do not have an expiration date. Company does not charge customers any administrative fees to purchase or redeem a gift card. To redeem the gift card, customers need only present the card at the time of checkout. At redemption, the gift card is treated as cash. The gift cards allow the holder to spend the value of the gift card at Company retail stores or its website. Customers can use the gift cards to purchase goods, services, or a combination of goods and services. There is no limit on the number of gift cards a customer can use during a single purchase and gift cards can be used in conjunction with any other type of tender. The gift cards are activated and become available for immediate use at the time of purchase, at which time Company is obligated to provide such goods or services as demanded from the gift card holder at redemption.

Company's gift cards, regardless of amount, have the same stock keeping unit (SKU), enabling Company to track when the gift cards are purchased. Gift card balances and redemption data are tracked electronically by a third party. Company suggests that customers generally buy the same proportion of goods, services, or both goods and services with Company gift cards as they do with cash or credit cards.

Company determines its breakage rate, the amount of gift cards never redeemed, using historical redemption patterns. After one period, for financial statement purposes, Company recognizes breakage income for those gift cards for which the likelihood of redemption is remote.

This technical advice request presents the question of whether all or a portion of the amounts received for gift cards which are redeemable for both merchandise and services constitute "advance payments."

The regulations define the term *advance payment* to include any amount received in a tax year pursuant to and to be applied against an agreement for the sale or other disposition in a future tax year of goods held by a taxpayer primarily for sale to customers.

An advance payment requires "an agreement." The term *agreement* includes a gift certificate that *can* be redeemed for goods. The amounts here were received for the sale of gift cards. If the gift cards can be redeemed for goods they are similarly an agreement under the regulation. Company's gift cards are redeemable for goods, warranties, delivery and installation, and other services. Furthermore, the regulation should be interpreted to apply to gift cards, like Company's, that can be redeemed for goods but can also be redeemed for other items, as well as to gift cards that can only be redeemed for goods.

It is also necessary to determine whether a gift card which can be redeemed in part for services or other items can still be considered an agreement for the sale of *goods*. That is, does the ability to redeem the gift cards for services or other items render the gift cards outside of the scope of the regulations?

An *agreement* includes contracts that obligate a taxpayer to perform services that are integral to a sale of goods. If a taxpayer receives an amount pursuant to an agreement that not only obligates the taxpayer to provide goods, but also obligates the taxpayer to perform non-integral services, such amount will be treated as an "advance payment" only to the extent such amount is properly allocable to the obligation to provide goods. If the amount not so allocable is less than 5 percent of the total contract price, such amount will be treated as so allocable if such treatment does not result in delaying the time at which the taxpayer would otherwise accrue the amounts attributable to such activities (hereinafter referred to as *de minimis*).

Regulations Section 1.451-5(a)(3) is written in the present tense and contemplates a taxpayer receiving an amount pursuant to an agreement to provide goods in the future where a proper allocation can be made in the taxable year in which the advance payment is received. Thus, the subparagraph applies to agreements with specific terms that provide a basis for a proper allocation.

Company's gift cards, however, leave to the discretion of the customer the choice of what items the gift card will be redeemed for and preserves for the customer that discretion until the time when the gift card is redeemed. Until Company's gift cards are redeemed, for any individual gift card Company cannot know whether it will be redeemed for services and other items that are not integral to a sale of goods by the company. These items may or may not be *de minimis* in amount and thus, may or may not be properly allocable to a sale of goods under the rules of Reg. Section 1.451-5(a)(3), were it applicable.

If not integral or properly allocable to the sale of goods these items cannot be considered *goods*, which is an exception to the general rule of income recognition and should be narrowly interpreted. Thus, for a gift card outstanding at the end of the taxable year in which it is purchased, an amount cannot be properly allocated to the provision of goods under the language of Reg. Section 1.451-5(a)(3) because what the card will be redeemed for is unknown.

The IRS concluded that gift cards that can be redeemed for goods and non-integral services are eligible to apply allocation rules similar to those described in Reg. Section 1.451-5(a)(3) by treating the total of the Company's outstanding gift cards at the end of the taxable year of their sale as a single agreement and allowing estimates to be used for the application of Reg. Section 1.451-5(a)(3). Applying this approach to Company's gift cards, it is eligible to defer amounts received for its gift cards to the extent it can make an appropriate estimate of the amounts that are deferrable under Reg. Section 1.451-5.

Deduction for Stock-Based Compensation

In PLR 201610006 the IRS addressed a circumstance in which the taxpayer was a corporation and the parent company of a consolidated group for U.S. federal income tax purposes, which includes a wholly owned subsidiary, as well as other U.S. subsidiaries. The taxpayer and its subsidiaries used the accrual method of accounting.

One of the businesses in which the taxpayer was engaged was the business of purchasing and distributing products to a variety of providers. The taxpayer's ability to obtain these products from manufacturers in necessary volume and with favorable pricing was critical to satisfying its customers.

The taxpayer and its wholly-owned subsidiary entered into several contracts with Company A, a domestic corporation, Company B, a foreign corporation, and Company C, a foreign corporation owned by Company A and B. The goal of these contracts was to increase the purchasing power of the parties involved with an objective to realize improved pricing for products. Central to the new relationship was the execution of a purchasing services agreement.

As part of the agreement, the taxpayer granted contingent equity rights, or warrants, subject to the performance requirements stated above, to each of Company A and Company B (via their respective subsidiaries) to acquire shares in the taxpayer. At the time the warrants were issued, the warrants did not have an ascertainable fair market value because, among other things, they were not actively traded on an established market and were not exercisable immediately in full by the recipient. The shares acquired pursuant to the exercise of the warrants were not subject to a substantial risk of forfeiture, and therefore, were substantially vested at the time of exercise.

The taxpayer granted the stock warrants when Company A, Company B, and Company C signed a contract for Company C to perform services. At the time of the grant, the then price of the taxpayer's stock was less than the exercise prices of the warrant tranches under the agreements. The taxpayer's goal was to provide appropriate long-term incentives for Company C to perform its duties under the agreement effectively. The agreements provided that if Company C failed to perform its duties under the agreements in a satisfactory and successful manner, the taxpayer had the right under the agreements to terminate them and cancel the warrants granted to Company A and Company B. Thus, the warrants would only become exercisable if Company C had fully complied with the terms of the agreements, including the performance of the required services, up to the applicable points in time.

The IRS concluded that all events had not occurred that establish the fact of the liability and permit it to be determined with reasonable accuracy until the contingencies surrounding the issuance of the warrants had lapsed. In contrast, economic performance will have occurred by the time the contingencies lapse because services by then will have already been provided to the taxpayer. Thus, the only question was whether the contingency lapse occurs when the warrants become exercisable or exercised. The warrants are subject to IRC Section 83 because the taxpayer granted the stock warrants to Company A and Company B in connection with the performance of services for the taxpayer on an ongoing basis. Therefore, IRC Section 83 determines the timing of the contingency lapse.

The warrants did not have an ascertainable fair market value on the date of grant. Thus, IRC Sections 83(a) and 83(b) did not apply on the issuance of the warrants or when they became exercisable, but become applicable only upon the warrants' exercise. Therefore, the taxpayer may claim a deduction in accordance with its method of accounting (in conformity with IRC Sections 446 and 461) when the substantially vested shares are transferred to Company A and/or Company B, as applicable, upon exercise of the stock warrants.

S Corp Did Not Have Second Class of Stock

In PLR 201607001 the IRS addressed a situation in which an S corporation employed A, who was also a shareholder. During that time, the corporation may have paid excessive compensation to A. A was an at will employee without a written compensation agreement. The corporation's board reviewed and approved the compensation of all of its employees annually. The corporation's governing provisions, including its articles of association, its bylaws and its shareholder agreements, confer identical rights to distribution and liquidation proceeds with respect to its outstanding shares of stock. The corporation also represents that it was not a principal purpose to circumvent the one class of stock requirement through compensation paid to A.

Based solely on these facts and representations, the IRS concluded that because the corporation's governing provisions provide for identical distribution and liquidation rights and because the corporation represented that it was not a principal purpose to circumvent the one class of stock requirement through compensation paid to A, any excessive compensation paid to A does not cause the corporation to be treated as having more than one class of stock and therefore the S corporation election did not terminate as a result of the compensation paid to A.

Mid-Year Changes to Safe Harbor 401(k) Plans

In Notice 2016-16, the IRS provided guidance on mid-year changes to 401(k) safe harbor plans and notices, including several examples.

A *mid-year change* is (1) a change that is first effective during a plan year, but not effective as of the beginning of the plan year, or (2) a change that is effective as of the beginning of the plan year, but adopted after the beginning of the plan year.

Not every mid-year change to a safe harbor plan alters information required to be provided in a plan's safe harbor notice (for example, information about a plan's entry date is not required to be provided in a plan's safe harbor notice). Similarly, information required to be included in a plan's safe harbor notice can change mid-year even if no change is made to the safe harbor plan (for example, a change in contact information).

The following mid-year changes are not subject to the provisions of Notice 2016-16, but instead would violate the Regulations unless the applicable regulatory conditions corresponding to each specified change are satisfied: (1) adoption of a short plan year or any change to the plan year; (2) adoption of safe harbor plan status on or after the beginning of the plan year; and (3) reduction or suspension of safe harbor contributions or changes from safe harbor plan status to non-safe harbor plan status. Other applicable law also may affect the permissibility of mid-year changes, including, for example, IRC Sections 411(d)(6) (anti-cutback restrictions), 401(a)(4) (nondiscrimination restrictions), and Reg. Section 1.401(k)-1(b)(3) (anti-abuse provisions).

An updated safe harbor notice that describes the mid-year change and its effective date must be provided to each employee otherwise required to be provided a safe harbor notice, within a reasonable period before the effective date of the change. Whether this timing requirement is met is based on all of the relevant facts and circumstances, but this timing requirement is deemed to be satisfied if the updated safe harbor notice is provided at least 30 days (and not more than 90 days) before the effective date of the change. If it is not practicable for the updated safe harbor notice to be provided before the effective date of the change (for example, in the case of a mid-year change to increase matching contributions retroactively for the entire plan year), the notice is treated as provided timely if it is provided as soon as practicable, but not later than 30 days after the date the change is adopted. If the required information about the mid-year change and its effective date was provided with the pre-plan year annual safe harbor notice, an updated safe harbor notice is not required.

Each employee required to be provided an updated safe harbor notice must be given a reasonable opportunity (including a reasonable period after receipt of the updated notice) before the effective date of the mid-year change to change the employee's cash or deferred election (and/or any after-tax employee contribution election). For this purpose, a 30-day election period is deemed to be a reasonable period to make or change a cash or deferred election. If it is not practicable for the election opportunity to be provided before the effective date of the change (for example, in the case of a mid-year change to increase matching contributions retroactively for the entire plan year), an employee is treated as having a reasonable opportunity to make or change an election if the election opportunity begins as soon as practicable after the date the updated notice is provided to the employee, but not later than 30 days after the date the change is adopted.

IRS OKs Liberal Reading of "Otherwise Excludable Employees"

The Office of Chief Counsel concluded in Chief Counsel Advice 201615013 that it is an acceptable application of the statutory and regulatory provisions to treat the population of otherwise excludable employees for purposes of coverage testing under IRC Section 410(b)(4)(B) and performing the ADP test as including employees participating in the plan who have not satisfied the IRC Section 410(a)(4) period applicable to them (meaning through the earlier of the date six months after the participant attains age 21 and completes one year of service or the first day of the first plan year after the participant attains age 21 and completes one year of service).

The IRS noted that there are other readings that may also be acceptable applications of the statutes and regulations. For example, one could take the position that (1) a covered employee is an otherwise excludable employee only until the date on which he or she attains age 21 and completes one year of service (that is, no period is tacked on to the maximum age and service conditions specified in IRC Section 410(a)(1)(A)); or (2) a covered employee is an otherwise excludable employee for the period through the date on which he or she attains age 21 and completes one year of service and any additional waiting period specified in the plan before an employee who has satisfied the plan's minimum age and service requirements actually enters the plan (that is, the plan's waiting period, if any (and only the plan's waiting period, if any), is tacked on to the maximum age and service conditions specified in IRC Section 410(a)(1)(A)).

Partnership Conversion Deemed Not to be a Termination

Private Letter Ruling 201605004 considers a case in which PRS 1 is a limited partnership. PRS 2, through disregarded entities, owned all of the general and limited partnership interests in PRS 1. PRS 1 was classified as a disregarded entity for federal income tax purposes. PRS 1 owned an interest in PRS 3, a limited partnership.

Subsequently, PRS 4 acquired an interest in PRS 3. At the same time, PRS 4 exchanged its interest in PRS 3 for an interest in PRS 1, causing PRS 3 to become a disregarded entity and PRS 1 to become a partnership for federal income tax purposes. Effectively PRS 3 was converted into PRS 1. Later, PRS 4 sold its interest in PRS 1 and PRS 2 sold an interest in PRS 1 to PRS 5. The transfer of interests in PRS 1 during the 12-month period was less than 50 percent.

The IRS concluded that that PRS 1 will be considered a continuation of the partnership, PRS 3, and there was no termination of the partnership under IRC Section 708. Other than with respect to the sale of the partnership interests sold, the conversion of PRS 3 into PRS 1 did not cause the partners in PRS 3 or PRS 1 to recognize gain or loss. The holding period of the partners' interests in PRS 1 includes the period of time during which those interests were held as partners in PRS 3.

The conversion of PRS 3 into PRS 1 did not cause the taxable year of the partnership to close under IRC Section 706. PRS 1 does not need to obtain a new taxpayer identification number. The basis of the assets held by PRS 1 is the same as the basis of the assets in the hands of PRS 3 prior to the conversion. Finally, the conversion PRS 3 into PRS 1 did not result in the assets of the partnership being contributed or distributed to the partners of the partnership.

Partnership Liabilities

In PLR 201608005 the IRS addresses a situation where two construction companies, X and Y, formed a partnership P to enter into long-term construction contracts to engineer, design, and construct certain industrial facilities for the owner, O. Under the contracts, P is obligated to perform all work, meaning all obligations, duties, and responsibilities required, including fabrication, construction, commissioning, performance testing, and any other services or work required to be furnished under the contracts. Further, the contracts spell out P's obligations to achieve substantial completion and final completion within specific timeframes. Each contract provides that P will follow a construction schedule and achieve substantial completion in a specified number of years.

As compensation for P's full and complete performance of the work, O is to pay P a specified sum under each contract. During the period that the work is being performed, O is required to make interim, or progress, payments to P in accordance with a payment milestone schedule, provided that P is otherwise in material compliance with its contractual obligations. Generally, under the payment milestone schedules, P is entitled to progress payments for the portion of work relating to completion of each payment milestone. Accordingly, over the term of the construction period, progress payments, generally, are tied to the completion of certain work. However, there are certain payments (the *Notice to Proceed payments*) to be made to P before the completion of the work and before incurring costs in performing the work, at the time O issues P certain notices to proceed with the next phase of construction.

Before P is entitled to receive payments under the contracts and, explicitly, to receive the Notice to Proceed payments, P is required to provide certain guarantees and also to deliver to O irrevocable standby letters of credit. The letters of credit secure P's obligations to perform under the contracts and cover O's damages in the event of non-performance or default by P. The amount of the letters of credit securing P's obligations roughly corresponds to the amount of the Notice to Proceed payments.

The contracts provide that if P fails to prosecute the work in a diligent and efficient manner, or if P abandons the project or repudiates any of its obligations, a default occurs. In that event, O is entitled to several remedies, including seeking specific performance (that is, obtaining judicial enforcement requiring P to make good on its obligation to perform the work) and recovery from P of costs, damages, losses, and expenses (that is, requiring P to make good on its obligation to cover O's damages in the event of nonperformance). Specifically, the contracts allow O to draw-down directly against the letters of credit in the event of a default by P.

P reports income using the percentage of completion method under IRC Section 460. Therefore, P reports income based on a comparison of contract costs incurred to estimated total contract costs. Because most progress payments are linked to work performed, and, correspondingly, to costs incurred, there generally is a correlation between the year in which payments are received and the year in which income is reported. However, the Notice to Proceed payments are different—they are not linked to contract performance and precede P's reporting of the related income.

The IRS concluded that P's obligations under the contracts to proceed with performing work and to incur costs in performing the work, and the corresponding obligations to satisfy O's remedies in the event P were to default or suspend work, constitute liabilities under IRC Section 752 upon and to the extent P receives the Notice to Proceed payments but has not yet reported the related income.

Medicare Shared Savings Amounts Not Accruable

On February 12, 2016 the IRS issued Chief Counsel Advice 201607026 addressing the accounting for Medicare Shared Savings amounts. The taxpayer in question operated Accountable Care Organizations (ACOs) under the Affordable Care Act. An ACO is an organization of health care providers that agrees to be accountable for the quality, cost, and overall care of Medicare beneficiaries who are enrolled in the traditional fee-for-service program who are assigned to it.

The taxpayer, through its various ACOs, is participating in the Medicare Shared Savings Program described in Section 3022 of the Affordable Care Act. The Act established the Shared Savings Program to promote accountability for care of Medicare beneficiaries, improve the coordination of Medicare fee-for-service items and services, and encourage investment in infrastructure and redesigned care processes for high quality and efficient service delivery.

The Shared Savings Program is a voluntary program in which ACOs accept responsibility for the overall quality, cost and care of a defined group of fee-for-service beneficiaries for at least a three-year agreement period. Under the program, ACOs are accountable for a minimum of 5,000 fee-for-service beneficiaries. The ACO must define processes to promote evidence-based medicine and patient engagement, monitor and evaluate quality and cost measures, meet patient-centeredness criteria and coordinate care across the care continuum. Medicare service providers and suppliers participating in an ACO will continue to receive fee-for-service payments in the same manner as such payments would otherwise be made; however, an ACO that meets quality performance standards and demonstrates that it has generated savings against an appropriate benchmark of expected average per capita fee-for-service expenditures will be eligible to share in savings earned

The taxpayer in this case pointed out that the actual amount of the Shared Savings Program payment is contingent upon factors that are not ultimately determinable until the end of the contract term. Additionally, the taxpayer did not believe the information currently provided by CMS is sufficient and reliable for purposes of calculating Shared Savings Program payments. The reason for Taxpayer's uncertainty includes: The beneficiary population is subject to change; the final performance year benchmark for the ACOs is subject to change; the actual average per capita performance year Medicare expenditures for the beneficiary population for the ACOs is subject to change; the achievement of performance quality standards is unknown until after the tax year ends; the impact of the opt out beneficiaries on the calculation is unknown until after the tax year ends; the actual per capita expenditures for the beneficiary population related to claims for drug and alcohol is subject to change; and the information received from Medicare has contained errors and been unreliable.

IRC Section 451 provides the general rule that the amount of any gross income shall be included in gross income for the taxable year in which received by the taxpayer, unless such amount is to be properly accounted for in a different period. Accrual method taxpayers recognize income when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. Ordinarily, a taxpayer's right to income is fixed under the *all events test* when either the amount is unconditionally due or the taxpayer has performed. The general rule states that all the events that fix the right to receive income occur when (1) the required performance takes place, (2) payment is due, or (3) payment is received, whichever happens first. In order to be fixed, any material contingencies on the taxpayer's eventual receipt of income must have been removed. Due to the programmatic factors related to the Shared Savings Program, Chief Counsel did not believe that all events had occurred which fixed the taxpayer's right to receive the income during the performance year. Further, Counsel did not believe the taxpayer could determine the amount with reasonable accuracy at the end of the performance year.

Health care service providers and suppliers participating in an ACO continue to receive fee-for-service payments in the same manner as such payments would otherwise be made. Therefore, they will continue to be paid for their services in the same way they had always been. However, in order to be eligible to receive payments for Medicare share savings, the income at issue in this case, an ACO must meet quality performance standards established by HHS/CMS and demonstrate that it has achieved savings against an appropriate benchmark of expected average per capita fee-for-service expenditures.

For several reasons, the taxpayer cannot be assured at the end of its taxable year that it will have achieved the necessary savings to participate in the Shared Savings program. For instance, the beneficiaries used to determine an ACO's performance are assigned retroactively, after a three month claims run-out. The benchmark of expected average per capita fee-for-service expenditures is determined approximately six months after the performance year ends. The beneficiary per capita costs for the performance year are determined retrospectively, after the three month claims run-out, and can include fee-for-service claims billed by other practitioners if the fee-for-service beneficiaries received care outside the care rendered to them by the ACO practitioners. At the conclusion of their tax year, the ACO practitioners may not have knowledge of all of the other fee-for-service claims. Because of these factors, at the close of its taxable year, the taxpayer is unable to determine if it will have achieved the necessary savings to participate in the Shared Savings Program. The amount is not fixed as it is not unconditionally due.

The second requirement for accrual under the all events test is that the amount of income be determinable with reasonable accuracy. It is not necessary that the exact amount be known, income is accruable if a reasonable basis for calculation exists.

The determination of whether amounts are accruable under the all events test is made on the basis of information available to the taxpayer at the end of the year. This is a factual determination. If there is agreement on the general basis under which the amount due is to be calculated, accrual is generally required. However, where there is a dispute over the method of calculation, or if there is no objective standard to be used in making the calculation, the amount is not ascertainable with reasonable accuracy

If the facts from which a calculation can be made are established as of the end of the tax year, the amount is accruable even though the calculation may not be made until afterwards. Revenue Ruling 81-176 demonstrates this principle in a case involving Medicaid payments. In Rev. Rul. 81-176, the taxpayer ran a nursing home and was entitled to Medicaid payments. The taxpayer was entitled to compensation equal to the *reasonable costs* incurred by the taxpayer in rendering nursing home care plus a ten percent return on equity capital as a profit factor. The taxpayer billed the government monthly on the basis of a tentative rate based upon the projected *reasonable cost* of providing patient care during the year. After the close of the year, the taxpayer submitted cost reports to the government. Any refund owed the government needed to be submitted with the cost report. Any amount due to the taxpayer was made upon settlement of a desk audit performed by the health department. The IRS ruled that the amounts eventually claimed on the cost sheets should be reflected in the taxpayer's income for the year because all the facts necessary for the computation were fixed as of the close of the tax year.

In the instant case, the facts from which a calculation could be made were not knowable at the end of the tax year. At the end of the tax year, the taxpayer did not know the beneficiaries used to determine its performance as those beneficiaries were not assigned until after a three month claims run-out after the close of the performance year. The performance benchmark is determined approximately six months after the performance year ends. The beneficiary per capita costs are determined after the three month claims run-out. The taxpayer is given the sample of beneficiaries for whom it must report quality performance on certain measures after the close of the performance year and this quality performance impacts the final savings rate.

Thus, at the close of its taxable year, the amount of income, if any, the taxpayer will receive from the Shared Savings Program is not fixed. Further, the amount cannot be determined with reasonable certainty.

KNOWLEDGE CHECK

1. XYZ suspect that it is at risk of a data breach, so it provides its employees with $500 in cash so that they can pay for identity theft insurance. Subsequently, there is, in fact, a data breach at XYZ. XYZ employees will have to include the $500 in income because

    a. The value of identity protection services provided by an employer is taxable.
    b. Proceeds from an identity theft insurance policy are taxable.
    c. The payment was made before there was a data breach.
    d. The payment was made in cash.

2. On December 1, 2016, ABC Partnership has received a notice from the IRS that an audit of the 2015 tax year will be conducted. Which statement is correct?

    a. If any of ABC's partners are S corporations, the TEFRA audit rules will apply to the audit.
    b. If ABC has three partners, all of whom are individuals, the tax treatment of any changes will be determined at the partnership level.
    c. The new centralized audit procedures will apply.
    d. Once the new centralized system is in place, all partnerships will be able to choose between those rules and the old rules.

3. ABC, LLC is a limited liability company that has not elected to be taxed as a corporation. The sole member of ABC is XYZ partnership, consisting of partners Sam and Carol. Both Sam and Carol perform services for both XYZ and ABC. Adam is an employee of ABC. Which statement is correct?

    a. Because ABC is owned by a partnership, it will not be disregarded and will be taxed as a corporation.
    b. Sam and Carol are considered employees of XYZ.
    c. Adam will be considered an employee of ABC for purposes of employment taxes.
    d. Sam and Carol are not subject to self-employment taxes with respect to their share of ABC's income.

4. A partnership consisting of three equal partners (A, B, and C) owns and operates the Algonquin Hotel in Lake Placid, NY. The partnership borrows money on a nonrecourse basis to complete certain improvements to the hotel. The loan is secured by the hotel and personally guaranteed by C. Under the partnership agreement, C has no right of indemnification or contribution from the other partners with respect to her guarantee. In this case,

    a. The borrowing is qualified nonrecourse financing because it is secured by the hotel.
    b. The borrowing is qualified nonrecourse financing because of C's guarantee.
    c. All of the partners will be considered at-risk for an equal share of the loan.
    d. The borrowing is not qualified nonrecourse financing.

5. Which statement is correct?

    a. The threshold for filing is equal to the standard deduction.
    b. Personal exemptions are phased out when the taxpayer reaches a threshold amount of AGI.
    c. An individual that can be claimed as a dependent can use their own personal exemption if the other taxpayer does not actually claim the dependency exemption.
    d. The standard deduction for someone who can be claimed as a dependent but files their own return is the same as for all other taxpayers.

6. Which statement is not correct?

    a. The amount used to determine the refundable portion of the child tax credit is adjusted annually for inflation.
    b. For 2016, taxpayers may contribute $2,550 in salary reduction payments to a health FSA.
    c. The deduction for qualified education loan interest is phased out based on AGI.
    d. Certain expatriates must recognize gain or loss on all of their property upon expatriation.

7. If a taxpayer wishes to change from an impermissible method of depreciation to a permissible one with respect to an item of property placed in service in the taxable year immediately preceding the year of change, the taxpayer

    a. Must get advance consent from the IRS.
    b. May file an amended return before the next year's return is filed.
    c. May make the change prospectively without notifying the IRS.
    d. Must file a Form 3115 with the return for the year of the change.

QUARTERLY FEDERAL TAX UPDATE – SECOND QUARTER 2016

Solutions

The AICPA offers a free, daily, e-mailed newsletter covering the day's top business and financial articles as well as video content, research and analysis concerning CPAs and those who work with the accounting profession. Visit the CPA Letter Daily news box on the www.aicpa.org home page to sign up. You can opt out at any time, and only the AICPA can use your e-mail address or personal information.

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SOLUTIONS

QUARTERLY FEDERAL TAX UPDATE – SECOND QUARTER 2016

Solutions to Knowledge Check Questions

1.

a. Incorrect. Pursuant to IRS Announcement 2016-2, the value of identity theft protection services provided by an employer are not taxable to the employees.
b. Incorrect. Although this statement is true, the $500 given to the employees is to pay the premium on such insurance; it does not represent proceeds from insurance.
c. Incorrect. Pursuant to IRS Announcement 2016-2, the value of identity theft protection services is nontaxable, whether they are provided before or after a data breach.
d. Correct. Announcement 2016-2 does not apply to cash received in lieu of identity protection services.

2.

a. Correct. The new rules only apply with respect to returns filed for partnership taxable years beginning after December 31, 2017. Under the old rules, the TEFRA rules are applied to partnerships with more than 10 partners or with passthroughs as partners.
b. Incorrect. Under the current rules for partnerships with 10 or fewer partners that have not elected the TEFRA audit rules, audit and adjustment rules applicable generally to taxpayers apply.
c. Incorrect. The new rules only apply with respect to returns filed for partnership taxable years beginning after December 31, 2017.
d. Incorrect. Only certain eligible partnerships will be able to elect out of the centralized system.

3.

a. Incorrect. An LLC that has a sole member and does not elect to be taxed as a partnership is a disregarded entity, regardless of the tax status of its sole member.
b. Incorrect. Partners cannot be employees of their own partnership.
c. Correct. A sole member LLC is treated as a separate taxpayer for employment tax purposes.
d. Incorrect. Temp. Reg. Section 301.7701-2T clarifies that the rule that a disregarded entity is treated as a corporation for employment tax purposes *does not* apply to the self-employment tax treatment of any individuals who are partners in a partnership that owns a disregarded entity.

4.

a. Incorrect. Because the partnership operates the hotel, the borrowing is not with respect to the activity of "holding" real property.
b. Incorrect. To the contrary, when an individual partner guarantees a partnership obligation, the amount of the guaranteed debt no longer meets the definition of *qualified nonrecourse financing*.
c. Incorrect. Because C is the only partner guaranteeing the debt and because C has no right of indemnification, only C will be considered at-risk.
d. Correct. When an individual partner guarantees a partnership obligation, the amount of the guaranteed debt no longer meets the definition of *qualified nonrecourse financing*.

5.

a. Incorrect. Filing requirement thresholds are based on the personal exemption and standard deduction available to a particular taxpayer.
b. Correct. For most taxpayers, the personal exemption is reduced by 2 percent for each $2,500 (or any fractional portion of $2,500) by which the taxpayer's AGI exceeds a threshold amount based on the taxpayer's filing status. For taxpayers filing married-separate returns, the 2 percent reduction applies for each $1,250 (or any fractional portion of $1,250) by which the taxpayer's AGI exceeds the threshold amount.
c. Incorrect. An individual who can be claimed as a dependent by another taxpayer is not entitled to a personal exemption on his or her own return, even if the other taxpayer does not actually claim the dependency exemption.
d. Incorrect. For tax year 2016, the basic standard deduction of individuals who can be claimed as dependents by another taxpayer is limited to the greater of (1) $1,050 or (2) $350 plus the individual's earned income for the year (limited to a maximum of $6,300).

6.

a. Correct. The amount used to determine the refundable portion of the child tax credit is not adjusted annually, but will remain the same through 2017. For tax years through 2017, the value used to determine the amount of child tax credit that may be refundable under Section 24 is $3,000.
b. Incorrect. For the taxable years beginning in 2016, the dollar limitation on voluntary employee salary reductions for contributions to health flexible spending arrangements is $2,550.
c. Incorrect. The $2,500 maximum deduction for interest paid on qualified education loans begins to phase out for taxpayers with modified adjusted gross income in excess of $65,000 ($130,000 for joint returns) in 2016 and is completely phased out for taxpayers with modified adjusted gross income of $80,000 or more ($160,000 or more for joint returns).
d. Incorrect. For calendar year 2016, an individual is a covered expatriate (and thus must recognize gain or loss as if all their property was sold on the day before the expatriation date for its fair market value) if the individual's "average annual net income tax" for the five taxable years ending before the expatriation date is more than $161,000.

7.

a. Incorrect. A taxpayer may generally make a change from an impermissible method of depreciation or amortization to a permissible one using the automatic consent procedures.
b. Correct. If the item of property is placed in service in the taxable year immediately preceding the year of change (one-year depreciable property), the taxpayer may make the change by filing an amended federal tax return for the property's placed-in-service year prior to the date the taxpayer files its federal tax return for the taxable year succeeding the placed-in-service year.
c. Incorrect. Section 446(e) requires taxpayers to obtain the IRS's consent before changing a method of accounting for federal income tax purposes.
d. Incorrect. A taxpayer *may* make a change from an impermissible method of depreciation or amortization to a permissible one using the automatic consent procedures and filing Form 3115, but see the answer to b previously.