2016 TAXB Supplement

NOTE – This document continues to be updated through early January 2017. You might want to just use it online rather than print it. Also, the links are live.

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H.R. 34, The "21st Century Cares Act" (Enacted 12/13/16) – HRA Penalty
Tax Relief for Small Businesses

Background

The Affordable Care Act (ACA) does not require small employers (with less than 50 employees) to provide any health coverage to their employees and does not penalize small employers for failing to do so. However, if the small employer does provide a group health plan to employees, then that plan must meet the ACA market reforms or the employer is subject to an excise tax of $100 per employee per day which totals $36,500 for the year (section 4980D)--not counting the additional 5% penalty if the employer fails to file Form 8928 admitting liability for the section 4980D tax.

Historically, many small employers, rather than providing a company group health insurance plan, have reimbursed all or a portion of the cost of their employees’ individual health insurance premiums. Such arrangements are income tax favored and are referred to as employer payment plans (per Notice 2013-54). Rev. Rul. 61-146 holds that if certain easily satisfied conditions are met, then an employer reimbursement for non-employer sponsored health insurance premiums is excludible from the employee's gross income under section 106. The ACA does not change Rev. Rul. 61-146 or the exclusion under section 106.

The ACA change--the big problem for small employers—was first announced in Notice 2013-54 (Sept. 13, 2013). An arrangement in which an employer provides reimbursements for the purchase of major medical coverage in an individual market health insurance policy (inside or outside of the exchange), or directly pays the premium, is itself a group health plan provided by the employer. Such plans are labeled employer payment plans (EPPs). Furthermore, like all other group health plans, the EPP is subject to the market reforms in the ACA. Worse, an EPP generally violates the ACA market reforms “without regard to whether the employer treats the money as pre-tax or post-tax” (Notice 2015-17 Q&A 5), and such violations are subject to the $100 per employee per day penalty (discussed above). EPPs violate the market reforms because EPPs (1) impose an annual limit and (2) fail to provide cost-free preventive services. The faulty EPP group health plan cannot be “integrated” with the individual health insurance policy in order to satisfy the market reforms (Notice 2013-54, Q&A 1).
EPPs are a type of Health Reimbursement Arrangement (HRA) that only reimburses individual market health insurance premiums (per Notice 2013-54 Q&A 1). The definition of HRA is broader and includes reimbursements to employees in non-EPP employer provided health plans (traditional group plans), and reimbursements of medical care expenses other than merely health insurance premiums:

“An HRA is an arrangement that is funded solely by an employer and that reimburses an employee for medical care expenses (as defined under Code § 213(d)) incurred by the employee, or his spouse, dependents, and any children who, as of the end of the taxable year, have not attained age 27, up to a maximum dollar amount for a coverage period.” (Notice 2013-54, Part II, A)

Unlike an EPP, an HRA can meet the market reforms if it is integrated with a non-HRA group health plan, thus satisfying the annual dollar limit prohibition and the preventive services requirements if, and only if, it meets the requirements under either of the integration methods described in Notice 2013-54, Q&A 4. Under either method, the HRA must only be available to employees who are enrolled in non-HRA group coverage (i.e., a company provided group insurance plan).

Observation: One of the confusing aspects of the treatment of EPPs as group health plans in Notice 2013-54, subject to the market reform penalties, is the obvious conflict with the income tax treatment of the employer paid premiums. EPPs are eligible for favorable income tax treatment (the section 106 exclusion from income tax) and that encourages the creation of EPPs; however, EPPs are emphatically discouraged by the ACA excise tax in section 4980D.

If an S corporation pays or reimburses the health insurance premiums for individual market coverage of a more than 2-percent shareholder (hereinafter: “2-percent shareholder”), then that payment or reimbursement is income to the S shareholder, but the shareholder can deduct the amount of the premium, above AGI, if the requirements in section 162(l) are satisfied. Notice 2008-1 provides that if health insurance premiums of 2-percent shareholders are not paid by the S corporation, then the plan is not “established by the S corporation” and the 2-percent shareholder is denied an above AGI deduction under section 162(l) (Notice 2008-1). Therefore, a more than 2% shareholder who purchased individual health insurance with after-tax compensation--to allow the S corporation to avoid the excise tax penalty in section 4980D--could not qualify for a deduction under section 162(l). Such shareholder would need to deduct her insurance premiums as an itemized deduction subject to the 10% floor for medical expenses (Notice 2008-1).

Section 9831(a)(2) “provides that the market reforms do not apply to a group health plan that has fewer than two participants who are current employees on the first day of the plan year.” So a reimbursement arrangement involving only one employee is not subject to the market reforms and thus not subject to the excise tax.

Notice 2015-17 Relief

Notice 2015-17 provides relief from the excise tax (penalty) in two situations:
**Through June 30, 2015,** no excise tax under section 4980D will be imposed on a small employer’s EPP that reimburses employees for individual health insurance premiums or Medicare Part B or Part D. Employers eligible for the relief need not file Form 8928 “for the period for which the employer is eligible for the relief” (Q&A 1). According to the IRS, the reason for the temporary relief is that the SHOP Marketplace is “still transitioning” and small employers needed more time to implement SHOP or other alternatives such as simply eliminating the EPP and paying higher compensation. (Notice 2015-17, Q&A 1)

The relevant time period for determining status as a small employer, thus eligibility for the transition relief, is as follows:

- For EPPs in calendar year 2014, the employer is a small employer if it had fewer than 50 full-time (including FTE) employees for at least 6 consecutive months, as chosen by the employer, in 2013, and
- For EPPs through June 30, 2015, the employer is a small employer if it had fewer than 50 full-time (including FTE) employees for at least 6 consecutive months, as chosen by the employer, in 2014.

**Indefinite Relief for 2-Percent Shareholders.** “**Until additional guidance is issued**” no excise tax penalty under section 4980D will be imposed for “any failure to satisfy the market reforms by a 2-percent shareholder-employee healthcare arrangement.” In other words, EPPs can remain in place for more than 2% shareholder-employees. Also, absent additional guidance, no Form 8928 needs to be filed with respect to 2-percent shareholders. (see Notice 2015-17 Q&A 2)

**H.R. 34 (12/13/2016)**

HRA relief was included in H.R. 34 (the "21st Century Cares Act") which primarily dealt with medical research and related topics.

**In General.** Beginning in 2017, the new law allows small employers to provide a "qualified small employer health reimbursement arrangement" (QSEHRA) to employees and avoid the penalties for failing to satisfy the ACA market reform requirements (discussed above). IRC Section 9831(d).

**Retroactive Relief – Extension of Notice 2015-17.** In addition to the new QSEHRA, the new law extends the relief in IRS Notice 2015-17:

> “The relief under Treasury Notice 2015–17 shall be treated as applying to any plan year beginning on or before December 31, 2016.” (Act section 18001(a)(7)(A))

**Observation #1:** This retroactive relief is welcome news for taxpayers who did not correct HRA plans that violated “market reforms” after the relief in Notice 2015-17 expired.
Observation #2: The reference in the new law to “relief under Treasury Notice 2015-17”, is apparently referring to the broad fixed relief in Q&A 1 (which ended June 15, 2015), and is implicitly not referring to the unfixed relief in Q&A 2 with respect to 2-percent S shareholders (extended until “additional guidance is issued”). Clarification from the IRS is needed.

Qualified Small Employer Health Reimbursement Arrangements (QSEHRA).

The new law provides that the term “group health plan” shall not include any qualified small employer health reimbursement arrangement (QSEHRA). Therefore, A QSEHRA avoids the section 4980D excise tax imposed on group health plans (EPPs) that fail to meet the ACA market reform requirements.

Definition of QSEHRA. A QSEHRA:

- Must be “provided on the same terms to all eligible employees” (Section 9831(d)(2)(A)(ii)). An arrangement does “not fail to be treated as provided on the same terms to each eligible employee merely because the employee's permitted benefit under such arrangement varies in accordance with the variation in the price of an insurance policy in the relevant individual health insurance market based on”:
  - the age of the eligible employee (or the eligible employee's family members), or
  - the number of family members of the eligible employee. (Section 9831(d)(2)(C))

An eligible employee is any employee of an eligible employer, except that the arrangement may exclude from consideration employees who

(i.) have not completed 90 days of service;
(ii.) under age 25;
(iii.) part-time or seasonal employees; [see Reg. Reg. 1.105-11(c)(2)(iii)(C) – less than 25 hours, but perhaps less than 35 hours depending on hours of others (see regulation)
(iv.) are not included in the plan who are included in a unit of employees covered by an agreement between employee representatives and one or more employers which the Secretary finds to be a collective bargaining agreement, if accident and health benefits were the subject of good faith bargaining between such employee representatives and such employer or employers; and
(v.) nonresident aliens and who receive no earned income (within the meaning of section 911(d)(2)) from employer which constitutes income from sources within the US (within meaning of section 861(a)(3)).

[§105(h)(3)(B)] (see also Section 9831(d)(3)(A))

- Is maintained by an employer that is not an “applicable large employer” (employs fewer than 50 employees) and “does not offer a group health plan to any of its employees”. (Section 9831(d)(3)(B).
- No employee contributions to the funding are permitted (no salary reduction contributions).
- “It provides, after the employee provides proof of coverage, for the payment of, or reimbursement of, an eligible employee for expenses for medical care (as defined in Code Sec. 213(d)) incurred by the eligible employee or the eligible employee's family members (as
determined under the HRA's terms). (Section 9831(d)(2)(B)(ii))

- Amount of payments and reimbursements for any year do not exceed $4,950 ($10,000 if for payments or reimbursements for family members of the employee). Inflation adjusted.

**Impact on Income Tax Exclusion:**

For purposes of section 105 (Amounts received under accident and health plans) and Section 106 (Contributions by employer to accident and health plans), payments or reimbursements from a QSEHRA of an individual for medical care (as defined in Code Sec. 213(d)) will “not be treated as paid or reimbursed under employer-provided coverage for medical expenses under an accident or health plan if, for the month in which such medical care is provided, the individual does not have minimum essential coverage “ under Code Sec. 5000A(f) (Section 106(g)). In other words, the employer reimbursement is taxable to the employee if the employee does not have minimum essential coverage.

**Coordination with Premium Credit**

An employee is not eligible a Premium Tax Credit for any month where the employee is provided a qualified small employer health reimbursement arrangement which constitutes affordable coverage. The law also explains how to know if the coverage is affordable (the standard for measuring for these purposes). See section 36B(c)(4)(C).

**Reporting and Notice Requirements**

Employer notice requirement – An employer funding a qualified small employer health reimbursement arrangement for any year shall, not later than 90 days before the beginning of such year provide a written notice to each eligible employee which includes:

- A statement of the amount which would be such eligible employee's permitted benefit under the arrangement for the year.

- A statement that the eligible employee should provide the information described above to any health insurance exchange to which the employee applies for advance payment of the premium assistance tax credit.

- A statement that “if the employee is not covered under minimum essential coverage for any month the employee may be subject to tax under section 5000A for such month and reimbursements under the arrangement may be includible in gross income”. (Emphasis added) Section 9831(d)(4).

Penalty: §6652(o) “Failure To Provide Notices With Respect To Qualified Small Employer Health Reimbursement Arrangements.—In the case of each failure to provide a written notice as required by §9831(d)(4), unless it is shown that such failure is due to reasonable cause and not willful neglect, there shall be paid, on notice and demand of the Secretary and in the same manner as tax, by the person failing to provide such written notice, an amount equal to $50 per employee per incident of failure to provide such notice, but the total amount imposed on such person for all such failures during any calendar year shall not exceed $2,500.”

Employer reports information on W-2 - New §6051(a)(15) - “the total amount of permitted benefit (as defined in §9831(d)(3)(C)) for the year under a qualified small employer health reimbursement arrangement (as defined in §9831(d)(2)) with respect to the employee.”
Effective Date

Generally effective for tax years beginning after 12/31/16.

“TRANSITION RELIEF—relief under Treasury Notice 2015–17 shall be treated as applying to any plan year beginning on or before December 31, 2016.”

Effective date for written notice to each employee required by section 9831(d)(4) – no later than 90 days after date of enactment.

**Observation:** An employer who wishes to create a QSEHRA in 2017, and comply with the written notice requirement in section 9831(d)(4) has 90 days from Dec. 13, 2016 to comply with the above notice requirement. Otherwise, the notice is due 90 days before the beginning of the year.

Signing H.R. 34 on 12/13/16 (from the White House website):

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**FBAR Extensions to October 15 are Truly Automatic says FinCEN**

Starting with the 2016 FBAR, the normal and extended due date are the same as for Form 1040. On 12/16/16, FinCEN within Treasury [announced](https://www.fincen.gov/news-center/press-releases/bureau-financial-crimes-enforcement-network-announces-automatic-extension-time-file-2016-fbar) that if an FBAR is not filed by April 15 (April 18 for 2016 forms), Treasury will treat the taxpayer as having made an automatic extension of time to file until October 15. Thus, no form is needed to extend the FBAR. Click [here](https://www.fincen.gov/news-center/press-releases/bureau-financial-crimes-enforcement-network-announces-automatic-extension-time-file-2016-fbar) for pdf of the announcement. [FinCEN = Financial Crimes Enforcement Network]

**New Research Credit Form 8974 When Using Credit Against Payroll Tax**

On 12/2/16, the IRS [announced](https://www.irs.gov/newsroom/new-research-credit-form-8974-when-using-credit-against-payroll-tax) it is seeking comments on new Form 8974, due by 1/31/17.
Chapter 3: C Corporations

Reasonable Compensation Guide for the IRS

As noted in the materials, there were a few reasonable compensation cases in 2016 (H.W. Johnson and Brinks Gilson & Lione). Also helpful in determining reasonable compensation, particularly how the an IRS examiner may develop the issue is an IRS guide for employees – Reasonable Compensation – Job Aid for IRS Valuation Professionals, 10/29/14, a 28-page reference guide developed by the LB&I Division.

Transferee Liability for 2003 Corporate Taxes – Stuart, Jr., Transferee, No. 15-3319

Stuart, Jr., Transferee, No. 15-3319 and Walters, Jr., Transferee, No. 1503320, and others (8th Cir., 11/14/16) – Stuart, Walters and two estates owned the stock of Little Salt Development Company until 2003. LS is a Nebraska corporation that owned 160 acres of saline wetland near Lincoln, Nebraska used for duck hunting. LS sold the land to the city of Lincoln in 2003 for $472,000, leaving only cash as LS’s assets. The IRS sought taxes from the shareholders for 2003 after LS failed to pay its taxes. A few other transactions occurred that raised the question of how much liability the shareholders might have. The Tax Court reached a lower figure than the IRS sought so the IRS appealed. The 8th Circuit remanded to the Tax Court to resolve the issue.

During the process of selling the land in 2003, MidCoast Investments, Inc., contacted LS offering to buy LS’s stock after the land sale. The price offered equaled the cash held by LS less 64.92% of LS’s federal and state tax liabilities for 2003. This amount would be larger than what the LS shareholders would have received if they had liquidated LS and paid the taxes owed for 2003. LS shareholders accepted the offer.

In August 2003, LS wired $467,721 to a trust account maintained by M’s attorney. “in turn wired the $358,826 purchase price for the shareholders’ stock to their counsel's trust account. Counsel for the shareholders then distributed the purchase price to the shareholders pro rata.” M then wired the $467,721 to an account held in LS’s name at SunTrust Bank. The next day, $467,000 was transferred from that account to another at the same bank. That account was called “MidCoast Credit Crop. Accounts Payable.” LS recorded this as a shareholder loan.

LS filed its corporate tax return in December 2003 showing $432,148 of taxable income and tax due of $148,456. This return indicated that LS had cash of $278 and a shareholder loan of $467,000. LS did not pay the tax owed.

In 2004, M sold its LS shares to Wilder Capital Holdings, LLC. LS reported a bad debt deduction of $450,370 which created an NOL it carried back to the 2003 return.

In 2007, the IRS disallowed the bad debt deduction and NOL carryback, thereby assessing $145,923 against LS and a penalty of $58,369. Unable to collect from LS, the IRS issued notices of transferee liability to the former shareholders per §6901. The IRS argued that the transactions of 2003 should be treated instead as a liquidating distribution of LS’s cash to its shareholder to redeem their shares, followed by a payment from the shareholders to M for facilitating the distribution.
The Tax Court disagreed with the IRS that the arrangement should be a liquidating distribution to the shareholders. Instead, the court found that the transfer of $467,721 to M was a fraudulent transfer making the shareholders liability under the Nebraska Uniform Fraudulent Transfer Act. The shareholders’ liability for this transfer was limited to $58,842 (difference between what the shareholders received from the stock sale and the amount they would have received if they had liquidated LS and paid the taxes).

The IRS appealed, “arguing the Tax Court erred by failing to consider whether the stock sale should have been recharacterized as a liquidating distribution under Nebraska law and by limiting the extent of the shareholder liability as transfer beneficiaries.”

The 8th Circuit noted that §6901 only creates a procedure for collection, it does not establish the amount of the liability.

The court found that the Tax Court approach was out of step with other courts. “Although the Tax Court concluded that the question of substantive liability under § 6901 is a question of state law, the court failed to consider the IRS argument that under Nebraska law the stock sale should be recharacterized as a liquidating distribution to the shareholders. The Tax Court instead respected the form of the transaction and concluded that the former shareholders were liable for a portion of Little Salt's tax deficiency as beneficiaries of the transfer from Little Salt to MidCoast. On appeal the IRS argues that the Tax Court's failure to consider whether the stock sale should be recharacterized under state law was error. We agree.”

“Had the Tax Court considered the IRS's state law recharacterization argument and determined that the stock sale should be recast as a liquidating distribution to the shareholders, the outcome of this case could well have been different. The Tax Court's decision to limit the IRS's recovery to $58,842 depends on the shareholders' status as transfer beneficiaries and its conclusion that $58,842 is the amount by which the shareholders benefitted from Little Salt's transfer of its cash to MidCoast. The rationale underlying this measure of recovery would have little application if the Tax Court had concluded that the stock sale should be recharacterized as a liquidating distribution directly to the former shareholders. If the transaction is recharacterized under Nebraska law, the IRS could be entitled to collect the full amount of its claim from the former shareholders.”

§367 – Certain Triangular Reorgs Involving Foreign Corporations – Notice 2016-73

Per the IRS (12/2/16): “Notice 2016-73 announces the modification of rules under section 367 that would address certain triangular reorganizations involving foreign corporations where a subsidiary acquires its parent’s stock for property and uses that stock to acquire a target corporation. The rules would also modify the “all earnings and profits” amount that must be included in income as a result of certain inbound asset acquisitions that repatriate “excess asset basis.””

Chapter 4: S Corporations
Chapter 5: Partnerships and LLCs

Chapter 6: Credits

Low-Income Housing Credit (§42)

1. Notice 2016-77 (12/12/16) – Per the IRS: “relates to allocations of low-income housing credits to projects and serves as a reminder to taxpayers that a project located in a qualified census tract is not described in § 42(m)(1)(B)(ii)(III) unless the project’s development contributes to a concerted community revitalization plan.”

2. Rev. Rul. 2016-29 – Per the IRS (12/12/16): “relates to allocations of low-income housing credits to projects and clarifies that §42(m)(1)(A)(ii) neither requires nor encourages State housing credit allocating agencies to reject the proposed development of a low-income housing project that does not obtain the approval of the locality where the project is proposed to be developed.”

Chapter 7: State of California and Multistate

California Tax Directory

FTB Taxpayer Rights Advocate – Susan Maples
(916) 845-6724 (direct)
(800) 883-5910 (toll-free general)
https://www.ftb.ca.gov/aboutFTB/Taxpayer_Advocate/index.shtml

Report ID Theft, Scams and Fraud -
https://www.ftb.ca.gov/online/Fraud_Referral/index.shtml?WT.mc_id=Contact_Info_Report_Fraud

FTB Online Answer website - https://www.ftb.ca.gov/aboutFTB/contact.shtml

FTB Live Chat - https://www.ftb.ca.gov/aboutFTB/Live_Chat.shtml

FTB Ask a Legal Expert - https://www.ftb.ca.gov/contact_us/Ask_a_Legal_Expert.asp


FTB Legal Division Directory - https://www.ftb.ca.gov/law/directory.shtml
FTB Chief Counsel – Jozel Brunett
(916) 845-6467 (direct)


BOE Taxpayer Rights Advocate – Todd Gilman
(916) 324-2796 (direct)
(888) 324-2798 (toll-free general)
http://www.boe.ca.gov/tra/

BOE Chief Counsel – Robert Tucker
(916) 445-4380 (direct)

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<thead>
<tr>
<th>FTB Legal Rulings and Notices for 2016</th>
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<tbody>
<tr>
<td>• Legal Ruling 16-01 - Calculation of the Limited Liability Company Fee for Real Estate Dealers</td>
</tr>
<tr>
<td>• FTB Notice 2016-05 — Notifications, Notices and Requests under Regulation Section 19195-1.</td>
</tr>
<tr>
<td>• FTB Notice 2016-04 — Extension of Time for Filing Returns for Taxpayers Subject to the Corporation Tax Law.</td>
</tr>
<tr>
<td>• FTB Notice 2016-03 — Processing of Cases Raising the Compact Election Issue After the United States Supreme Court Denied the Petition for a Writ of Certiorari in The Gillette Company v. Franchise Tax Board.</td>
</tr>
<tr>
<td>• FTB Notice 2016-02 — Treatment of Water's Edge Elections after change in law.</td>
</tr>
<tr>
<td>• FTB Notice 2016-01 — Action on Cases Involving the Compact Election Issue After the Decision of the California Supreme Court in The Gillette Company v. Franchise Tax Board.</td>
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<tbody>
<tr>
<td>The FTB published the inflation adjusted nexus factors for tax years beginning on or after 1/1/16. See the table below comparing the 2016 figures to those for 2015.</td>
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<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2015</th>
</tr>
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<tbody>
<tr>
<td>Sales</td>
<td>$547,711</td>
<td>$536,446</td>
</tr>
<tr>
<td>Payroll</td>
<td>$54,771</td>
<td>$53,644</td>
</tr>
<tr>
<td>Property</td>
<td>$54,771</td>
<td>$53,644</td>
</tr>
</tbody>
</table>

This legislation (discussed in Tax A materials) is also relevant to employers who do not offer retirement plans for employees.

Per State Treasurer Chiang:

“The most ambitious push to expand retirement security since the passage of Social Security in the 1930s became a reality on September 29, 2016 when Governor Jerry Brown signed Senate Bill 1234.”

“This new law will go into effect on Jan. 1, 2017 and will authorize the Secure Choice Board, chaired by Treasurer John Chiang, to begin the development and build-out of the retirement program. Once Secure Choice opens its doors it will be phased in: eligible employers with more than 100 employees will need to participate within 12 months after the program is open for enrollment; employers with more than 50 employees will be mandated to participate within 24 months after the program is open for enrollment; and within 36 months all other eligible employers will be required to participate.”

His website notes that 7.5 million Californians work for employers who do not offer retirement plans.

Also see:

- **Fact sheet**
- **SB 1234** (Chapter 04; 9/29/16)
- **Governor Brown’s press release** (9/29/16) upon signing SB 1234

  Per the press release: “Under the new law, workers who do not have a workplace retirement plan will automatically contribute 3 percent of wages to a new retirement account, the California Secure Choice Retirement Savings Trust. This fund will invest in a diversified portfolio that focuses on long-term financial growth. Workers can change their contribution levels at any time, or choose not to participate. The legislation prohibits the state or employers from incurring any liabilities associated with the new program.”

- **Employer safeguards:** (per Controller’s website)
  - No liability for employee’s decision to participate in, or opt out of, the Program;
  - No liability for the investment decisions of participating employees;
  - Are not a fiduciary of the Program;
  - No responsibility for the administration, investment, or investment performance of the Program;
  - No liability for Program design, investment returns, and benefits paid to participating employees;
  - Employers are not able to contribute to the employee account unless there is a change in federal law that permitted contributions without triggering ERISA requirements.

- **Website** still under construction at 11/25/16,
Prop 64 Marijuana Legalization

Prop 64 on the November ballot passed (56.9% in favor). This proposition legalizes recreational marijuana with specified restrictions (such as not for individuals under age 21, rules on labeling and advertising and more) and new taxes. Sales cannot start until 1/1/18.

The tax structure per the Secretary of State:

<table>
<thead>
<tr>
<th>Type of Tax</th>
<th>Type of Marijuana Taxed</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>New state tax on growing</td>
<td>Both medical and nonmedical</td>
<td>$9.25 per ounce of dried marijuana flowers and $2.75 per ounce of dried marijuana leaves.</td>
</tr>
<tr>
<td>New state retail excise tax</td>
<td>Both medical and nonmedical</td>
<td>15 percent of retail price.</td>
</tr>
<tr>
<td>Existing state and local sales tax</td>
<td>Nonmedical only</td>
<td>Rates vary across the state but average around 8 percent.</td>
</tr>
<tr>
<td>Existing and future local taxes</td>
<td>Can apply to both medical and nonmedical.</td>
<td>Subject to local government decisions.</td>
</tr>
</tbody>
</table>

Starting in 2020, the taxes are adjusted for inflation. These taxes do not apply to medical marijuana. Local governments may impose additional taxes and regulations.

- Marijuana flowers – “the dried flowers of the marijuana plant as defined by the board.”
- Marijuana leaves – “all parts of the marijuana plant other than marijuana flowers that are sold or consumed.”

Also per the Secretary of State:

"Allocation of Certain State Tax Revenues." Revenues collected from the new state retail excise tax and the state tax on growing marijuana would be deposited in a new state account, the California Marijuana Tax Fund. Certain fines on businesses or individuals who violate regulations created by the measure would also be deposited into this fund. Monies in the fund would first be used to pay back certain state agencies for any marijuana regulatory costs not covered by license fees. A portion of the monies would then be allocated in specific dollar amounts for various purposes….

All remaining revenues (the vast majority of monies deposited in the fund) would be allocated as follows:

- 60 percent for youth programs—including substance use disorder education, prevention, and treatment.
- 20 percent to clean up and prevent environmental damage resulting from the illegal growing of marijuana.
- 20 percent for (1) programs designed to reduce driving under the influence of alcohol, marijuana, and other drugs and (2) a grant program designed to reduce any potential negative impacts on public health or safety resulting from the measure.”

A 11/17/16 news release from the BOE (NR 92-16-G) notes that Prop 64 adds a sales tax exemption for medical marijuana sold to those with a medical marijuana identification card.
(MMIC). This exemption through 12/31/17, is due to a date omission in the Prop 64 language (text sec. 34010(g)). Apparently, the sales tax exemption for medical marijuana was not to start until other taxes start on 1/1/18. See Keith Humphreys, “Analysis: This blunder on California marijuana Prop. 64 could cost state millions,” The Denver Post, 11/16/16.

No changes was made to California’s conformity (or lack thereof) to IRC Section 280E which denies deductions for expenses related to marijuana operations (other than cost of sales).

FTB website on medical marijuana related activities (as of 11/25/16, FTB states they are working on the income tax impacts and will update the website as needed).

FTB’s summary of application nof 280E to California income taxes:

- **Individuals**[1] – Medical marijuana businesses operating under California's personal income tax law may deduct cost of goods sold (COGS). However, they are not allowed to deduct business expenses, such as rent and wages. [R&T 17201]

- **Corporations and Unincorporated Associations**[2] – Medical marijuana business entities operating under California's corporation tax law are allowed to deduct COGS, as well as business expenses. [R&T 24436.1]

- **Tax Credits** – Medical marijuana businesses may be eligible to generate tax credits, as long as they meet the specific requirements for the particular credit. The tax credits of a medical marijuana business that operates as a cooperative or collective generally do not flow through to the members.”

Footnotes:


[2] Includes eligible business entities electing to be taxed as a corporation, non-profit organizations, and collectives. These entities/organizations are taxed under the California Corporation Tax Law in Part 11 of the California Revenue and Taxation Code.”

Additional FTB resources – [here](#).

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**Final Market Sourcing Regs For Other Than Tangible Property**

In fall 2016, the FTB finalized title 18 regulations at §25136-2 on Market-Sourcing for Other Than Tangible Personal Property. The regulations are effective 1/1/17, but per FTB, “operative for most taxpayers for tax years beginning on or after January 1, 2015.”

Also, per the FTB (October 2016 News):

“The new amendments provide:

- The definition of and assignment rules for "marketable securities"
- Assignment rules for dividends and goodwill, and
- Assignment rules for interest

For tax year 2015, the new amendments may require some taxpayers to file an original return if...
they were not previously aware they had a filing requirement.

A taxpayer might have to amend a return when they did not properly assign the sale under the new assignment rules. For example, a taxpayer may have mistakenly assigned investment interest to the location of the customer, rather than the location where the investment is managed, as is required by the new rules.

Another example of when a taxpayer might need to file an amended return is when a taxpayer discovers they have California sales in the form of marketable securities. When the taxpayer is in the form of a partnership or LLC, the filing of the amended return will also require its partners and members to amend their returns.

FTB Interested Parties Meetings for 2016

Topic list follows. See that website for links to details for the discussion drafts for each meeting.
Also see FTB Regulatory Activity [website](#) for similar information about the regulation projects.

As of 11/25/16, the only [final regulations](#) for 2016 are the Market-Based Rules for Sales Other Than Sales of Tangible Personal Property (discussed earlier).
New Film Credit

Per FTB: “AB 1839, chaptered on Sept. 18, 2014, expanded the credit. This credit is referred to as the “new credit.” The amount available for allocation was increased to $330 million starting fiscal year 2015/2016. The new bill is effective from taxable year beginning January 1, 2016, and will continue until fiscal year 2019/2020.”

For details, see https://www.ftb.ca.gov/individuals/california_motion_picture_and_television_production_credit/index.shtml.

Selected Legislative Activities Relevant to Businesses (not covered elsewhere)

- FTB’s 2016 Code Section Report by Code Section.
- **AB 567** – Called for a six month tax amnesty for medical marijuana businesses. Vetoed by Governor Brown on 9/29/16 because he believes it is too early to create a tax amnesty program for medical marijuana businesses.

- **AB 691** (Chapter 551, 9/24/16) – enacts “the Revised Uniform Fiduciary Access to Digital Assets Act, which would authorize a decedent’s personal representative or trustee to access and manage digital assets and electronic communications, as specified. The bill would authorize a person to use an online tool to give directions to the custodian of his or her digital assets regarding the disclosure of those assets. The bill would specify that, if a person has not used an online tool to give that direction, he or she may give direction regarding the disclosure of digital assets in a will, trust, power of attorney, or other record. The bill would require a custodian of the digital assets to comply with a fiduciary’s request for disclosure of digital assets or to terminate an account, except under certain circumstances, including when the decedent has prohibited this disclosure using the online tool. The bill would make custodians immune from liability for an act or omission done in good faith in compliance with these provisions.”

  Also see press release from sponsor Assembly member Calderon (9/24/16). “Through this bill, an individual may use the following methods to provide direction regarding the disclosure of their assets upon death:

  - A person may use a website’s online tool.
  - If an online tool is not provided or used, a person may give direction in a will, trust, power of attorney or other record.
  - In the absence of the first two, a website’s terms of service would determine how to disclose information.”

- **AB 821** (Chapter 811, 9/29/16) – “authorize, before January 1, 2022, a person issued a seller’s permit for a place of business that is a dispensary, as defined in the Medical Cannabis Regulation and Safety Act, to remit amounts due for retail sales at the dispensary by a means other than electronic funds transfer.”

- **AB 1289** (Chapter 740, 9/28/16) – Adds additional requirements for Transportation Network Companies (such as Uber and Lyft); no tax provisions included.
• **AB 1437** – Not enacted - Internet Fantasy Sports Games Consumer Protection Act/Licensed Operators Shall Facilitate Collection of Personal Income Tax by FTB – to provide consumer protections and require licensed operators to help collect PIT from winners - version at 6/21/16 + FTB analysis.

• **AB 1727** – Not enacted. Creates certain rights for independent contractors such as to organize and negotiate with “hosting platforms.”

• **AB 1847** (Chapter 294, 9/12/16) – Expands the current employee notification requirement for the federal EITC to also include the California EITC, effective after 2016.

• **AB 1856** (Chapter 98, 7/25/16) – Per Senate Analysis (6/29/16), this bill “allows a taxpayer making installment payments on an outstanding liability on taxes administered by the Board of Equalization (BOE) to file a single claim for refund to cover all prior overpayments and all subsequent overpayments.”

• **AB 1920** (Chapter 611, 9/25/16) – Allows the California Tax Credit Allocation Committee (TCAC) to create a schedule of fines when terms and conditions or agreements are violated related to the affordable housing developments receiving low-income housing tax credits.

• **AB 2365** – Vetoed by Governor Brown on 8/29/16 due to budget issues. “New sales tax exemptions, like new spending on programs, need to be considered comprehensively as part of the budget deliberations.” Per Assembly analysis (8/29/16): “Provides that the terms "sale" and "purchase" do not include the transfer of "vested property", as defined, by a "pawnbroker" to a person who pledged the property to the pawnbroker as security for a loan if specified requirements are met, thus excluding such transfers from taxation under the Sales and Use Tax (SUT) Law.”

• **AB 2900** (Chapter 582, 9/24/16) – Requires additional reporting for the California Competes Credit Program.

• **SB 821** (Chapter 811, 9/29/16) – authorizes, “before January 1, 2022, a person issued a seller’s permit for a place of business that is a dispensary, as defined in the Medical Cannabis Regulation and Safety Act, to remit amounts due for retail sales at the dispensary by a means other than electronic funds transfer.”

• **SB 836** (Chapter 31, 6/27/16), Budget Act of 2016 – Clarifies California Competes credit such as by allowing a taxpayer’s financial solvency to be a criteria, as well as current and past compliance with federal and state laws.

• **SB 837** (Chapter 32, 6/27/16), Budget Act of 2016 – allows sale of low-income housing tax credits under specified conditions (R&T 17039) and extends the credit for farm donations to food banks from 2017 to 2022 and increases credit from 10% to 15% (R&T 17053.88.5).

Food Bank Credit – See R&T 17053.88 and 17053.88.5, **AB 1577** (Chapter 400, 9/21/16 + FTB Analysis), and June 2016 press release from the California Association of Food Banks.
R&T 17053.88.5. “(a) In the case of a qualified taxpayer who donates fresh fruits or fresh vegetables to a food bank located in California under Chapter 5 (commencing with Section 58501) of Part 1 of Division 21 of the Food and Agricultural Code, for taxable years beginning on or after January 1, 2017, and before January 1, 2022, there shall be allowed as a credit against the "net tax," defined by Section 17039, an amount equal to 15 percent of the qualified value of those fresh fruits or fresh vegetables.”

“Qualified taxpayer” means the person responsible for planting a crop, managing the crop, and harvesting the crop from the land.”

See R&T 17053.88.5 for the balance of the rules. Also see Form 3811, Donated Fresh Fruits or Vegetables Credit (this is the 2015 form).

- **SB 996** (Chapter 836, 9/29/16) – “increases the amount of the welfare exemption from property tax for non-publicly financed affordable housing.”
- **SB 1171** (Chapter 86, 7/22/16) – various technical corrections to California statutes.

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### EDD E-Filing

**EDD Reminder of 12/16/16:** “**EMPLOYERS**: The e-file and e-pay mandate is coming soon! If you are an employer with 10 or more employees, you are required to electronically file and pay your payroll taxes for the period beginning January 1, 2017. Employers subject to the mandate will no longer automatically be mailed payroll tax deposit coupon booklets, tax returns, or wage reports unless an *E-file and E-pay Mandate Waiver Request*, DE 1245W, has been submitted and approved. Visit [www.edd.ca.gov/EfileMandate](http://www.edd.ca.gov/EfileMandate) for more information.”

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### Base Year Value and Construction in Progress

In a 10/26/16 memo (No. 2016/042) to county assessors, the BOE clarifies “base year” and valuation in response to a February 2016 ruling – *Ellis v. County of Calaveras*, 245 Cal.App. 4th 64 (2016). Per the memo:

“This case clarifies several principles in the valuation and appeal of new construction in progress:

1. Pursuant to section 110.1, the value of construction in progress on the lien date is a base year value.

2. Pursuant to section 71 and Rule 463(d), construction in progress shall be appraised at its full value each lien date until construction is complete. 5 Ellis supra, 245 Cal.App.4th, at p. 72; original italics. 6 Id. at pp. 72–73. TO COUNTY ASSESSORS 4 October 26, 2016

3. Appeals challenging an assessor's valuation of construction in progress are appeals of base year values under section 80, and taxpayers may file such applications in the year of the assessment or in any of the three succeeding years.

4. A taxpayer who successfully appeals a base year value on construction in progress is entitled to a refund of taxes only if the appeal was filed in the same year the base year
value was established and only for the year in which that base year value was established. The appeal must be filed in the same year the base year value was established since section 80(a)(5) limits refunds to the year in which the appeal was filed and in succeeding tax years. If the appeal is filed within the section 80(a)(3) deadline but in a year subsequent to the establishment of the base year value, a refund cannot be granted since it would be for a year prior to the filing of the application for appeal. A refund is available only for the year in which the base year value on construction in progress was established because that base year value is valid only for that year. New base year values are established for subsequent lien dates on which the construction is still in progress.”

**Prop 56 and Tobacco Tax**

Prop 56 on the November ballot passed (64.2% in favor). Increases the cigarette tax by $2/pack with an equivalent amount for other tobacco products and electronic cigarettes that use nicotine. With the increase, the tax on a pack of cigarettes is $2.87 starting 4/1/17. Funds are allocated for health care programs and tobacco use prevention programs. Revenue estimate is over $1 billion for 2017-2018.

**Yeast Used to Make Wine – Sales Tax Annotation 245.1102 (1/19/16)**

Annotation 245.1102 (1/19/16) – “Yeast purchased by both beer and winemakers are both food products and are used for similar purposes. Beer brewers and winemakers select specific strains of yeast for the flavor, aroma, and alcohol content that the yeast contributes to the end product. Therefore, sales of viable yeast that is sold as food for human consumption in the production of beer, mead, ale, and wine are not subject to tax under Regulation 1602.”

Per the 1/6/16 memo explaining this annotation, the change was made because prior annotations found that sales tax did not apply to yeast used in beer brewing but did apply to yeast used in winemaking. The processes in making both beverages is similar in terms of use of the yeast. Finding no reason to treat them differently, the new annotation provides that yeast purchased for winemaking is not subject to sales tax.

**2017 EDD Rates and Information**

The 2017 rates for employment taxes administered by the EDD are available at http://www.edd.ca.gov/Payroll_Taxes/Rates_and_Withholding.htm.

**Property Tax and Spacecraft**

A few new annotations were issued involving aircraft, air taxis and spacecraft. For example, new annotation 205.0280 was added as follows:
“205.0280 Space Transportation Equipment. Space transportation equipment fabricated and used to transport satellites and cargo to locations in outer space, which is not operationally reusable and over which ultimate control is relinquished at launch, qualifies for the business inventory exemption. C 12/24/2013.”

**Alabama – Nexus for Local Taxes**

Attorney General Opinion 2017-001 (10/5/16) – The issue involved identifying which local jurisdiction a transaction is considered to take place if the delivery point and title transfer point differ for a retail sale. Per the conclusion:

“Local tax is due in the jurisdiction where title to the goods is transferred, which will be at the time of delivery, unless explicitly agreed otherwise. If parties to a retail sales transaction are not using common carrier for delivery and so agree to allow title to transfer at the place of the sale, then local tax is due in the jurisdiction where the sale takes place. If, however, common carrier is the method of delivery, then local tax is due in the jurisdiction where delivery is completed, regardless of any agreement to allow title to transfer at the place of the sale.”

**Ohio Commercial Activity Tax (CAT) Nexus Cases Decided**

The CAT, a gross receipts tax, uses a factor presence test (aka bright line) for determining when a business is subject to the tax. For example, over $500,000 of sales in the state is sufficient to have nexus.


As summarized in the *Crutchfield* case, the majority holds: “We hold that given the $500,000 sales-receipts threshold, the burdens imposed by the CAT on interstate commerce are not “clearly excessive” in relation to the legitimate interest of the state of Ohio in imposing the tax evenhandedly on the sales receipts of in-state and out-of-state sellers. As a result, the tax satisfies the substantial-nexus standard under the dormant Commerce Clause, and we decline to address the tax commissioner’s alternative argument that the physical-presence standard has been satisfied.”

Dissenting judges thought that the *Quill* physical presence test should apply.

**Chapter 8: Accounting Methods and Section 199**

**IRS Audit Guide for TPR**

In September 2016, the LB&I Division issued an 18-chapter, 202-page guide, *Capitalization of Tangible Property*, to help examiners with all aspects of the tangible property regulations including reviewing methods changes and depreciation. Some of the suggestions noted for examiners are geared to large companies, such as telling the examiner to look for something in the taxpayer’s 10-K report, the report is still a helpful review of the TPR. The chapters:
1) Examination of tangible property
2) Compliance considerations
3) Unit of property
4) Amounts paid to acquire or produce property
5) De minimis safe harbor
6) Improvement rules – betterments
7) Improvement rules – restorations
8) Improvement rules – new or different use
9) Safe harbors – special rules – other provisions
10) Materials and supplies
11) Leased property
12) Disposition concepts and MACRS accounting rules
13) Dispositions in general
14) MACRS disposition rules
15) General asset account rules
16) Accounting method changes
17) Accounting method changes – capitalization
18) Accounting method changes – depreciation and dispositions

Query: Will the IRS SB/SE Division issue a guide for its auditors?

**Extension of Eligibility Rule Waivers for Certain Automatic Changes Made To Comply with the Final Tangible Property Regulations**


“The Treasury Department and the IRS are aware that taxpayers continue to request consent to change their methods of accounting to utilize the final tangible property regulations and final depreciation and disposition regulations. To continue to ease taxpayers’ transition to these final regulations and to reduce the administrative burden that would result from requiring taxpayers to apply for non-automatic changes of accounting methods for each of the changes specified above, this notice modifies the applicable sections of Rev. Proc. 2016-29 to extend the waiver of the eligibility rule under section 5.01(1)(f) of Rev. Proc. 2015-13 for one year to any taxable year beginning before January 1, 2017.” See Notice 2017-06 for a list of the relevant changes
§199 and Video Programming and Film Production – TAM 201647007

TAM 201647007 (11/18/16) – Involved a taxpayer operating as a “multichannel video programming distributor (MVPD) regulated by the Federal Communications Commission (FCC) as a telecommunications service provider.” The IRS found that T was not eligible for the §199 deduction, for selling packaged channels, but might qualify for qualified film it produces. Per the IRS:

“ISSUES: 1. For purposes of the domestic production activities deduction under §199, whether a package that includes multiple channels of video programming, or the Signals transmitted by Taxpayer to distribute the package of video programming (together referred to as a “---------------- Package”) is a qualified film within the meaning of §199(c)(6), and §1.199-3(k)(1) of the Income Tax Regulations.

2. Whether the gross receipts that Taxpayer derived from its ---------------- Packages qualify as domestic production gross receipts (DPGR) under § 199(c)(4)(A)(i)(II) and § 1.199-3(k)(3).

CONCLUSIONS:

1. No. A ---------------- Package is not a qualified film within the meaning of §199(c)(6) or §1.199-3(k)(1) because it is not property described in §168(f)(3) (“any motion picture film or video tape”), or “live or delayed television programming” within the meaning of §1.199-3(k)(1).

2. No. The gross receipts that Taxpayer derived from its ---------------- Packages were not from the disposition of a qualified film produced by Taxpayer and are not DPGR under §199(c)(4)(A)(i)(II) and §1.199-3(k). However, the gross receipts that Taxpayer derived from any individual film included in a ---------------- Package that is a qualified film produced by Taxpayer may qualify as DPGR. Thus, a portion of Taxpayer’s gross receipts may be DPGR under §199(c)(4)(A)(i)(II) and §1.199-3(k), and each qualified film produced by Taxpayer may be considered an “item” as provided by § 1.199- 3(d)(1)(ii).”

This seems to be a modification of an earlier ruling of the IRS. See TAM 201049029 (12/10/10) with the following issue and ruling:

“ISSUE: Whether gross receipts derived from Taxpayer’s licensing of a group of programs that includes programs produced by Taxpayer, programs produced by third parties, commercial advertisements, and interstitials (together a “Programming Package”) to customers in the normal course of Taxpayer’s business can be domestic production gross receipts (DPGR) under §199(c)(4)(A)(i)(II) of the Internal Revenue Code (Code)?

CONCLUSION: Gross receipts derived from licensing a Programming Package can be DPGR under §199(c)(4)(A)(i)(II).”

TIGTA Report on DPAD Problems

Per a 11/9/16 press release, TIGTA released a report (9/28/16), The IRS Can Do Better at Identifying Potentially Erroneous Domestic Production Activities Deductions. TIGTA notes that “adequate controls are not in place to ensure that businesses and corporations properly claim the Domestic Production Activities Deduction (DPAD) on their tax returns.” IRS is unable to determine if the deduction is overclaimed. “In its review, TIGTA identified 2,829 taxpayers who filed returns for Tax Year 2013 that potentially overclaimed the DPAD by more than $27 million.” In addition, “TIGTA identified 177 electronically filed Tax Year 2013 Form 1040 returns that claimed $850,329 in the DPAD without proper support.”
Recommendation to the IRS include:

1. Review form 8903 to include a line with additional information (redacted from the report).
2. Use math error authority to disallow the deduction where appropriate.

**Chapter 9: International Tax**

**T.D. 9792, 11/03/2016; Reg. 1.954-2, 1.956-1, -1T, -2, -3, -4 -- Final CFC Regs**

On What Constitutes U.S. Property and FBCI

Per the IRS Summary:

“[TD 9792] contains final regulations that provide rules regarding the treatment as United States property of property held by a controlled foreign corporation (CFC) in connection with certain transactions involving partnerships. In addition, the final regulations provide rules for determining whether a CFC is considered to derive rents and royalties in the active conduct of a trade or business for purposes of determining foreign personal holding company income (FPHCI), as well as rules for determining whether a CFC holds United States property as a result of certain related party factoring transactions.”

*Deloitte United States Tax Alert on Final and Proposed Subpart F Regulations (11/3/2016)*

**REG-114734-16, Prop Reg § 1.956-4 (11/03/2016) -- Liquidation Value Percentage Determines Controlled Partnership's U.S. Property Share**

Per the IRS summary:

“[REG-114734-16] contains proposed regulations that provide rules regarding the determination of the amount of United States property treated as held by a controlled foreign corporation (CFC) through a partnership. The proposed regulations affect United States shareholders of CFCs.”

*KPMG Tax News Flash (Nov. 2, 2016) on the Proposed Regulations.*

**EU Common Consolidated Corporate Tax Base (CCCTB)**

The EU “re-launched” its CCCTB proposal of 2011, in October 2016. The goal is to have a streamlined, equitable system of allocating EU income among the countries, with the amount so allocated taxed at the rates in that country. Per the 10/25/16 press release from the EU:
“Re-calibrated as part of a broader package of corporate tax reforms, the Common Consolidated Corporate Tax Base (CCCTB) will make it easier and cheaper to do business in the Single Market and will act as a powerful tool against tax avoidance.” …

“With the CCCTB, companies will for the first time have a single rulebook for calculating their taxable profits throughout the EU. Compared to the previous proposal in 2011, the new corporate taxation system will:

- Be mandatory for large multinational groups which have the greatest capacity for aggressive tax planning, making certain that companies with global revenues exceeding EUR 750 million a year will be taxed where they really make their profits.
- Tackle loopholes currently associated with profit-shifting for tax purposes.
- Encourage companies to finance their activities through equity and by tapping into markets rather than turning to debt.
- Support innovation through tax incentives for Research and Development (R&D) activities which are linked to real economic activity.

Corporate tax rates are not covered by the CCCTB, as these remain an area of national sovereignty. However, the CCCTB will create a more transparent, efficient and fair system for calculating the tax base of cross-border companies, which will substantially reform corporate taxation throughout the EU.”

The EU also claims it will eliminate profit-shifting. Per the fact sheet:

The EU countries still need to agree on the common tax base. Each country can have its own tax rates though.

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**Chapter 10: Payroll Tax and Worker Classification**

CCA 201645012 (released 11/4/2016) – Chief Counsel Rules That Elective Deferral, With Employer Match, Escapes Section 409A.

Background:

“The 409A generally provides that if certain requirements related to the timing of elections, distributions, and funding are not met at any time during a taxable
year, amounts deferred under a nonqualified deferred compensation plan for that year and all previous taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. Amounts includible in income under section 409A are also subject to two additional taxes under section 409A(a)(1)(B).” CCA 201645012
(Emphasis added)

CCA facts, issue, and conclusion:

Facts:

“On November 1, 2014, an employee entered into an agreement to defer $15,000 of the employee's salary that would otherwise have been paid during 2015, with payment of the deferred amount to be made as a lump-sum payment on January 1, 2018, but only if the employee continues to provide substantial future services until December 31, 2017. Under the agreement the employee's salary is reduced by $600 each biweekly pay period (so 26 x $600 or $15,600) and the employer credits matching amounts to the employee's deferred compensation account of 25% of each salary reduction (so 26 x ($600 /4) or $3,900) for a total amount deferred of $19,500. The matching amounts are credited each time a salary reduction amount is credited, which is the time the salary reduction amount would otherwise be paid as salary.”

Issue:

“May the salary that the employee could have elected to receive as compensation be treated as subject to a substantial risk of forfeiture under section 409A through December 31, 2017, if as part of the imposition of the service requirement through December 31, 2017, the employer provides a matching contribution resulting in a 25% increase in the present value of the amount of deferred compensation.”

Conclusion:

“Yes, an amount that an employee could have elected to receive as salary may be treated as subject to a substantial risk of forfeiture under section 409A if the employer provides a matching contribution resulting in a 25% increase in the present value of the amount deferred.”

Analysis:

Generally, “the addition of any risk of forfeiture after the legally binding right to the compensation arises, or any extension of a period during which compensation is subject to a risk of forfeiture, is disregarded for purposes of determining whether such compensation is subject to a substantial risk of forfeiture.” However, a risk of forfeiture in such circumstances is respected “if the present value of the amount subject to a substantial risk of forfeiture is ‘materially greater’
than the present value of the amount the recipient otherwise could have elected to receive absent such risk of forfeiture. Chief Counsel concluded that the 25% increase (via employer matching) was a “material increase” which prevented the triggering of a section 409A inclusion in gross income:

Under the facts here, the present value of the amount deferred by the employee is 25% greater than the amount the employee otherwise could have received absent the addition of the substantial risk of forfeiture. A 25% increase in the present value of the amount a service provider could have received absent the risk of forfeiture is a material increase. Accordingly, the combined deferred amount of 2015 salary ($15,600) plus the deferred amount of the employer's matching contribution ($3,900) is subject to a substantial risk of forfeiture for purposes of section 409A until December 31, 2017.

Observation: If the top tax rate is reduced in 2018 (relative to 2015), then this taxpayer may achieve a salary increase (via the employer matching contribution), a deferral, and reduced income tax by making the deferral election. The downside is that the deferred compensation is subject to a risk of forfeiture.

Chapter 11: ACA Update

Issuers of Forms 1095-B and 1095-C have until March 2, 2017

Per the IRS (11/18/16): “Notice 2016-70 extends the due dates for certain information reporting requirements for 2016 imposed by the Patient Protection and Affordable Care Act (ACA) under section 6055 and 6056. Specifically, this notice extends the due date for furnishing to individuals the 2016 Form 1095-B, Health Coverage, and the 2016 Form 1095-C, Employer-Provided Health Insurance Offer and Coverage, from January 31, 2017, to March 2, 2017. This notice also provides for transitional good-faith relief from the penalties imposed by sections 6721 and 6722 relating to the 2016 information reporting requirements under sections 6055 and 6056.”

There is no extension of time to get the forms and transmittal forms (1094) to the IRS. These normal dues dates are:

- Paper filing – February 28, 2017
- Electronic filing – March 31, 2017

If more time is needed to get the forms to the government, see Form 8809 and instructions, as well as Reg. 1.6081-8T.

Credit for Small Employers - SHOP Concerns – Notice 2016-75 (12/2/16)
Per the IRS: “Notice 2016-75 provides guidance on section 45R for certain small employers that cannot offer a qualified health plan (QHP) through a Small Business Health Options Program (SHOP) Exchange because the employer’s principal business address is in a county in which a QHP through a SHOP Exchange will not be available for the 2016 calendar year (the counties, which are listed in the notice, are all in Wisconsin). With respect to those employers, this notice provides transition relief allowing employers to claim the credit by satisfying the pre-2014 rules.”

### ESRP Data

A March 2016 CBO report, *Federal Subsidies for Health Insurance Coverage for People Under Age 65: 2016 to 2016*, notes the following regarding ESRP collections:

“In CBO and JCT’s projections, payments of those penalties total $228 billion over the 2017–2026 period. However, the increased costs for employers who pay the penalties are projected to reduce other revenues by about $50 billion because employers will generally shift the costs of the penalties to workers by lowering taxable wages, yielding a net reduction in the deficit of $178 billion (see Table 3). The associated effects of changes in taxable compensation on tax revenues are included in JCT’s estimate of the effects of the tax exclusion for employment-based coverage (in Table 2).”

#### Table 3. Direct Spending and Revenue Effects of the Insurance Coverage Provisions of the Affordable Care Act

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<tr>
<td>Gross Cost of Coverage Provisions</td>
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<td>134</td>
<td>152</td>
<td>164</td>
<td>174</td>
<td>187</td>
<td>199</td>
<td>212</td>
<td>225</td>
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<td>Penalty Payments by Uninsured People</td>
<td>-3</td>
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<td>Penalty Payments by Employers&lt;sup&gt;c&lt;/sup&gt;</td>
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<td>Excise Tax on High-Premium Insurance Plans&lt;sup&gt;d&lt;/sup&gt;</td>
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<tr>
<td>Other Effects on Revenues and Outlays&lt;sup&gt;e&lt;/sup&gt;</td>
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<td>-9</td>
<td>-13</td>
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<td><strong>Net Cost of Coverage Provisions</strong></td>
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<td>113</td>
<td>119</td>
<td>123</td>
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<td>150</td>
<td>157</td>
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<td>170</td>
<td>1,403</td>
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</table>

The CBO report does not explain why $0 is shown for the ESRP revenues for 2016 given that the penalty is first enforced by the IRS for 2015 (rather than 2014 per the ACA statute).

A 2016 report by Accenture Consulting estimates that an additional $10 billion of ESRP could be owed for 2016 due to unintentional errors, such as due to the change in penalty exposure from 2015 to 2016 for employers with 50 but note more than 100 full-time and full-time equivalent employees.
Chapter 12: Estate, Gift and GST Tax

Legislation Introduced to Stop the Proposed Valuation Discount Regulations

a. H.R. 6042, To nullify certain proposed regulations relating to restrictions on liquidation of an interest with respect to estate, gift, and generation-skipping transfer taxes – Introduced by Congressman Sensenbrenner (R-WI). See 9/15 press release. The text is as follows:

“Regulations proposed for purposes of section 2704 of the Internal Revenue Code of 1986 relating to restrictions on liquidation of an interest with respect to estate, gift, and generation-skipping transfer taxes, published on August 4, 2016 (81 Fed. Reg. 51413), and any substantially similar regulations hereafter promulgated, shall have no force or effect.”

b. Protect Family Farms and Business Act – introduced by Congressman Davidson (D-OH) – see text (no bill number as of 9/23/16) and explanation (9/21 press release). The text of the bill is as follows:

“The proposed regulations under section 2704 of the Internal Revenue Code of 1986 relating to restrictions on liquidation of an interest with respect to estate, gift, and generation-skipping transfer taxes, published on August 4, 2016, in the Federal Register (81 Fed. Reg. 51413) shall have no force or effect. No Federal funds may be used to finalize, implement, administer, or enforce such proposed regulations or any substantially similar regulations.”

See S. 3436.

c. Also see H.R. 6100 which also calls for the regulations to have no effect.

d. On 11/3/16, the Republicans on the House Ways & Means Committee sent a letter to Treasury Secretary Lew asking that the regulations be withdrawn. An excerpt follows:

“The legislative history of Section 2704 is clear that this provision was enacted to overturn the result in Estate of Harrison, a case that involved the valuation of a limited partnership interest transferred among family members who all had the same rights to liquidate the partnership. The provision was not intended otherwise to affect the valuation of minority discounts or other discounts. The current regulations, enacted in 1992, are clear that Section 2704 is not meant to apply in cases where an individual owner gives up the right to control the business by transferring ownership interests to other family members. This properly reflects congressional intent.

In contrast, Treasury’s recently proposed regulations, as drafted, would eliminate, or severely limit, minority discounts for transfers among family members of business interests in family-owned businesses. This new approach does not reflect congressional intent.”
TE/GE Announces New Information Document Request Management Process

On 11/21/16, the IRS TE/GE Division issued via email, news of a new process for IDR. Per the IRS:

“The Tax Exempt and Government Entities Division of the Internal Revenue Service has issued new internal guidance for its agents on issuing information document requests (IDRs). The IRS issues IDRs to gather information during an examination. The new process will go into effect on April 1, 2017. Prior to its implementation, TE/GE will provide training to its agents on the new process.

Under the new process:

1. Taxpayers will be involved in the IDR process.
2. Examiners will discuss the issue being examined and the information needed with the taxpayer prior to issuing an IDR.
3. Examiners will ensure that the IDR clearly states the issue and the relevant information they are requesting.
4. If the taxpayer does not timely provide the information requested in the IDR by the agreed upon date, including extensions, the examiner will issue a delinquency notice.
5. If the taxpayer fails to respond to the delinquency notice or provides an incomplete response, the examiner will issue a pre-summons notice to advise the taxpayer that the IRS will issue a summons unless the missing items are fully provided.
6. A summons will be issued if the taxpayer fails to provide a complete response to the pre-summons letter by its response due date.

The new process requires the examiners’ managers to be actively involved early in the process and ensures that IRS Counsel is prepared to enforce IDRs through the issuance of a summons when necessary. Throughout this process, the IRS will respect taxpayer rights and the changes will reflect the agency's commitment to the Taxpayer Bill of Rights.

The updated process will:

• Provide for open and meaningful communication between the IRS and taxpayers.
• Reduce taxpayer burden and provide consistent treatment of taxpayers.
• Allow the IRS to secure more complete and timely responses to IDR.
• Provide consistent timelines for IRS agents to review IDR responses.
• Promote timely issue resolution.”

Chapter 15: Looking Forward