July 22, 2016 – Important 2016 Second Quarter Federal Tax Developments

During the second quarter of 2016, there were many important federal tax developments. This letter highlights some of the more significant developments for you. As always, contact our office if you have any questions.

Tax legislation

President Obama signed the *Recovering Missing Children Act* (HR 3209) in June. The bill amends Code Sec. 6103 to allow the IRS to share tax return information with federal, state and local law enforcement agencies to help with investigations involving missing or exploited children.

House Republicans released a tax reform blueprint in June. Republican lawmakers indicated that they will use the blueprint to develop legislative proposals during the remaining months of 2016. The blueprint would consolidate the individual tax rates into three brackets: 12, 25 and 33 percent, and repeal the alternative minimum tax (AMT). Additionally, the blueprint would lower the corporate tax rate to 20 percent. A new 25 percent business tax rate for small businesses organized as sole proprietorships or pass-through entities would be created.

Partnerships

The IRS issued final, temporary and proposed regulations in May intended to preserve a partner’s status as a partner, and not an employee, where the partner works for a disregarded entity owned by the partnership. The regulations are consistent with Rev. Rul. 69-184, which concluded that members of a partnership are not employees of the partnership, even if they devote time to the partnership’s trade or business or provide services to the partnership as an independent contractor. The IRS described the rules as clarifying the employment tax treatment of partners in a partnership that owns a disregarded entity (DE).

Business deductions

IRS Chief Counsel determined in June that a retailer could not characterize any gross receipts derived from the sale of its products as domestic production gross receipts (DPGR). Since the products were manufactured, produced, grown or extracted outside the United States, the gross receipts from the sale were not DPGR on which the Code Sec. 199 domestic production activities could be calculated.

Individuals

The IRS reminded taxpayers that the *Protecting Americans from Tax Hikes Act of 2015* (PATH Act) may impact some refunds in 2017. The changes affect taxpayers who file early in the filing season and who claim the Earned Income Tax Credit (EITC) and/or additional child tax credit (ACTC). The IRS will hold refunds on EITC and ACTC-related returns until February 15. The additional time will help prevent revenue lost due to identity theft and refund fraud related to fabricated wages and withholdings.

The IRS provided guidance in June on how wrongfully-incarcerated individuals can make a claim for a retroactive exclusion from income for any civil damages, restitution or other monetary award received in connection with their incarceration. The guidance details the procedures that qualified taxpayers are to follow in making their claims. The wrongful-incarceration exclusion was part of the PATH Act.

The Tax Court found in May that the IRS improperly denied a taxpayer's American Opportunity Tax Credit (AOTC) based on amounts reported on Form 1098-T, Tuition Statement (*Terrell, TC Memo. 2016-85*). Although the university had charged a portion of the taxpayer's spring 2011 semester tuition to her account in November 2010, her student loan proceeds were not disbursed and credited to her account until 2011.

Employers

The IRS unveiled a package of final, temporary and proposed reliance regulations about the new voluntary certification program for professional employer organizations (PEO). The IRS also announced that the certification application process will commence July 1, 2016.

In June, a federal district court granted an employer a refund of employment taxes paid because the taxpayer had a reasonable basis for treating its nonmedical homecare service providers as independent contractors instead of employees (*Nelly Home Care, Inc.*, *DC-Pa.*). The court found that the taxpayer was entitled to protections afforded by the safe harbor provisions of Section 530 of the *Revenue Act of 1978.*

The IRS posted an updated Form 8850, Pre-Screening Notice and Certification Request for the Work Opportunity Tax Credit (WOTC), and its Instructions, to reflect the PATH Act. The PATH Act renewed the WOTC and added a new targeted group.

Income

The IRS issued proposed reliance regulations in April on the amount and timing of taxable deemed distributions of stock and stock rights. The proposed regulations also provide guidance to withholding agents on their withholding and reporting obligations for the deemed distributions.

Retirement plans

The IRS issued proposed reliance regulations under Code Sec. 409A in June intended to clarify and liberalize existing rules on nonqualified deferred compensation plans. The regulations also tighten the anti-abuse provision in the proposed income inclusion regulations regarding amounts subject to a substantial risk of forfeiture.

The IRS announced in June that the staggered five-year remedial amendment cycle system for individually designed plans under Rev. Proc. 2007-44 will terminate January 1, 2017. The agency also provided new rules for individually designed plans.

In May, the IRS released final regulations on disbursements from designated Roth accounts to multiple destinations. The final regulations generally track proposed rules issued in 2014, which provided that an amount paid in a direct rollover is not required to be treated as a separate distribution from any amount paid directly to the employee.

Also in May, the IRS issued final rules on the suspension of benefits for multiemployer defined benefit plans in critical and declining status under the *Multiemployer Pension Reform Act of 2014* (MPRA). The IRS also issued Rev. Proc. 2016-27 describing the specifics of the application process for approval of a proposed benefit suspension under a multiemployer defined benefit pension plan that is in critical and declining status.

International

The IRS issued final regs in June that require country-by-country (CbC) reporting by multinational enterprises (MNEs) based in the U.S. Although the regs are not effective until June 30, 2016, the IRS stated that it would accept filings of CbC reports for periods beginning on or after January 1, 2016.

A federal district court dismissed a lawsuit challenging statutes and international agreements that require foreign financial institutions (FFIs) and U.S. taxpayers to report certain foreign financial accounts (*Crawford v. Treasury*, DC-Ohio). The lawsuit challenged the *Foreign Account Tax Compliance Act* (FATCA), intergovernmental agreements (IGAs) that operate like FATCA to require reporting, and the Report of Foreign Bank and Financial Accounts (FBAR) requirement.

Tax administration

The IRS commenced notifying taxpayers of special procedures permitting return of seized assets in June. Individuals and entities must show that they may be entitled to a return of their property seized through civil asset forfeiture.

IRS Chief Counsel determined in June that the Financial Industry Regulatory Authority (FINRA) is a corporation or other entity serving as an agency or instrumentality of the government of the United States. Therefore, fines paid to FINRA are not tax deductible, Chief Counsel concluded.

In May, the IRS announced that throughout the agency all initial contacts with taxpayers to commence an examination must be made by mail, instead of the telephone, using the appropriate initial contact letters. Going forward, employees must use the appropriate initial contact letters listed in the Internal Revenue Manual (IRM) to notify a taxpayer when a return is selected for examination, and will not make initial contact by telephone.

The IRS updated in June the "North American area" for purposes of the Code Sec. 274 (h) limitation on deducting convention expenses. The update, the first since 2011, clarifies the status of several Caribbean jurisdictions.

The 2016 filing season received mixed reviews. The Government Accountability Office (GAO) reported that the IRS made progress improving customer service levels. The National Treasury Employees Union (NTEU), which represents IRS employees, cautioned that budgetary pressures continue to impair taxpayer services.

Identity theft

The IRS announced in June new safeguards to prevent identity theft. All individual taxpayers will be required to update their credentials to a minimum eight-digit password and establish security questions. The IRS with its stakeholders will also continue the "Taxes.Security.Together" public education campaign.

Tax Court procedure

In cases where its Clerk's Office is inaccessible on the last date of a limitations period, the limitations period will be extended to the next day that is not a Saturday, Sunday or holiday, the Tax Court held in June (*Guralnik, 146 TC No. 15*).

REITs

The IRS issued final, temporary and proposed regulations intended to limit the ability of corporations to spin off appreciated assets to a real estate investment trust (REIT) and to avoid recognizing gain on the assets. The rules generally apply to transactions occurring on or after June 7, 2016.

If you have any questions about these or other federal tax developments, please contact our office.