March 2017

Tax Talk

A quarterly publication of Bridges & Dunn-Rankin, LLP

Inside this issue:

Dear Clients and Friends,

December 23rd is for many people a day for last minute Christmas shopping, or a day when you hope to receive some early Christmas presents. But this most recent December 23rd the IRS gave many a gift they would prefer to be able to return. On December 23, 2016, the IRS issued a notice identifying syndicated conservation easement deals which provide a 2.5 to 1 or greater write-off as "tax avoidance transactions" and making such "listed transactions" for purposes of the required disclosure rules. I sent some of you an e-mail about this within a day or two of the notice coming out. For the rest of you, if you have participated in a syndicated conservation easement deal in the last 7 years, or are contemplating one, be sure to read the article on such in this issue.

There has been much in the news recently about a possible "border-adjustment tax" (a/k/a "destination based cash flow tax"). We will discuss that in this issue, along with significant changes to the partnership tax return audit rules, and R&D tax credits (and recent Federal law changes that make such much more valuable). Finally, you should note that the due date for personal income tax returns this year will be April 18.

Kent Bridges, Managing Partner

We hope that you will enjoy this issue and gain from it some useful information.

Sincerely,

Kent Bridges

Syndicated Conservation Easement Deals are Now "Listed Transactions"

Let's assume you have a tract of land which could potentially be developed into a residential subdivision, but you don't want to ever see the land developed, desiring for it to forever remain in its beautiful natural state. If you are willing to grant a perpetual conservation easement to a qualified organization (effectively giving up your rights to develop the property), then the tax law will reward you with a tax deduction. The amount of the deduction is the difference between the appraised value of the land assuming its highest and best use value before the granting of the conservation easement and its value after granting the conservation easement.

Provided that you carefully comply with all of the rules and have reasonable appraisals, this works quite well. But can you essentially buy a conservation easement deduction by investing in a partnership which will then allocate you a conservation easement deduction, the tax benefit of which exceeds the amount of your investment? Such structured partnership arrangements have become quite popular in recent years, and the IRS has been scrutinizing these arrangements.

On December 23, 2016, the IRS issued Notice 2017-10 identifying syndicated conservation easement deals which provide a 2.5 to 1 or greater write-off as "tax avoidance transactions" and making such "listed transactions" for purposes of the required disclosure rules. 2.5 to 1 (tax deduction to investment ratio) is the point at which an investor in the highest Federal ordinary income tax rate bracket begins to break even on the transaction.

The gist of the rules is that if a taxpayer participates in a "listed transaction" they have to disclose such to the IRS on a Form 8886. For an individual, the penalty for failure to do so (in addition to any other understatement penalties which may apply) is the lesser of 75% of the tax savings from the transaction or $100,000. For entities, the penalty can be up to $200,000.

Disclosure is required for any transaction entered into after January 1, 2010. So taxpayers who have participated in a conservation easement deal in past years will need to go back and file the disclosure statement now, unless the statute of limitations for assessment has run for that tax year. In general, the statute of limitations expires three years after you file a return. But there are a number of exceptions to this general rule, including the possibility that the tax matters partner has agreed with the IRS to extend the statute (very common in IRS examinations).

The disclosure rules apply not only to investor participants, but also any "material advisor" to the transaction.

There is, of course, a new sheriff in town (President Donald Trump) who is not known to be very friendly towards the IRS, so it is possible that the IRS may soften its position with respect to conservation easement transactions. However, the bottom line here is that if you have participated in a syndicated conservation easement transaction in the past seven years, you should contact your tax advisor to discuss next steps.

Border Adjustment Tax

President Trump has frequently made reference to imposing a tariff on imported goods, and Congress is now talking about enacting a "border adjustment tax", also known as a "destination based cash flow tax". So what does this mean, who are the likely winners and losers, and what are the chances of this actually becoming law?

The current US income tax system is generally regarded as being anticompetitive, especially as pertains to multinational companies and goods and services which are exported rather than imported. The current Federal corporate income tax rate is 35%, and we have what is known as a "worldwide" system of taxation, rather than the "territorial" system used by most other countries. What this means is that the US taxes its resident companies on their worldwide income (with a credit or partial credit for taxes properly paid to other countries), rather than just taxing US companies on profits earned from sales derived from US customers. US-based multinational companies often defer (indefinitely) US taxation of their profit earned outside the US by leaving it parked offshore in foreign subsidiaries; and some US companies have undertaken corporate inversion transactions in order to become non-US based and avoid the US worldwide taxation system. There has been some talk recently of changing the rules to provide for an immediate US tax on the profits left offshore, but the greater focus appears to be on changing to a system which would greatly favor net exporters and punish net importers.

A lot of details remain to be fleshed out, but the basic concept of a border adjustment tax (BAT) is that revenue from exports would be tax-exempt, while revenue from domestic sales is subject to income tax, and the cost of goods and services purchased domestically would be tax deductible, whereas the cost of goods and services imported would be nondeductible. Accordingly, a company importing 100% of its goods and services would pay income tax on 100% of its revenue (much like a sales tax, but at a much higher rate), whereas a company exporting 100% of its goods or services would pay no income tax (and conceivably report a huge loss for income tax purposes, even if very profitable).

So who would be the big winners and losers? If we assume a static environment in which no one changes their behavior due to changes in tax law, then companies which tend to produce in the US but sell abroad (think Boeing, GE, Caterpillar, etc.) would be huge winners, while companies which import much of what they sell (think big retailers like Wal-Mart) would be significantly harmed. Companies which operate almost entirely domestically (both in terms of revenues and costs) would theoretically not be impacted (except to the extent they enjoyed the anticipated cut in the tax rate).

Realistically, we do not operate in a static environment. Importers would, of course, attempt to pass this new cost along to their customers (some larger retailers have estimated this would result in price increases of 15%); and consumers might then reduce their spending. A BAT would most likely violate World Trade Organization (WTO) rules, and our trading partners would likely retaliate by slapping tariffs on goods and services imported from the US; potentially resulting in a trade war. Also, other countries might not honor the tax treaties we have entered into which serve to protect US companies and individuals from double taxation. As Sir Isaac Newton said, for every action, there is an equal and opposite reaction.

While a BAT could become the backbone of tax reform, it seems at least as likely to become the impediment to getting any tax reform done. It seems likely that few if any Democrats will support it, and there will likely be some Republican opposition as well (e.g. Republican Senator Tom Cotton from Arkansas, home of Wal-Mart, has referred to the theory that a BAT would strengthen the US dollar as "a theory wrapped in speculation inside a guess"). Cynics might say that talk of a BAT is just a fundraising bonanza for members of the House and Senate tax-writing committees; and deep-pocketed groups have certainly lined up on either side of this proposal.

The New Partnership Tax Return Audit Rules

The partnership format (which includes most LLCs) is a very popular entity choice for income tax purposes, because it provides flow-through treatment (i.e. no risk of double taxation, and ability to pass tax losses through to the owners) and greater flexibility than does the S-corp format (e.g. no limit on number or type of owners, ability to specially allocate income or losses, ability to provide for preferred returns, etc.). From the IRS' perspective, however, they are much more difficult from an examination perspective.

When an IRS examination of a C-corp or an individual results in an adjustment, the IRS simply assesses the tax against that corporation or individual. With respect to a partnership, however, the IRS must flow the adjustment through to the partners (including, potentially, many tiers of partnerships) and assess the ultimate owners. For partnerships with numerous owners or multiple tiers of ownership, this can be a time-consuming, cumbersome, and expensive process for the IRS.

In 1982 (TEFRA), Congress sought to provide the IRS some relief in dealing with larger partnerships (generally those with more than 10 partners or with another flow-through entity as a partner), enacting consolidated audit procedures whereby the IRS could handle the examination largely at the partnership level and deal primarily with an appointed Tax Matters Partner. This streamlined the examination process itself somewhat for the IRS, but the IRS still must flow any adjustments through to the ultimate owners and deal with the actual tax computations and assessment at the partner level.

In late 2015, Congress passed new legislation (the Bipartisan Budget Act of 2015, or BBA) making substantial changes to the partnership audit rules. The rules are extremely complex (e.g. the proposed regulations which came out in January 2017 are 277 pages long), but the basic gist of the rules is that the IRS can deal solely with a designated partnership representative and assess the tax directly at the partnership level.

There are special provisions under which certain partnerships may elect out of the new rules, and provisions under which a

(Continued on page 3)

The New Partnership Tax Return Audit Rules — continued

(Continued from page 2)

partnership may elect to push the adjustment out to the partners.

The new rules first take effect (unless you elect for earlier application) for tax returns for years 2018 or later. They are complex and controversial, and may be repealed before ever actually taking effect. However, if you are forming a new partnership or considering investing in or buying an interest in an existing partnership, you should give careful consideration to whether and how these new rules are addressed by the partnership agreement. Otherwise, you could potentially find yourself bearing the economic cost of an IRS adjustment to an item from which you never derived a tax benefit.

R&D Tax Credits: A Good Deal Made Even Better By Recent Legislation

In order to encourage companies to invest in R&D, and to reward them for doing so, Federal and Georgia tax rules provide what can be very significant tax credits (dollar for dollar reduction in tax liability) for R&D (or "research and experimentation" to use the actual terminology used in the law). The rules in this area are very complex, change frequently, and the credits can be subject to a number of limitations, but, in general, from a very high level, the net benefit of the Federal credit is usually about 6.5 cents for each dollar spent on qualifying R&D and the Georgia credit about 10 cents per dollar of qualified expenses.

For flow-through entities (e.g. S-corps and LLCs), the credit generally passes through to the shareholders. However, a special rule which has been in effect for Georgia for a number of years permits the entity to instead elect to apply the credit as an offset against Georgia tax withheld from employee pay (i.e. the company gets to keep the withheld tax instead of remitting such to GA DOR), and recent Federal legislation (effective for R&D incurred in 2016 and later) provides a similar rule at the Federal level for small early-stage companies.

For years prior to 2016, the benefit of the Federal R&D credit was often limited either by the alternative minimum tax (R&D credits could not offset AMT) or simply the lack of tax liability (e.g. an early stage company with no profits). However, beginning with 2016, R&D credit generated by companies with average annual revenue of $50 million or less (as computed over the three preceding years) is no longer limited by the AMT. Further, a "qualified small business" (those with gross receipts of less than $5,000,000 for the current year and no gross receipts in any year preceding the 5-taxable-year period ending with the current tax year) can elect to claim up to $250,000 of its research tax credit as a credit against employer FICA (the 6.2% OASDI portion). The credit is utilized in the first calendar quarter following the date on which the income tax return reporting the research credit is filed, and any excess carries forward. S-corps and partnerships can make this election at the entity level. This provision could be huge for early stage companies with no income tax to otherwise utilize the research credit against.

Federal and Georgia rules use the same definition of qualifying R&D expenses, except that Federal rules provide that the research must be conducted in the U.S., whereas Georgia further limits qualifying expenses to be only those which are incurred within the state. You must be eligible for the Federal credit in order to claim the Georgia credit.

While R&D tax credits can generally be claimed on original or amended returns (subject to the statute of limitations on making claim for refund), there are some potentially serious limitations and drawbacks with respect to claiming on amended returns (e.g. you cannot make the election to take reduced Federal credit in lieu of addback to deductions and you cannot elect to claim Georgia credit as an offset against withholding).

Scott A. Fincher, CPA

When it comes to computing the R&D tax credit, the grayest area tends to be in determining what activities qualify as "research and experimentation". The term "research or experimental expenditures", for purposes of the R&D tax credit, means expenditures which represent research and development costs in the experimental or laboratory sense. The term includes generally all such costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property, and the improvement of already existing property of the type mentioned. The term does <u>not</u> include expenditures such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or promotions. However, the term does include the costs of obtaining a patent, such as attorneys' fees expended in making and perfecting a patent application. On the other hand, the term does not include the costs of acquiring another's patent, model, production or process, nor does it include expenditures paid or incurred for research in connection with literary, historical, or similar projects. In addition to meeting the requirements above, the activity must be one which is undertaken for the purpose of discovering information which is technological in nature and substantially all of the activities of which constitute elements of a process of experimentation for a purpose related to a new or improved function, performance or reliability or quality. Expenditures do not qualify for the credit to the extent the research is funded by another party (i.e. the taxpayer claiming the credit must be at-risk with respect to the expenditures incurred).

Many years ago, the IRS took the position that software development could not qualify for the R&D tax credit. However, Congress directed the IRS to treat software companies in the same manner as any other tech companies.

Once you determine what activities, if any, you have undertaken which qualify, the next step is to determine the eligible expenditures. The types of expenditures which qualify are taxable W-2 wages, 65% of amounts paid to independent contractors, certain computer leasing time, and supplies consumed in the process. Nontaxable fringe benefits, payroll taxes, rent, overhead, etc. do not qualify. If any employee spends 80% or more of their

(Continued on page 4)

R&D Tax Credits: A Good Deal Made Even Better By Recent Legislation — continued

(Continued from page 3)

time on qualifying R&D, then you can count 100% of their taxable wages. For the Federal credit, the R&D must be conducted in the U.S. For the Georgia credit, the R&D must be conducted in Georgia.

While the credit is designed to encourage companies to conduct R&D and to reward them for doing so, there are a number of limitations and potential drawbacks associated with claiming the credit; especially in the case of a flow-through entity, and even more so with respect to claiming the credit on an amended return. Such limitations and drawbacks include:

- 10-year amortization for AMT if passive - A "passive" shareholder of a flow-through entity conducting R&D must, for purposes of the alternative minimum tax (AMT), capitalize their share of the company's R&D expenses and amortize such over 10 years. This can create a situation whereby the shareholder would have been much better off tax-wise if the company had incurred no R&D expenses. "Passive" for these purposes is generally defined as spending less than 500 hours per year working in the business.

- IRC 41(g) limitation - An LLC member or shareholder in an S-corp can utilize the Federal R&D credit only to offset tax incurred on K-1 income from the LLC or S-corp.

- AMT limitation - For most years prior to 2016, Federal alternative minimum tax cannot be offset by the R&D tax credit. This has tended to greatly limit the benefit for many owners of flow-through entities. Recent legislation has changed this for R&D credits generated by small companies during 2016 and later years.

- IRC 280C[c] addback - The general rule is that you must reduce your deductions by the amount of the Federal R&D tax credit claimed. A special rule provides that you can instead elect to take a reduced credit of 65% of the amount of the credit you are otherwise eligible for. To the extent a taxpayer is not in the AMT and is in a 35% marginal Federal rate bracket, then their result will generally be the same whether they take full credit with add-back to deductions or take reduced credit. However, where a taxpayer is in the AMT, for years prior to 2016 they are much better off to elect the reduced credit. Accordingly, we generally elect the reduced credit. Unfortunately, the election to take reduced credit must be made on a timely-filed original return. The election cannot be made on an amended return. This can create a situation whereby claiming the credit on an amended return actually results in a balance due from the taxpayer.

- Georgia limitation - The amount of Georgia R&D credit utilized to offset income tax cannot exceed 50% of the taxpayer's otherwise Georgia tax liability for the year.

Federal credit which cannot be utilized in the current year due to the above limitations can be carried back 2 years or forward 20 years (subject to the same limitations with respect to each carryback or carryforward year). Georgia credit which cannot be utilized in the current year due to the 50% of tax liability limitation can be carried forward for up to 10 years.

Georgia has a special rule whereby an LLC or S-corp can elect to retain some portion or all of its credit at the entity level and apply against Georgia taxes withheld from employee pay. However, this election must be made at least 30 days before you file the Georgia income tax return for that year.

As noted above, recently-enacted Federal legislation provides that for R&D incurred in 2016 or later by companies with average annual gross receipts of $50,000,000 or less the R&D credit will not be limited by the AMT, and that for R&D incurred in 2016 or later by early stage companies with average annual receipts of $5,000,000 or less the credit can be used as an offset against FICA withheld from employee pay.

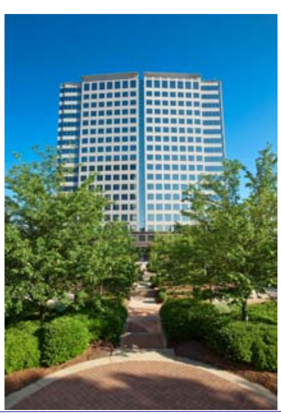
The IRS recently added the R&D credit to its "Dirty Dozen" list of tax scams. In its news release, the IRS acknowledged that the credit is an important feature in the tax code to encourage R&D by the private sector, but indicated that it continues to see significant misuse of the credit, generally involving a failure to participate in or substantiate qualified research activities and/or a failure to satisfy the requirements related to qualified expenses. This is no reason to avoid claiming the credit if you are entitled to it, but it does mean that the IRS is likely to be more closely scrutinizing claims of the credit, and so you should be sure to have your documentation in order.

April 18 is the Deadline this Year

This year April 15 falls on a Saturday, which would normally push the tax return filing date to Monday, April 17. However, Emancipation Day (a legal holiday in DC) will be observed on Monday, April 17, so the filing deadline for most individual and trust returns and first quarter 2017 estimated tax payments will be pushed to Tuesday, April 18, 2017.

Bridges & Dunn-Rankin, LLP
CERTIFIED PUBLIC ACCOUNTANTS

400 Galleria Parkway, Suite 1050
Atlanta, GA 30339
Phone: 770-563-8888
Fax: 770-563-8885
www.bridgesdunnrankin.com



Bridges & Dunn-Rankin, LLP is an Atlanta-based full-service accounting firm serving clients in the technology, real estate, services, manufacturing, distribution, construction and healthcare industries, as well as high net worth families.