Current Federal Tax Developments

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SECTION: 41
INTERIM GUIDANCE ISSUED FOR TAXPAYERS ELECTING TO CLAIM RESEARCH CREDIT AGAINST PAYROLL TAXES

Citation: Notice 2017-23, 3/30/17

The Protecting Americans from Tax Hikes Act of 2015 provided for a new way for certain businesses to receive the benefit of the research credit under IRC §41. A qualifying small business may, in lieu of the income tax credit, receive a credit against the employer portion of social security taxes [IRC §41(h)]. The IRS has provided interim guidance on taking advantage of this provision in Notice 2017-23.

A "qualifying small business" for this purpose must meet the following criteria:

- The gross receipts (as determined under the rules of § 448(c)(3), without regard to subparagraph (A) thereof) of such entity for the taxable year are less than $5,000,000, and
- Such entity did not have gross receipts (as so determined) for any taxable year preceding the 5-taxable-year period ending with such taxable year.

For an individual, the above limits are computed using only the aggregate gross receipts received by the person in carrying on the trades or businesses of the person. As well, an organization exempt from tax under IRC §501 is not eligible to claim this payroll tax credit.

The credit is capped at $250,000 for any payroll tax election.

The IRS begins the Notice by stating:

> The Treasury Department and the IRS recognize that businesses need immediate guidance to determine their eligibility for the payroll tax credit election with respect to taxable years beginning in 2016, and the procedures for making the election and claiming the credit. In response to Notice 2016-26, 2016-14 I.R.B. 533, which requests recommendations for the 2016-2017 Priority Guidance Plan, several commenters requested guidance under §§ 41(h) and 3111(f). In particular, commenters requested guidance regarding the term "gross receipts" for purposes of determining whether a business is a "qualified small business" under § 41(h)(3). In addition, commenters requested guidance regarding controlled groups of corporations and groups of trades or businesses under common control (collectively referred to as controlled groups) in the context of § 41(h). Because immediate guidance is necessary, this notice prescribes interim guidance in sections 3 and 4 regarding the definition of "qualified small business" and the time and manner of making the payroll tax credit election. Further, because the Treasury Department and the IRS are developing guidance under § 41(h), the Treasury Department and the IRS request comments in section 6 of this notice on the interim guidance provided in this notice and other issues under § 41(h) that may require additional guidance.

The notice, while reciting the basic provisions of the law noted above for a qualifying taxpayer, provides the following specific examples of what is and what is not a qualified small business:

> (1) Corp A, a calendar year corporation, is not a tax-exempt organization under § 501 or a member of a controlled group in taxable year 2016. Corp A has gross receipts, as determined under section 3.04 of this notice, of $1 million, $7 million,$4 million, $3 million, and $4 million for taxable years 2012, 2013, 2014, 2015, and 2016, respectively. Corp A did not have gross receipts, as determined under section 3.04 of this notice, for any taxable year prior to 2012. Corp A is a qualified small business for taxable year 2016 because it has less than $5,000,000 in gross receipts for taxable year 2016 and did not have gross receipts before taxable year 2012 (before the-taxable-year period ending with 2016). Corp A's gross receipts in taxable years 2012-2015 are not relevant in determining whether Corp A is a qualified small business in taxable year 2016. Because Corp A had gross receipts in taxable year 2012, Corp A is not a qualified small business in taxable year 2017, regardless of its gross receipts in 2017.

(2) Corp A, Corp B, and Corp C are calendar year taxpayers that are not tax- exempt organizations under § 501 and are members of a controlled group for taxable year 2016 (Corp ABC controlled group). Corp A has gross receipts, as determined under section 3.04 of this notice, of $1 million, $7 million, $4 million, $3 million, and $4 million for taxable years 2012, 2013, 2014, 2015, and 2016, respectively. Corp B has gross receipts, as determined under section 3.04 of this notice, of $500,000, $1 million, $2 million, $1 million, and $1 million for taxable years 2012, 2013, 2014, 2015, and 2016, respectively. Neither Corp A nor Corp B had gross receipts, as determined under section 3.04 of this notice, for any taxable year prior to 2012. Corp C has gross receipts, as determined under section 3.04 of this notice, of $1 million, $3 million, $4 million, $3 million, $1 million, and $500,000 for taxable years 2011, 2012, 2013, 2014, 2015, and 2016, respectively. Corp A, Corp B, and Corp C are not qualified small businesses for taxable year 2016 because the aggregate gross receipts of Corp ABC controlled group for taxable year 2016 are not less than $5 million ($4 million (Corp A) + $1 million (Corp B) + $500,000 (Corp C)). In addition, neither Corp A, Corp B, nor Corp C is a qualified small business in taxable year 2016 because Corp C had gross receipts in taxable year 2011 (before the 5-taxable-year period ending with 2016).

The notice also outlines the following procedures for making the payroll tax credit election in Section 4.02:

A qualified small business makes a payroll tax credit election by completing the appropriate portion of Form 6765, Credit for Increasing Research Activities, or successor form, relating to the payroll tax credit election, and attaching the completed form to the qualified small business's timely filed (including extensions) return for the taxable year to which the election applies. The term "return" means the return required to be filed under § 6031 in the case of a partnership (for example, the Form 1065 or successor form), the return required to be filed under § 6037 in the case of an S corporation (for example, the Form 1120-S or successor form), and the return with respect to income tax for the taxable year in the case of any other qualified small business.

If a qualified small business timely files its return for a taxable year beginning after December 31, 2015, but fails to make the payroll tax credit election, it may make the election on an amended return filed on or before December 31, 2017. To qualify for this extension, the business must either: 1) indicate on the top of its Form 6765 reflecting the payroll tax credit election that the form is "FILED PURSUANT TO NOTICE 2017-23," or 2) attach a statement to its Form 6765 reflecting the payroll tax credit election that the form is filed pursuant to Notice 2017-23.

The notice continues in Section 4.03 to outline the maximum amount of the election:

The amount of any payroll tax credit election may not exceed the least of:

(1) The qualified small business's research credit for the taxable year (determined before the application of § 41(h)),

(2) $250,000, or

(3) In the case of a qualified small business other than a partnership or S corporation, the amount of the qualified small business's business credit carryforward under § 39 carried from the taxable year (determined before the application of § 41(h)).

Notice Section 4.04 also provides that no election is available if the taxpayer has made an election for five or more preceding taxable years.

The notice contains, in Section 4.05, detailed provisions for dividing up the credit for members of a controlled group.

Section 4.06 details how to go about claiming the credit on payroll tax returns:

A qualified small business that elects to claim the payroll tax credit and files quarterly employment tax returns, claims the payroll tax credit on its employment tax return for the first quarter that begins after it

> files the return reflecting the election as specified in section 4.02 of this notice. For example, if a qualified small business files an income tax return on April 10, 2017, with a Form 6765 attached reflecting the payroll tax credit election, the qualified small business would claim the payroll tax credit on its Form 941, Employer's Quarterly Federal Tax Return, for the third quarter of 2017. A qualified small business that files annual employment tax returns claims the payroll tax credit on its annual employment tax return that includes the first quarter beginning after the date on which the business files the return reflecting the election as specified in section 4.02 of this notice. A qualified small business claiming the payroll tax credit on its employment tax return must complete Form 8974, Qualified Small Business Payroll Tax Credit for Increasing Research Activities, or successor form, and attach the completed form to that employment tax return. Under various employment tax procedural rules, the Employer Identification Number (EIN) of the taxpayer filing the employment tax return may differ from the EIN of the taxpayer that filed the return with an attached Form 6765 reflecting the election as specified in section 4.02 of this notice. On Form 8974, the taxpayer filing the employment tax return claiming the credit provides the EIN used on the Form 6765 reflecting the election.
>
> The payroll tax credit claimed by an employer on an employment tax return cannot exceed the employer portion of the social security tax for any calendar quarter on wages paid with respect to the employment of all individuals in the employ of the employer. The employer uses Form 8974 to apply this limit to the amount of the payroll tax credit it elected on Form 6765 and to determine the amount of the credit allowed on its employment tax return. If the payroll tax credit elected on Form 6765 exceeds this limitation, then the excess determined on Form 8974 is carried over to the succeeding calendar quarter(s) and allowed as a payroll tax credit for the succeeding quarter(s), subject to the social security tax limitation applicable to the quarter(s).

The notice concludes with a request for comments on issues to be dealt with in the permanent guidance to be issued later.

SECTION: 162
NO EVIDENCE ANY SERVICES WERE OR COULD HAVE BEEN PERFORMED FOR MANAGEMENT SERVICES PAID TO RELATED CORPORATION

Citation: Home Team Transition Management v. Commissioner, TC Memo 2017-51, 3/28/17

For various reasons CPAs run into clients who have established several related taxable entities that have interactions with each other. And, quite often, this multiplicity of entities creates problems where one entity has "excess" deductions while the other has an excess of income. In the case of *Home Team Transition Management v. Commissioner*, TC Memo 2017-51 the IRS questioned the propriety of a deduction for "management fees" paid by the profitable entity to the corporation which held its shares.

In this case the holding company was Sacer Cor Enterprises which had reported receiving fees from Home Team Transition Management, the defendant in this case. The Court outlined how Sacer Cor ended up being the owner of Home Team Transition Management:

> Sacer Cor is a Missouri for-profit corporation that was incorporated by Charles N. Honigfort. Sacer Cor's shares were held in equal percentages by Charles and Mary Honigfort and Sean and Ruth Ann Noonan. When Sacer Cor was incorporated, it was the intention of the four shareholders to acquire in-home healthcare companies. On October 1, 2010, Sacer Cor acquired petitioner, which had been an ongoing business since 1994 and had the same four shareholders (owners) as Sacer Cor. When the owners acquired petitioner, it was owned and operated by an individual who lived in New York State and had an existing contract with Medicaid. During 2011 through 2013 petitioner was Sacer Cor's only holding and no other healthcare companies were acquired.

The taxpayer corporation in this case had claimed deductions in 2011-2013 for management fees of $120,000, $36,000, and $42,000. In each year, Home Team had transferred funds to Sacer Cor as it had cash available

to transfer, and the funds were initially recorded as loans to Sacer Cor. At the end of the year, some or all of the loans were reclassified as management fees.

The Court noted that the fees were based solely on Home Team's ability to pay rather than being payments for specifically invoiced services. Also, Sacer Cor had no employees for the years in question, although two of the Sacer Cor shareholders were employees of Home Team and were paid a salary by that organization. The Court noted that Home Team did not produce any evidence of any services provided by Sacer Cor.

To claim a deduction for these fees the Court noted that under Section 162 the taxpayer must show:

- The payments were for services actually performed;
- The services performed represented ordinary and necessary expenses of the business itself and
- The payments were reasonable for the services performed.

When related parties are involved, the Court has a natural skepticism about the true nature of the payments, a skepticism that generally must be overcome by showing evidence that establishes the arrangement is one that could be reasonably have been entered into by unrelated parties.

In this case, the taxpayers failed to carry any of the burdens to show that the payments were ordinary and necessary payments for services under Section 162. An unrelated third party would be unlikely to agree to be paid for services based solely on the company's available cash, and the company wouldn't be likely to agree to make such payments of available cash to a non-owner—however, such an arrangement does make sense to make dividend payments to a shareholder.

Similarly, Sacer Cor had no employees who would have been available to perform any management services, nor were there any records of exactly what "management services" were the responsibility of Sacer Cor. Rather, the funds simply went to the holding company that then turned around and paid out director fees to its four shareholders.

It is possible to have payments made to a related company that survive scrutiny—we discussed such a case back in May of 2016 (*H.W. Johnson, Inc. v. Commissioner*, TC Memo 2016-95) where administrative fees (a close relative of "management fees") were found to be reasonable. But in that case, unlike this one, there was a clear business reason for the existence of the related entity and a solid business justification for paying that organization (the related organization, owned by the minority shareholders, took on substantial risks the majority shareholder did not want to take on).

SECTION: 280F
IRS ANNOUNCES DEPRECIATION AND LEASE INCLUSION AMOUNTS ON VEHICLES FOR 2017

Citation: Revenue Procedure 2017-29, 3/24/17

In Revenue Procedure 2017-29 the IRS released the limits on depreciation for vehicles subject to the limitations of §280F(d)(7)(B)(i) for items placed in service in 2016, as well as the revised limits for 2017 for autos qualifying for bonus depreciation under IRC §168(k).

The 2017 limits are as follows:

REV. PROC. 2017-29 TABLE 1 DEPRECIATION LIMITATIONS FOR PASSENGER AUTOMOBILES (THAT ARE NOT TRUCKS OR VANS) PLACED IN SERVICE IN CALENDAR YEAR 2017 FOR WHICH THE §168(k) ADDITIONAL FIRST YEAR DEPRECIATION DEDUCTION APPLIES:	
Tax Year	Amount
1st Year	$11,160
2nd Year	$5,100
3rd Year	$3,050
Each Succeeding Year	$1,875

REV. PROC. 2017-29 TABLE 2 DEPRECIATION LIMITATIONS FOR TRUCKS AND VANS PLACED IN SERVICE IN CALENDAR YEAR 2017 FOR WHICH THE §168(k) ADDITIONAL FIRST YEAR DEPRECIATION DEDUCTION APPLIES:	
Tax Year	Amount
1st Year	$11,560
2nd Year	$5,700
3rd Year	$3,450
Each Succeeding Year	$2,075

REV. PROC. 2017-29 TABLE 3 DEPRECIATION LIMITATIONS FOR PASSENGER AUTOMOBILES PLACED IN SERVICE IN CALENDAR YEAR 2017 FOR WHICH THE §168(k) ADDITIONAL FIRST YEAR DEPRECIATION DEDUCTION DOES NOT APPLY:	
Tax Year	Amount
1st Year	$3,160
2nd Year	$5,100
3rd Year	$3,450
Each Succeeding Year	$1,875

REV. PROC. 2017-29 TABLE 4 DEPRECIATION LIMITATIONS FOR TRUCKS AND VANS PLACED IN SERVICE IN CALENDAR YEAR 2017 FOR WHICH THE §168(k) ADDITIONAL FIRST YEAR DEPRECIATION DEDUCTION DOES NOT APPLY:	
Tax Year	Amount
1st Year	$3,560
2nd Year	$5,700
3rd Year	$3,350
Each Succeeding Year	$2,075

The procedure also contains updated tables to be used for the lease inclusion amount under Reg. §1.280F-7 for lease terms beginning in calendar year 2017.

SECTION: 451
IRS RELEASES PROPOSED REVENUE PROCEDURE TO DEAL WITH ACCOUNTING METHOD CHANGE REQUESTS RELATED TO FASB REVENUE RECOGNITION STANDARD

Citation: Notice 2017-17, 3/28/17

One of the key developments keeping those CPAs who specialize on the "accounting and auditing" (or A&A as we tend to refer to it) side of the profession jumping has been the soon to be implemented standard titled "*Revenue from Contracts with Customers"* FASB Accounting Standards Update 2014-09, which makes significant changes to revenue recognition, particularly the timing of such recognition of revenue.

Of course, for those of us working in the tax arena, when you start talking about timing of recognition you realize that if any of this either does flow onto a tax return or a taxpayer reasonably would like to have it do so to keep tax and book the same in this area you realize you are dealing with an "accounting method" which would require IRS permission to change under IRC §446. And we also realize the timing of the inclusion of an item of income is governed under the IRC by IRC §451.

The IRS has been aware of this potential problem as well, and now has released a proposed Revenue Procedure to allow for certain automatic changes in accounting methods. This proposed procedure, on which the IRS is seeking comments, is found in IRS Notice 2017-17.

The IRS has previously asked for some guidance in this area in Notice 2015-40. In that notice, the IRS asked for guidance on the following issues:

- To what extent would using the new standards for federal income tax purposes result in acceleration or deferral of income under § 451 or other income provisions of the Code?
- What industry and/or transaction-specific issues might arise as a result of the new standards that may need to be addressed in future guidance?
- To what extent do the new standards deviate from the requirements of § 451? In what situations should the IRS allow taxpayers who adopt the new standards to follow their book method of accounting for tax purposes (for example, where income is always accelerated)?
- To what extent do the rules regarding allocation of standalone sales price and transaction price in the new standards affect taxpayers' ability to satisfy their tax obligations?

In a very broad sense, IRC §451 and Reg. §1.451-1(a) provide the following recognition rule as discussed in Section 2.03 of the proposed procedure:

> .03 Accounting for income generally. Section 451(a) of the Code and § 1.451-1(a) of the Regulations provide that any item of gross income must be included in gross income in the year in which it was received by the taxpayer unless it is includible for a different year pursuant to the taxpayer's method of accounting.

As the proposed procedure explains, the new revenue recognition standard has the following effective dates that aren't that far into the future:

> The new standards are effective for publicly-traded entities, certain not-for- profit entities, and certain employee benefit plans for annual reporting periods beginning after December 15, 2017. For all other entities, the new standards are effective for annual reporting periods beginning after December 15, 2018. Early adoption is allowed for reporting periods beginning after December 15, 2016. See FASB Update No. 2015-14, "*Revenue from Contracts with Customers (Topic 606), Deferral of the Effective Date*."

The IRS explains its view of the likely effect of the new accounting standard on tax matters in Section 2.05:

> (1) The Internal Revenue Service (Service) anticipates that many taxpayers will request consent to change a method of accounting for one or more items of income as a result of, or directly related, to the adoption of the new revenue standards for the same taxable year that the new standards are adopted for financial accounting purposes.
>
> (2) The Service must balance taxpayers' need to comply with the new standards with the Service's need to approve appropriate method changes.

The proposed ruling would provide for some automatic change approvals for a "qualifying same-year method change." The IRS defines that term as follows:

> A qualifying same-year method change is a change of method of accounting for recognizing income that is made for the same year as the year the taxpayer adopts the new standards and made as a result of, or directly related to, the adoption of those standards.

The procedure notes that any change under this procedure must comply with the general rules for automatic accounting method changes which will include filing a Form 3115, *Application for Change in Accounting Method*, in duplicate, one copy filed with the taxpayer's return for the year of change and one copy mailed to the specified IRS office (right now that office is in Covington, Kentucky but the IRS has varied the location over time).

Section 5.01 of the proposed procedure would apply if the method being sought is one for which there is an already existing automatic method change available under Revenue Procedure 2016-29 (or any successor). Not surprisingly, in that case the taxpayer is directed to simply follow the standard procedures for an automatic change found in Revenue Procedure 2015-13 (or any successor). But the problem arises for those changes which, while not contrary to the provisions of the Code or Regulations, do not currently have "automatic change" status.

Section 5.02 deals with those areas, outlining a temporary automatic change option for a "qualifying same-year method change" that complies with the income recognition provisions of the Code or Regulations. A taxpayer who has this change that isn't covered under the standard automatic change options will need to:

- File a Form 3115;
- Check the box for line 1(b), and write "Rev. Proc. 2017-XX" followed by the applicable income provision of the Code or Income Tax Regulations or the applicable relevant guidance; and
- Attach a brief description of the change and why it satisfies the applicable income provision or guidance referenced in line 1(b) of the Form 3115.

Normally when a taxpayer makes a change in accounting method, the taxpayer is required to account for the cumulative effect of the change on taxable income under the rules of IRC §481(a), which requires the taxpayer to recognize the cumulative change:

- Entirely in the year of change if
  - The cumulative effect is negative *or*
  - The cumulative effect is positive, less than $50,000 and the taxpayer elects to recognize the adjustment all in one year; or
- Recognized evenly over four years, including the year of change.

However, the proposed procedure will allow that a taxpayer <u>may</u> make the change on a "cut-off" basis for certain small trades or business. To qualify for cut-off treatment the taxpayer must have one or more distinct trade(s) or business(es) (within the meaning of Reg. §1.446-1(d)) that individually have:

- Total assets of less than $10 million as of the first day of the taxable year for which a change in method of accounting is requested, or
- Average annual gross receipts of $10 million or less for the three preceding taxable years, as determined under § 1.263(a)-3(h)(3) (substituting "separate and distinct trade or business" for "taxpayer")

Somewhat confusingly, though, the ruling goes on to say "a § 481(a) adjustment is neither permitted nor required for each such separate and distinct trade or business." The statement that a §481(a) seems to imply there is no election, but the term "may" suggests just the opposite. Presumably the IRS means that if you elect this method you don't do a §481(a) adjustment.

From a practical standpoint, for most taxpayers this option would have the same effect as a §481(a) adjustment taking effect entirely in the year of change—only those with contracts that began before the start of the tax year and are still in process at the end of the tax year would see a different result.

While the above guidance uses the same tests for a "small business" as was found for the capitalization/repair regulation relief granted in Revenue Procedure 2015-20 and, as with that relief, allows for a "cut-off" recognition of the change, this relief does not remove the need to file the Form 3115 itself.

For those changes that do not meet the "small business" exception above, a separate §481(a) adjustment will need to be computed for each separate and distinct trade or business the taxpayer conducts.

The proposed revenue procedure concludes by noting that multiple requests to make qualifying same-year method changes may be made in a single request. That is, a single Form 3115 would suffice, rather than needing a separate Form 3115 for each distinct method change.

One key take-away from this proposed procedure is that the IRS is <u>not</u> providing that all changes required by the new FASB standard will be rendered acceptable for tax purposes merely by filing a Form 3115. Rather, the burden is on the taxpayer to establish that the method being requested is not itself at odds with the law or regulations under IRC §451. Rather, to the extent the new standard results in a method that is acceptable under the already existing law, the IRS will smooth the path to allow the taxpayer to bring its revenue for tax purposes more into line with what the entity will now be reporting for financial statement purposes.