THOMSON REUTERS
CHECKPOINT™

Five-Minute Tax Briefing®

Robin Tuttle Christian, CPA; Shaun Hunley, J.D., LL.M.; and Suzanne Scriven, CPA
Five-Minute Tax Briefing Editors

No. 2016-24
December 20, 2016

Highlights

21st Century Cures Act Establishes Small Employer HRAs: Under the 21st Century Cures Act enacted 12/13/16, certain small employers are allowed to offer standalone Health Reimbursement Arrangements (HRAs) to employees without suffering a market reform penalty. The HRA must meet certain requirements and the amount the employer can contribute to the HRA is limited. Additionally, reimbursements to the employee for medical expenses are tax-free only if the employee is enrolled in other health coverage (e.g., individual coverage) that is minimum essential coverage. The new law also provides penalty relief for small employer HRAs that reimbursed individual health insurance premiums before 1/1/17. For more information, see NTA-970 in this issue.

2017 Standard Mileage Rates: Beginning on 1/1/17, the standard mileage rates for cars, vans, pickups, and panel trucks will be 53.5 cents per mile for business miles, 17 cents per mile for medical or moving purposes, and 14 cents per mile for charitable purposes. The business expense rate is down half a cent per mile from 2016, and the medical and moving expense rates are down two cents per mile from the 2016 rates. The charitable rate is set by law and remains unchanged from last year's rate. The portion of the business standard mileage rate treated as depreciation is 25 cents per mile for 2017. When computing the allowance under a Fixed and Variable Rate (FAVR) plan, the standard vehicle cost cannot exceed $27,900 for autos or $31,300 for trucks and vans. Notice 2016-79, 2016-52 IRB.

Expanded Due Diligence Penalties for Certain Tax Credits: The IRS released temporary regulations (TD 9799) that implement the PATH Act expansion of the preparer due diligence penalties under IRC Sec. 6695(g) to the (1) child tax credit, (2) additional child tax credit, and (3) American Opportunity Tax Credit. Previously, the penalty applied only to the earned income tax credit. For 2016 returns, preparers will be subject to a $510 penalty for any tax return or refund claim for which they didn't properly determine the individual's eligibility and correct credit amount. Preparers must use Form 8867 (Paid Preparer's Due Diligence Checklist) to certify that they have confirmed their clients' eligibility for these credits. The expanded penalty rules apply for tax years beginning after 2015. Proposed regulations, which mirror the temporary regulations, were also issued. Temp. Reg. 1.6695-2T; Prop. Reg. 1.6695-2.

Tax Filing Season to Begin January 23, 2017: The IRS has announced that the federal tax filing season for 2016 will begin on Monday, 1/23/17, which means that electronic and paper returns will be accepted beginning on that day. According to the IRS, taxpayers claiming certain tax credits should expect a longer wait for refunds (until the week of 2/27/17). Beginning in 2017, the PATH Act requires the IRS to hold refunds on tax returns claiming the Earned Income Tax Credit (EITC) or the Additional Child Tax Credit (ACTC). The entire refund must be held, even if a portion is not associated with the EITC and ACTC, until 2/15/17. In 2017, tax returns are due on April 18, rather than the usual April 15, because of a weekend and the Emancipation Day holiday in the District of Columbia. News Release IR-2016-167.

Practitioners
Tax Action Bulletins®
(USPS 017197)

MANAGING EDITOR
Robin Tuttle Christian, CPA

FIVE-MINUTE TAX BRIEFING EDITORS
Robin Tuttle Christian, CPA
Shaun Hunley, J.D., LL.M.
Suzanne Scriven, CPA

LEAD COPY EDITOR
Lisa M. Bossier

For Customer Service needs or to subscribe, call (800) 431-9025
tax.thomsonreuters.com

Published semimonthly by Thomson Reuters Tax & Accounting, 2395 Midway Rd., Carrollton, TX 75006.

Periodicals postage paid in the Carrollton, TX office and other locations. POSTMASTER: Send address changes to *Practitioners Tax Action Bulletins*, P.O. Box 115008, Carrollton, TX 75011-5008, Attn: Customer Service.

Send all correspondence and subscription orders to the above address.

Other Current Releases

Foreign Reporting—Additional Reporting Required for Certain Foreign-owned LLCs: The IRS issued final regulations (TD 9796) that treat a domestic disregarded entity (a single-owner LLC) wholly owned by a foreign person as a domestic corporation separate from its owner for Section 6038A reporting. These rules, which are intended to provide the IRS with improved tax transparency, are much the same as the proposed regulations issued in May, but have a few changes. Foreign single owners of domestic LLCs must still report to the IRS as already required for 25% foreign-owned corporations, but new reporting requirements apply to the foreign owners. Besides obtaining EINs, the foreign owners must file an information return disclosing all transactions with foreign related parties. The final rules apply to tax years beginning on or after 1/1/17 and ending on or after 12/13/17. Regs. 1.6038A-1, 1.6038A-2, and 301.7701-2.

Foreign Reporting—Failure to File FBAR Was Willful: The taxpayers owned a shop in California that shipped German-made cameras to customers around the world. Commissions from these sales were deposited into a Swiss bank account in the taxpayers' name. The taxpayers did not disclose the existence of this account to anyone other than their two children. In addition, the taxpayers did not maintain any books with respect to the business. After failing to file Foreign Bank and Financial Accounts Reports (FBARs) for many years, the taxpayers applied to participate in the IRS's Offshore Voluntary Disclosure Program (OVDP). However, the application included several misrepresentations. The District Court for the Central District of California found that the taxpayers' failure to timely file the FBAR was willful despite their OVDP application. The taxpayers should have been aware of the filing requirement, and their conduct with respect to their OVDP application further undermined their credibility. *August and Maria Bohanec*, 118 AFTR 2d 2016-XXXX (DC CA).

Identity Theft—Protecting against Identity Theft and Refund Fraud: In a recent News Release, the IRS describes new initiatives that it will enact, along with state tax agencies and the tax industry, to protect taxpayers from identity theft and refund fraud. According to the IRS, many of the changes being made will not be visible to taxpayers, but will help the IRS and states detect fraudulent returns and protect taxpayer information. A new Identity Theft Tax Refund Fraud Information Sharing and Analysis Center (ISAC) will be launched in 2017 to help identify emerging identity theft schemes and quickly share that information. The IRS also offers steps that can help taxpayers protect their data and identity from identity thieves, such as always using (and regularly updating) antimalware security software on all digital devices (including tablets and mobile phones), encrypting tax return files and all sensitive files stored on a computer, and using passwords that are long and complex and not repeating them for multiple accounts. News Release IR 2016-166.

Income Tax—Deductions Reduced for Compensation and Cost of Goods Sold: The taxpayer, Transupport, Inc., a closely-held corporation, was a supplier and dealer of aircraft engines and a parts distributor. Rather than maintaining a physical inventory of unsold parts, the president of the company (also the company's founder) estimated the ending inventory based on a percentage of sales, which, in his experience, was 30%. He and his four sons were the only full-time employees and officers. Although the sons performed no supervisory functions and had no special experience or educational background, their compensation amount, which was determined by their father, ranged from $575,000 and $720,000 for the years at issue. Upon audit, the IRS issued a notice of deficiency, significantly reducing the compensation deductions and adjusting Transupport's cost of goods sold to reflect a 75% profit on sales of surplus parts. Although Transupport hired an appraiser to dispute these adjustments, the Tax Court agreed with the IRS. *Transupport, Inc.*, TC Memo 2016-216 (Tax Ct.).

Income Tax—Eligibility for Low-income Housing Tax Credit (LIHTC): Under IRC Sec. 42(f), the LIHTC is allowed each year over a 10-year credit period beginning with the tax year a qualified low-income building is placed in service (or, if elected, the next tax year). In a Notice, the IRS reminds taxpayers that a project won't qualify for the preference specified in IRC Sec. 42(m)(1)(B)(ii)(III) unless the project (a) is located in a qualified census tract, and (b) development contributes to a "concerted community revitalization plan." Qualified census tracts are designated by the U.S. Dept. of Housing and Urban Development and are characterized by either the percentage of households below a certain income threshold or by a poverty rate above a certain threshold. Notice 2016-77, 2016-52 IRB.

Income Tax—Empowerment Zone Tax Benefits Still Available: The IRS reminds eligible businesses that they can still claim empowerment zone tax benefits, including tax credits, increased expensing for qualifying property, tax-exempt bond financing, and deferred capital gains tax on the sale and replacement of qualified assets, through the end of 2016. In general, empowerment zones are certain urban and rural areas where employers and other taxpayers qualify for special tax incentives. The Department of Housing and Urban Development (HUD) and the Department of Agriculture designated 40 economically distressed locations as empowerment zones. The list of these zones can be found in the instructions to Form 8844 (Empowerment Zone Employment Credit). For more information about empowerment zones on HUD's website, see **www.hudexchange.info/programs/community-renewal-initiative**. IRS Special Edition Tax Tip 2016-16.

Income Tax—IRS Releases Final Regulations on Exempt Bond Arbitrage Restrictions: The IRS has released final regulations (TD 9801) that revise the definition of *issue price* for purposes of the arbitrage investment restrictions under IRC Sec. 148. In general, for bonds issued for money, the issue price is the first price at which a substantial amount of the bonds (defined to be 10%) is sold to the public. For bonds issued for money in a private placement to a single buyer that is not an underwriter or a related party, the issue price is the price paid by the buyer. The final regulations also adopt, with modifications, a special rule proposed in 2015 pertaining to initial offering prices to the public. The final regulations apply to bonds that are sold on or after 180 days after 12/9/16. Regs. 1.148-1 and 1.148-11.

Income Tax—Spousal Support Payments Not Alimony Despite State Law Provision: In a recent Private Letter Ruling, the taxpayer was awarded spousal support pursuant to a divorce decree. The decree provided that the court would not have jurisdiction to modify the award in the future. In addition, the decree did not expressly state that the payments would end upon the taxpayer's death. However, under state law, the obligation to pay spousal support ended upon the death of either party or the remarriage of the party receiving maintenance unless otherwise agreed to in writing. The IRS concluded that the payments did not constitute alimony under IRC Sec. 71(b)(1) because the obligation to make the payments would not end upon the death of the payee spouse. The IRS reasoned that the parties' agreement to deprive the court of continuing jurisdiction made the state law provision inapplicable to the support payments. Ltr. Rul. 201648001.

IRS Issues Fall 2016 Statistics of Income Bulletin: The IRS has released the Fall 2016 issue of the Statistics of Income Bulletin, which features data on 2014 sole proprietorship and partnership returns. For that year, taxpayers reported sole proprietorship activity on approximately 24.6 million individual income tax returns—a 2.3% increase from 2013. In addition, the number of partnerships and partners increased during 2014. Partnerships filed more than 3.6 million returns, representing more than 27 million partners. The bulletin also covers transactions between large foreign-owned domestic corporations and foreign related persons for the 2010 tax year. The report is available at **www.irs.gov/uac/soi-tax-stats-soi-bulletin-fall-2016**. News Release IR 2016-157.

IRS Revises Guidance on Facility Construction for Certain Tax Credits: The IRS has revised recent guidance on when construction must begin for certain facilities to qualify for the renewable electricity production tax credit under IRC Sec. 45 or the energy investment tax credit under IRC Sec. 48. Among other things, the revised guidance provides that a facility will satisfy the Continuity Safe Harbor if it is placed in service by the later of (1) a calendar year that is no more than four calendar years after the year during which construction began or (2) 12/31/18. In addition, the guidance clarifies the prohibition against combining methods to satisfy the beginning of construction requirement and the costs that may be included in the 5% Safe Harbor for retrofitted renewable energy facilities. The IRS will not issue any private letter rulings with respect to this guidance. Notice 2017-4, 2017-3 IRB.

Procedure—Interest Rates to Remain the Same for First Quarter 2017: The interest rates for tax overpayments and underpayments for the quarter beginning on 1/1/17 will be the same as the prior quarter. For noncorporate taxpayers, the rate for both underpayments and overpayments will be 4%. The 4% rate also applies to estimated tax underpayments for the first quarter of 2017. For corporations, the overpayment rate will be 3%, with a 1.5% rate applicable to overpayments exceeding $10,000. The underpayment rate for corporations will be 4%, except for large corporate underpayments, which will be 6%. Rev. Rul. 2016-28, 2016-51 IRB.

Procedure—IRS Issues Temporary Regulations on Disclosures to Census Bureau: Under IRC Sec. 6103(j)(1)(A), the Secretary of the Treasury is authorized to disclose tax return information to the Bureau of the Census upon written request of the Secretary of Commerce. On 8/2/16, the Commerce Secretary requested disclosure of several tax return items to assist the Census Bureau in structuring the censuses and carrying out its economic statistics program. In response to this request, the IRS has issued temporary regulations (TD 9802) that allow disclosure of the items requested by the Commerce Secretary. Among other things, the temporary regulations permit disclosure of certain deductions from business tax returns, information related to the research tax credit, and whether a business has closed or stopped paying wages. The temporary regulations apply to disclosures to the Census Bureau made on or after 12/9/16. Temp. Reg. 301.6103(j)(1)-1T.

Procedure—New Online Tool Provides Taxpayers with Basic Account Information: The IRS announced the launch of an online application that will assist taxpayers with straightforward balance inquiries in a safe, easy, and convenient way. The new secure tool allows taxpayers to view their IRS account balances, including amounts owed for tax, penalties, and interest. Taxpayers may access various online payment options, including Direct Pay, pay by card, and online payment agreement. Before accessing the tool, taxpayers must authenticate their identities through the rigorous Secure Access process. The IRS anticipates additional capabilities will be added to this platform as they are developed and tested. News Release IR 2016-155.

tax.thomsonreuters.com/PPCSubscriptions/TABN (User Name: PTAB1016, Password: NEWS2U-1)

Tax Action Memo®

TAM-1825
December 20, 2016

Year-end Giving Strategies

Type of Clients: Individuals interested in making gifts to relatives and/or charities. **Situation:** You will want to suggest tax-smart strategies as yearend rapidly approaches. **Deadline:** ASAP.	**Tax Action Required:** Read this release for some ideas and contact interested clients before it's too late. Consider using the sample client letter in Appendix 1 at the end of this release.

Background

The end of the year is a good time to assess one's tax situation. Of course, clients often take it to the limit by waiting until the last minute to implement tax-smart strategies—especially when it comes to making gifts to relatives and charities. Here are some gift-giving ideas to suggest to clients who are so inclined.

Make Year-end Gifts of Appreciated Securities to Relatives in Lower Tax Brackets

As the Internal Revenue Code stands right now, the federal income tax rate is 0% for Long-term Capital Gains (LTCGs) that fall within the boundaries of the 10% and 15% ordinary income tax brackets. Apparently, President-elect Trump plans to keep the 0% rate, even though he doesn't plan to keep the 10% and 15% brackets. They would be replaced by a new 12% bracket. Presumably, the 0% rate for LTCGs would be allowed for those in the new 12% bracket, which is proposed to cover the first $75,000 of taxable income for married joint-filing couples and the first $37,500 for unmarried individuals. (Trump's plan would eliminate head of household filing status.) So, if your clients have children, grandchildren, or other relatives who will be eligible for the 0% rate (under the current rules if they remain standing or under the Trump plan if it is enacted), giving them appreciated stock or mutual fund shares before yearend could be a tax-smart move.

Under the federal gift tax exclusion privilege, a client can give away assets worth up to $14,000 during 2016 to an individual recipient without any adverse gift or estate tax consequences. In other words, such gifts won't reduce the client's $5.45 million unified federal gift and estate tax exemption (for 2016). A married couple can jointly give away up to $28,000 during 2016 without any adverse tax consequences.

Warning: Under current law, the Kiddie Tax rules may impede this strategy for gift recipients who are: (1) under age 19 or (2) under age 23 and a student for the year when appreciated securities are sold [IRC

Sec. 1(g)]. However, who knows if the Kiddie Tax will still be around next year under the Trump Administration?

Make Year-end Gifts to Directly Cover Tuition Costs or Medical Bills

For clients making year-end gifts that exceed the $14,000 annual gift tax exclusion, one option is to cover some or all of the intended gift recipient's tuition costs (not room and board or other costs) by making direct payments to the educational institution. Such direct tuition payments won't reduce the giver's $5.45 million unified federal gift and estate tax exemption (for 2016) nor do they count against the $14,000 annual federal gift tax exclusion. Note that this break is available for K–12 private school tuition costs, as well as college tuition. [See IRC Sec. 2503(e).]

In addition to directly paying for tuition costs, up to $14,000 per donee can be given away under the annual federal gift tax exclusion privilege ($28,000 for joint gifts by a married couple). Gifts covered by the exclusion privilege won't reduce the giver's unified federal gift and estate tax exemption.

As a bonus, the gifts will reduce the giver's taxable estate, although that may not matter if Trump comes through on his promise to repeal the federal estate tax. Then again, any repeal could be unwound at some point in the future, so reducing the value of a healthy-sized estate still seems like a good strategy.

> **Example:** Erin's 20-year-old grandson Eric attends an expensive university. Erin would like to make a generous year-end gift to benefit Eric without dipping into her federal gift and estate tax exemption. Before the end of this year, Erin could pay Eric's $22,000 tuition bill for the 2017 spring semester (which starts in January) by writing a check directly to the university. (In most cases, tuition bills for the first academic period of 2017 are due in late December or early January.) In addition, Erin could give Eric up to $14,000 of cash before yearend to cover room and board and out-of-pocket expenses for next year. The $36,000 of year-end gifts will not reduce Erin's unified federal gift and estate tax exemption.

Note: The same favorable tax outcome also applies to direct payments to cover a person's medical costs. As long as the payments go directly to medical providers, there are no adverse gift or estate tax consequences for the giver. [See IRC Sec. 2503(e).]

Make Year-end Gifts to Fund Section 529 College Savings Plan Accounts

Contributions to fund another person's Section 529 plan account qualify as completed gifts to that person for federal gift and estate tax purposes. As such, the contributions are eligible for the annual federal gift tax exclusion privilege. However, a beneficial rule for Section 529 plans allows the giver to contribute a larger amount and spread it over five years for federal gift tax purposes. This effectively allows the giver to use five year's worth of annual gift tax exclusions to shelter the contribution.

For example, the special rule allows up to $70,000 (5 × $14,000) to be contributed at the end of 2016 to a child's or grandchild's Section 529 plan account without reducing the giver's unified federal gift and estate tax exemption (this assumes that no gifts to benefit the same child or grandchild were made earlier in 2016 and that none will be made in 2017–2020). A married couple can jointly contribute up to $140,000 (5 × $14,000 × 2).

Under current law, Section 529 plan contributions reduce the giver's taxable estate. However, if a contribution is spread over five years under the special rule, a portion of the enhanced gift tax exclusion amount must be added back to the giver's taxable estate if he or she dies before the end of the four-year period beginning with the year after the year of the contribution (i.e., before 1/1/21 for a 2016 contribution). [See IRC Sec. 529(c)(2) and (4).]

Make Year-end Gifts to Fund Coverdell Education Savings Accounts

Contributions to fund another person's Coverdell Education Savings Account (CESA) also qualify as completed gifts to that person for federal gift and estate tax purposes. As such, the contributions are eligible for the annual federal gift tax exclusion privilege. However, there's a $2,000 annual limit on contributions to one or more CESAs set up for the same beneficiary (typically a child or grandchild).

For example, say your client has five grandchildren. Before the end of 2016, she could contribute up to $2,000 to a CESA for each grandchild (total contributions of $10,000), assuming no contributions to their accounts were made earlier this year. (See IRC Sec. 530.) As a bonus, CESA contributions will reduce the giver's taxable estate. As stated earlier, that may not matter if the Trump plan to repeal the federal estate tax becomes law.

Make IRA Contributions for Children or Grandchildren

If the client's young child or grandchild has earned income in 2016, the client could make a cash gift to fund a 2016 contribution to a traditional or Roth IRA set up for the child or grandchild. The gift would be eligible for the $14,000 federal gift tax exclusion privilege. However, contributions to a child's or grandchild's IRA are limited to the lesser of: (1) $5,500 or (2) the child's or grandchild's 2016 earned income. Generally, a Roth IRA contribution will make more sense for a young child or grandchild because he or she may not gain any current tax benefit from a traditional IRA contribution.

For example, say your client funds a $5,500 Roth IRA contribution for a 16-year-old grandchild. Assuming an 8% annual rate of return, the Roth IRA would amount to about $258,000 of federal-income-tax-free money by the time the grandchild is 65. Wow! As a bonus, the contribution will reduce the client's taxable estate.

Accelerate Deductible Charitable Donations

If the Trump tax plan is enacted and takes effect next year, higher-income clients may face lower marginal tax rates in 2017. That would make deductible charitable donations made this year worth more than those made next year. Under the Trump plan, the maximum individual rate would be 33% versus 39.6% under current law. Even if the client doesn't turn out to enjoy a lower tax rate next year, accelerating deductible donations will reduce this year's tax bill.

Make Year-end Charitable Contributions of LTCG Securities

Clients should be advised that a charitable contribution of a LTCG asset (such as appreciated stock or mutual fund shares) generally results in a charitable write-off equal to the full FMV of the asset and avoidance of any federal capital gains tax on the appreciation. So, making year-end contributions of LTCG assets is generally a great idea. In contrast, clients should not contribute loser securities (those with current FMV that is less than tax basis). Instead, clients should sell losers, claim the resulting capital loss on Schedule D, and contribute the cash from the sales proceeds.

Make Charitable Donations from IRAs

IRA owners and beneficiaries who have reached age 70½ can make cash donations of up to $100,000 to IRS-approved public charities directly out of their IRAs [IRC Sec. 408(d)(8)]. These so-called *Qualified Charitable Distributions* (QCDs) are federal-income-tax-free to the donor, but he or she gets no itemized charitable write-off. That's okay because the tax-free treatment of QCDs equates to an immediate 100% federal income tax deduction without having to worry about restrictions that can delay itemized charitable write-offs. If your client wants to take advantage of the QCD strategy for 2016, he or she will need to arrange with the IRA trustee or custodian for money to be paid out to one or more qualifying charities before yearend. Last, but not necessarily least, making a QCD will reduce the donor's taxable estate.

The QCD strategy can be beneficial for well-off seniors: (1) who don't itemize (under the "normal" rules, only itemizers get any income tax benefit from charitable donations), (2) whose itemized charitable donations would be reduced by the Section 68 phase-out provision and/or postponed by the percentage-of-AGI limitations, (3) who want to avoid being taxed on RMDs from their traditional IRAs, and (4) who are interested in estate-tax-reduction moves.

Note: The IRS has confirmed that the $100,000 limit is based on a per-IRA-owner concept. Therefore, when a husband and wife both own IRAs, each spouse is entitled to a separate $100,000 annual QCD limit (for a combined total of $200,000) even when a joint return is filed. (See IRS Notice 2007-7, Q&A-34.) The IRS also has confirmed that an IRA beneficiary (a person who inherits an IRA from the original account owner) can arrange for a QCD if the beneficiary is over age 70½. (See IRS Notice 2007-7, Q&A-37.)

References:

IRC Secs. 1(g), 68, 408(d), 529, 530, and 2503(e).
Notice 2007-7, 2007-5 IRB 395.

Subscriber Note: This *Tax Action Memo* was written by Tax Action Panel member William R. Bischoff, CPA of Colorado Springs, Colorado.

Appendix 1

Sample Client Letter on Year-end Giving Strategies

Dear Client:

As year end rapidly approaches, you may feel generously inclined to make gifts to loved ones and charities. Here are some ideas to consider.

- *Make Year-end Gifts of Appreciated Securities to Relatives in Low Tax Brackets*. Your gift recipient can potentially qualify for a 0% federal income tax rate when the appreciated securities are sold.

- *Make Year-end Gifts to Directly Cover Tuition Costs or Medical Bills*. Amounts paid directly to educational institutions (including private K–12 schools) for tuition and fees and to medical service providers don't reduce your federal gift and estate tax exemption, but they do reduce your exposure to the federal estate tax.

- *Make Year-end Gifts to Fund Section 529 College Savings Accounts or Coverdell Education Savings Accounts*. Amounts paid to fund accounts for children or grandchildren reduce your exposure to the federal estate tax. A special rule allows extra-favorable treatment for relatively large lump-sum contributions to a Section 529 account.

- *Make IRA Contributions for Children or Grandchildren*. If you have minor children or grandchildren with some earned income for the year, you can fund a contribution to a Roth IRA or traditional IRA set up in their name. Your generosity will reduce your exposure to the federal estate tax.

- *Accelerate Deductible Charitable Donations*. If the Trump tax plan is enacted and takes effect next year, you may face a lower marginal tax rate in 2017, which could cause deductible charitable donations made this year to be worth more than those made next year.

- *Make Year-end Charitable Contributions of Winner Securities*. Charitable contributions of long-term capital gain assets (such as appreciated stock or mutual fund shares that you've owned for more than one year) generally give you a charitable write-off equal to the full current market value of the asset, and you avoid of any federal capital gains tax on the appreciation. On the other hand, you should not contribute loser securities (those currently worth less than you paid for them). Instead, sell the losers, claim the resulting tax-saving capital loss on your return, and contribute the cash from the sales proceeds.

- *Make Charitable Donations from IRAs*. If you own one or more IRAs and have reached age 70½, you can make cash donations totaling up to $100,000 to IRS-approved public charities directly out of your IRA(s). Making donations in this fashion will reduce your exposure to the federal estate tax.

Yearend is a great time for making gifts to loved ones and charities. Contact us if you have questions or want help in identifying the best tax-smart giving strategies for your situation.

Sincerely,

Tax Action Memo®

TAM-1826
December 20, 2016

S Corporations Can Still Be Used to Moderate Federal Employment Taxes

Type of Clients: Those who currently operate their small businesses as sole proprietorships, partnerships, or LLCs. **Situation:** The self-employment tax can be a heavy burden, and it's getting worse. **Deadline:** Soon.	**Tax Action Required:** Discuss with selected clients whether operating as an S corporation might be worth the extra trouble to reduce Social Security and Medicare taxes.

Background

It can get to the point where enough is enough. Some small business clients may be at that point with the self-employment (SE) tax. For 2017, the tax will be assessed at the painfully high rate of 15.3% on the first $127,200 of net SE income: 12.4% for the Social Security tax component and 2.9% for the Medicare tax component. The $127,200 Social Security tax ceiling is up a whopping 7.3% from the $118,500 ceiling for 2016. Ouch! Above the $127,200 Social Security tax ceiling, the Medicare tax component of the SE tax continues at a 2.9% rate before increasing to 3.8% at higher levels of net SE income thanks to the additional 0.9% Medicare tax.

Say your self-employed client has 2017 Schedule C income of $200,000. The SE tax bill will be a whopping $21,129 (after multiplying the $200,000 by 0.9235 on Schedule SE). That's a lot of cash down the chute. If inflation kicks up, the SE tax hit will quickly get worse. With these thoughts in mind, here's a planning strategy for self-employed clients who've reached the SE tax tipping point.

Note: For purposes of this release, we will refer to the Social Security and Medicare taxes collectively as *federal employment taxes*, whether paid in the form of the SE tax or in the form of FICA tax withholding on wages and matching employer payments.

Elect S Corporation Status to Control Federal Employment Taxes

For compensation paid to an S corporation employee in 2017, including an employee who happens to be a shareholder, the FICA tax rate will be 7.65% on the first $127,200: 6.2% for Social Security tax and 1.45% for Medicare tax. Above $127,200, the FICA tax rate drops to 1.45% because the Social Security tax component cuts out. But, the 1.45% Medicare tax has no compensation limit, and the rate increases to 2.35% at higher compensation levels thanks to the additional 0.9% Medicare tax.

As you know, the FICA tax is withheld from employee paychecks. The employer then pays matching amounts of Social Security tax and Medicare tax (except for the additional 0.9% tax) directly to the U.S. Treasury. Therefore, the combined FICA and employer rate for the Social Security tax is 12.4%, and the combined rate for the Medicare tax is 2.9%, increasing to 3.8% at higher compensation levels (same as the corresponding SE tax rates).

That's the bad news. The good news is that S corporation taxable income passed through to a shareholder-employee and S corporation cash distributions paid to a shareholder-employee are not subject to federal employment taxes. (See Rev. Rul. 59-221 and *Paul B. Ding*.) Finally, since passed-through S corporation taxable income increases the tax basis of the shareholder-employee's stock, distributions of corporate cash flow are usually federal-income-tax-free.

This federal employment tax treatment places S corporations in a potentially more favorable tax position than equivalent businesses conducted as sole proprietorships, single-member LLCs (SMLLCs) that are treated as sole proprietorships for federal tax purposes, partnerships, and multimember LLCs that are treated as partnerships for federal tax purposes. That's because S corporations can follow the tax-smart strategy of paying modest salaries to shareholder-employees while distributing most or all of the remaining corporate cash flow to them in the form of federal-employment-tax-free distributions.

Legislative Outlook Has Improved

Just a few months ago, it appeared the aforementioned strategy could be threatened by an incoming Clinton Administration. Clinton hinted that S corporation net business income, whether paid in salary or not, should be subject to federal employment taxes in the same fashion as partnership business income. In other words, the first $127,200 allocable to each shareholder-employee (in 2017) would have been made subject to the 12.4% Social Security tax, and amounts above that would have been subject to the 2.9%/3.8% Medicare tax. The November election, however, put the Republicans in control of the Presidency and both houses of Congress. It now looks like there won't be any change in the federal employment tax rules for S corporations for a while.

Bottom Line: The window remains open for the federal-employment-tax-reduction strategy of setting up an S corporation for what is now an unincorporated small business and then paying modest salaries to the S corporation's shareholder-employee(s).

Quantifying the Tax Savings

The following examples illustrate the tax savings that can be obtained through operating a small business as an S corporation.

Example 1: Sole proprietorship or SMLLC converts to an S corporation.

Sally is fed up with high SE tax bills. Therefore, she is willing to consider running her small business as an S corporation instead of a sole proprietorship. In 2017, Sally expects her business to earn net taxable income of $200,000 before contributions to fund her SEP account (assume $20,000) and payment of medical insurance premiums (assume $12,000). If Sally maintains sole proprietorship status, she will report $184,700 of net SE income on her 2017 Schedule SE (0.9235 × $200,000). Note that Sally's net SE income is *not* reduced by deductible contributions to her retirement account or by the Section 162(l) deduction for self-employed health insurance premiums. Therefore, Sally's 2017 SE tax liability would be a whopping $21,129 [(12.4% × $127,200) + (2.9% × $184,700)]. The SE tax results would be exactly the same if Sally operates her business as an SMLLC that's treated as a sole proprietorship for federal tax purposes.

Alternatively, Sally could start running her business as an S corporation. Assume the S corporation pays Sally a reasonable salary of $80,000. The federal employment tax hit would be only $12,240 (15.3% × $80,000). Assume the S corporation also makes a $20,000 deductible contribution to Sally's

SEP account (25% of salary) and pays $12,000 for her health insurance coverage. The remaining corporate cash flow is paid out to Sally as federal-employment-tax-free distributions. (Per Revenue Ruling 91-26, the company-paid medical insurance premiums are considered taxable compensation that is *not* subject to federal employment taxes as long as the guidelines in IRS Announcement 92-16 are met.)

Bottom Line: Operating as an S corporation instead of a sole proprietorship (or SMLLC) in 2017 would save a cool $8,889 in federal employment taxes ($21,129 versus $12,240). This is not a one-time benefit. Similar annual federal employment tax savings (or better) could be reaped in future years if Sally's business maintains or exceeds its current level of profitability and the tax rules remain the same.

Example 2: Partnership or LLC converts to an S corporation.

Fred and Phil are 50/50 partners in FP, LLC, which is treated as a partnership for tax purposes. They are disgusted with high SE tax bills, so they are amenable to the idea of running their business as an S corporation. Fred and Phil expect the business to earn 2017 net taxable income of about $400,000 before contributions to fund their SEP accounts (assume $20,000 each) and payment of health insurance premiums (assume $12,000 each). If they maintain partnership status, Fred and Phil will each have $184,700 of 2017 net SE income (0.9235 × 50% × $400,000). Note that net SE income is *not* reduced by deductible contributions to retirement accounts or by Section 162(l) deductions for self-employed medical insurance premiums. Fred and Phil will each owe $21,129 of SE tax for 2017 [(12.4% × $127,200) + (2.9% × $184,700)].

The tax planning alternative is for Fred and Phil to start running their business as an S corporation owned 50% by each. Assume the S corporation pays Fred and Phil reasonable salaries of $80,000 each. The federal employment tax hit would be only $12,240 for each (15.3% × $80,000). Assume the S corporation also makes deductible $20,000 contributions to each shareholder-employee's SEP account (25% of salary) and pays $12,000 for each shareholder-employee's medical insurance coverage. The remaining corporate cash flow is paid out 50/50 to Fred and Phil as federal-income-tax-free distributions. Operating as an S corporation in 2017 would save Fred and Phil $8,889 each in federal employment taxes ($21,129 versus $12,240).

Beware of Retirement Plan Side Effect

One potentially unfavorable side effect of paying modest salaries to S corporation shareholder-employees is reduced capacity to make deductible contributions to tax-favored retirement accounts. If the S corporation maintains a SEP or garden-variety profit-sharing plan, the maximum annual deductible contribution for each shareholder-employee is limited to 25% of salary. So, the lower the salary, the lower the maximum contribution. However, if the S corporation sets up a 401(k) plan, paying modest salaries won't preclude generous contributions.

In Example 1, up to $38,000 of deductible contributions could be made to Sally's 401(k) account for 2017 ($18,000 employee elective deferral contribution plus $20,000 employer contribution based on 25% of salary). If Sally is age 50 or older, up to $44,000 could be contributed ($24,000 employee contribution plus $20,000 employer contribution).

In Example 2, up to $38,000 of deductible contributions could be made to both Fred and Phil's 401(k) accounts for 2017 ($18,000 employee elective deferral contribution plus $20,000 employer contribution based on 25% of salary). If Fred and Phil are age 50 or older, up to $44,000 could be contributed ($24,000 employee contribution plus $20,000 employer contribution).

Mechanics of Converting to S Corporation Status

It generally isn't necessary to go through the actual legal step of incorporation to convert an existing domestic LLC into an entity that will be treated as an S corporation for federal tax purposes. That's because the IRS allows an SMLLC or multimember LLC that otherwise meets the S corporation qualification rules to simply elect S corporation status by filing Form 2553 (Election by a Small Business Corporation). In this scenario, there's no need to file Form 8832 (Entity Classification Election) to reclassify an electing SMLLC or multimember LLC as an S corporation. (See Reg. 301.7701-3(c)(1)(v)(C) and the instructions to Form 8832.) See Reg. 301.7701-3(g) for the steps that are deemed to occur when the conversion to S corporation status becomes effective.

To convert an existing sole proprietorship or partnership into an S corporation, a corporation must be formed under applicable state law and business assets contributed to the new corporation as necessary. Then, an S election must be made for the new corporation by filing Form 2553 by no later than two months and 15 days after the beginning of the tax year for which the election is to take effect (i.e., by 3/15/17 for an election to be effective for calendar year 2017).

IRS Knows This Game

As you can see, an S corporation can serve as a vehicle for minimizing federal employment taxes. However, the IRS is well-aware of this strategy, and the tax-saving advantage is lost if the government successfully asserts that S corporation cash distributions are actually disguised salary payments. The corporation risks being hit with back employment taxes, interest, and penalties. Not good!

In 2002, a Treasury Inspector General for Tax Administration (TIGTA) report said IRS auditors should be devoting substantial attention to the issue of understated compensation for S corporation shareholder-employees. However, there is little evidence to show that has actually happened. That said, S corporation clients should be prepared to defend stated shareholder-employee salary amounts as being reasonable (albeit maybe on the low side of reasonable) for the work performed.

Courts Have Weighed in Too

There have been a number of court decisions on the subject of paying minimal salaries to S corporation shareholder-employees in order to minimize federal employment taxes. These decisions make it clear that purported S corporation cash distributions can be recharacterized as disguised shareholder-employee compensation, subject to federal employment taxes, when stated compensation payments are unreasonably low. For examples see *Radtke, Veterinary Surgical Consultants, and Watson, P.C.* In reality, these cases are not very illuminating because they involve obvious compensation understatements (although the stated salary in *Watson, P.C.* was a whopping $24,000). For a taxpayer victory on this issue, see *Carol Davis* where the government's assessment of employment taxes was found to be arbitrary and capricious and was thrown out.

Bottom Line: Taxpayers are unlikely to lose on this issue if they gather some evidence to demonstrate that outsiders could be hired to perform the same work for salaries equal to the stated (modest) salaries paid to shareholder-employees. In many cases, it won't be hard to find such evidence—especially while private sector wages remain less than robust.

Conclusion

Because of the risk of assessments for back federal employment taxes, penalties, and interest, tax advisers should be sensitive to potentially understated compensation paid to S corporation shareholder-employees. Alarm bells should go off when you see S corporations that generate significant income while paying little or no stated compensation to shareholder-employees. Of course, this is especially true with professional service corporations. That said, there's little guidance about what constitutes an unreasonably low level of compensation in the context of S corporation shareholder-employees. And lots of talented people work hard for modest compensation these days. Therefore, it seems prudent to follow a "cautiously-aggressive" approach in setting salary levels for S corporation shareholder-employees. Until further notice, we believe the deck is still stacked in favor of taxpayers on this issue—as long as stated salary amounts are not absurdly low.

Finally, there's no denying that operating as an S corporation will trigger other tax complications. A separate federal return will have to be filed on Form 1120S (and perhaps an additional state return too). Transactions between S corporations and their shareholders (including asset transfers upon formation) must be carefully scrutinized for potential tax consequences. State-law corporation requirements such as having board of directors meetings and keeping minutes must be respected. So operating as an S corporation is no free lunch. However, it can be a much less-expensive lunch after considering the federal employment tax savings.

References:

Rev. Ruls. 59-221, 1959-1 CB 225; and 91-26, 1991-1 CB 184.
IRS Ann. 92-16, 1992-5 IRB 53.
David E. Watson, P.C., 109 AFTR 2d 2012-1059 (8th Cir. 2012).
Davis, Carol, d/b/a Mile High Calcium, Inc., 74 AFTR 2d 94-5618 (DC Colorado 1994).
Ding, Paul B., 84 AFTR 2d 99-7517 (9th Cir. 1999).
Radtke, Joseph, S.C., 65 AFTR 2d 90-1155 (7th Cir. 1990).
Veterinary Surgical Consultants, P.C., 93 AFTR 2d 2004-1273 (3rd Cir. 2004).

Subscriber Note: This *Tax Action Memo* was written by Tax Action Panel member William R. Bischoff, CPA of Colorado Springs, Colorado.

tax.thomsonreuters.com/PPCSubscriptions/TABN (User Name: PTAB1016, Password: NEWS2U-1)

Tax Action Memo®

TAM-1827
December 20, 2016

Sample 2016 Form 1040 Preparation Checklists

Type of Clients: Individuals. **Situation:** As a due diligence measure, the use of a checklist is a step in your preparation of 2016 individual tax returns. **Deadline:** As returns are prepared.	**Tax Action Required:** Consider using or adapting one of the Form 1040 checklists included in this *Tax Action Memo*. These checklists reflect significant recent tax developments.

Background

With this release, we've included two checklists to help you prepare 2016 Forms 1040.

- Checklist 1 provides a comprehensive set of questions to help you prepare complex individual income tax returns.
- Checklist 2 is a shorter version of the checklist for use with simpler individual income tax returns.

These checklists can be downloaded at **tax.thomsonreuters.com/PPCSubscriptions/TABN**. (Check the top of the first page of the most recent *Tax Action Memo* you've received for the current PTAB user name and password.) At the PTAB Online Resource Center, click on "Preparation Checklists."

Subscriber Note: These checklists were adapted from *PPC's 1040 Deskbook*, which provides practical reporting guidance and scores of tips to make the 1040 preparation process as accurate and efficient as possible. More information on the two-volume *PPC's 1040 Deskbook* is available at **tax.thomsonreuters.com/store** or by calling (800) 431-9025.

Checklist 1—2016 Form 1040 Preparation (Long Version)

Client:_____________________________________Preparer:___________________Reviewer:__________

	Yes	No	N/A
1. Administrative Issues			
a. Has an engagement letter been prepared?	____	____	____
b. Has information known from work for other clients (e.g., a related closely held corporation) been considered when relevant to this return?	____	____	____
c. Has the impact of any recent correspondence from taxing authorities, including revenue agents' reports, been considered in preparing the return?	____	____	____
d. If a significant error was discovered on a previously filed return, has the client been advised to amend the return?	____	____	____
e. Have all required state returns been prepared or assigned for preparation?	____	____	____
f. If the return will not be filed electronically, did the client provide a signed and dated request to file a paper return and mail the return to the IRS?	____	____	____
2. Filing Status, Exemptions, and Carryovers			
a. Were other filing options considered? (For example, married filing separately or head of household, if eligible.)	____	____	____
b. If the taxpayer is a legally married same-sex couple, are they filing under a "married status?"	____	____	____
c. Were social security numbers listed for the taxpayer, spouse, and all dependents, and do they agree with Social Security Administration records?	____	____	____
d. If noncustodial parent is claiming dependency exemption, was Form 8332 attached?	____	____	____
e. Does the client qualify for an extra dependent exemption by supporting (or helping support) a parent (even if not living with the client)?	____	____	____
f. Was the prior year's tax return checked for the following carryover items:			
(1) Overpayment credited to current year's estimated tax payments?	____	____	____
(2) Net operating loss (regular and AMT) or capital loss?	____	____	____
(3) Deferred gain from installment sales?	____	____	____
(4) Percentage depletion?	____	____	____
(5) Passive activity losses and credits?	____	____	____
(6) Losses deferred by at-risk or basis limitations?	____	____	____
(7) Charitable contributions?	____	____	____
(8) Investment interest expense?	____	____	____
(9) Section 179 expense?	____	____	____
(10) Vacation home rental loss or home office deduction?	____	____	____
(11) General business, minimum tax, foreign, or residential energy efficient property credit?	____	____	____
(12) Section 1231 unrecaptured losses?	____	____	____
g. For computer-prepared returns, were manual changes made or an amended return prepared that could affect carryovers into the current return?	____	____	____
3. Wages, Salaries, Interest, and Dividends			
a. Were all W-2s examined for any unusual items?	____	____	____
b. If the client worked for two or more employers and had total wages in excess of $118,500, was a credit taken on Form 1040 for the excess FICA?	____	____	____
c. Has Form 8959 (Additional Medicare Tax) been prepared, if required?	____	____	____
d. Were 1099s and applicable broker statements compared to client-generated information (e.g., in organizer) and to prior year's return for significant fluctuations and for omissions that could indicate securities transactions?	____	____	____
e. Are there loans to/from family or closely-held corporations that require imputed interest?	____	____	____
f. If taxpayer reports taxable or tax-exempt interest on bonds, has Original Issue Discount (OID) or market discount or premium been considered?	____	____	____
g. Was bond interest income offset with interest purchased between payment dates?	____	____	____
h. For interest on U.S. savings bonds, has the college education exclusion been considered?	____	____	____
i. For loans made to/from pass-through entities, have the self-charged interest rules been considered?	____	____	____

Checklist 1—2016 Form 1040 Preparation (Long Version) (Continued)

	Yes	No	N/A
j. Were capital gain distributions, nontaxable dividends (return of capital), and dividends reinvested properly accounted for?			
k. Were qualified dividends received that are subject to the reduced tax rate?			
l. Has the election to report children's interest and dividends on the parent's return been considered? If the election is made, has Form 8814 been prepared?			
4. Capital Asset Transactions			
a. Were 1099s and any closing statements for capital transactions reviewed?			
b. Were security transactions reported on Form 1099-B reconciled to Form 8949?			
c. On year-end sales of securities, was the trade date (rather than the settlement date) used to determine year of taxability?			
d. If mutual fund or stock shares were sold, was any additional basis from dividend reinvestments considered when gain or loss was determined?			
e. If securities were sold at a loss, were the wash sale rules considered?			
f. Was the proper capital gain rate applied to any collectible, Qualified Small Business Stock (QSBS), or unrecaptured Section 1250 gains?			
g. For installment sales, was all depreciation recapture reported in year of sale (even if no proceeds were received)?			
h. Has a Section 453(d) "election out" been considered for installment sales?			
i. For any property dispositions, was ordinary income recapture under Sections 1245, 1250, and 1254 considered?			
j. For sales of depreciable property to related parties, were the Section 1239 ordinary income requirements considered?			
k. Was the ordinary income recapture of prior Section 1231 losses considered?			
l. Should a worthless stock or securities loss be recognized this year?			
m. Was Section 1244 stock treatment considered for losses from worthlessness or dispositions of small business stock?			
n. Do any nonbusiness bad debts exist?			
o. Were any transactions conducted in a virtual currency, such as BitCoins?			
p. Were like-kind exchanges reported on Form 8824?			
q. If the taxpayer's principal residence was sold or destroyed, have the gain exclusion rules been considered and applied? Have periods of disqualified use been considered?			
r. Was appropriate portion of gain on sale of bonds recharacterized as ordinary rather than capital gain to the extent attributable to accrued market discount?			
s. If QSBS was sold, has gain been excluded or deferred if eligible?			
t. Has consideration been given to whether the taxpayer qualifies as a stock trader rather than investor? [Section 475(f) election may be needed.]			
u. Do the mortgage debt relief provisions of up to $2 million on a joint return apply?			
5. Trade or Business Issues			
a. Accounting methods:			
(1) Are the accounting methods used consistent with the preceding period?			
(2) Have the uniform capitalization rules been followed where required?			
(3) Was the accrual method of accounting used when required (i.e., when production, purchase, or sale of goods is material to the return)?			
(4) If taxpayer qualifies, has the cash method of accounting been considered even if the taxpayer maintains inventories?			
(5) Does a proposed change in accounting method meet the automatic change requirements?			
b. Cost recovery considerations:			
(1) Has bonus depreciation been claimed on qualifying assets?			
(2) Was the best use of the Section 179 deduction considered (e.g., to minimize the effect of the midquarter convention), and was the deduction limited to taxable income from active trades or businesses?			
(3) Is midquarter convention required due to over 40% additions in the fourth quarter?			
(4) Were separate basis and cost recovery records maintained for AMT?			
(5) Were adjustments made for obsolete, abandoned, or out of service assets?			
(6) Has the taxpayer maintained required documentation indicating the business and personal use of listed property?			
(7) Is any listed property used 50% or less for business depreciated using the straight line method over the applicable recovery period?			

Checklist 1—2016 Form 1040 Preparation (Long Version) (Continued)

	Yes	No	N/A
(8) If the taxpayer uses leased automobiles in a trade or business, have the price-based inclusion amounts been considered?	____	____	____
(9) Have the luxury auto depreciation limits (including higher limits for bonus depreciation and light trucks, vans, and SUVs) for vehicles been considered?	____	____	____
(10) Were leasehold improvements, restaurant buildings and improvements, and retail space improvements considered for Section 179 deductions and 15-year recovery period?	____	____	____
(11) Have all website development costs been properly treated for tax purposes?	____	____	____
(12) Have assets that were acquired in a like-kind exchange been properly depreciated?	____	____	____
c. Other issues:			
(1) If the taxpayer qualifies for a home office deduction, was Form 8829 completed?	____	____	____
(2) Has the safe-harbor deduction election been considered for a qualifying home office?	____	____	____
(3) Has self-employment (SE) tax been calculated when necessary?	____	____	____
(4) Have the hobby loss rules been considered?	____	____	____
(5) Was the meals and entertainment deduction limited to 50% where required?	____	____	____
(6) Were deductible local lodging and transportation costs considered?	____	____	____
(7) Have business investigation and start-up costs been properly handled?	____	____	____
(8) Have various business credits been considered, including the small business health insurance credit?	____	____	____
(9) Has the Section 199 domestic producer deduction been considered?	____	____	____
(10) Have lease agreements been reviewed to determine whether leased assets should be capitalized for tax purposes?	____	____	____
6. Pass-through Entities and Passive Activities			
a. Were all pass-through entities that were reported in the prior year's return considered or otherwise accounted for in the current year?	____	____	____
b. Were the tax basis and at-risk limitations (IRC Sec. 465) of each partnership or S corporation interest considered before claiming a loss from such interest?	____	____	____
c. Were any S corporation shareholder loans that permitted loss deductions in prior years repaid by the S corporation during the year? [This reduces the basis for losses and could result in gain recognition—see IRC Sec. 1367(b)(2).]	____	____	____
d. Has the tax basis in S corporation stock been properly disclosed in the return?	____	____	____
e. Were any "outside partnership" expenses treated correctly?	____	____	____
f. Is a deduction for abandonment or worthlessness of a partnership interest appropriate?	____	____	____
g. Has any interest expense on funds borrowed to invest in a partnership, S corporation, or LLC been properly reported on Schedule E, Part II?	____	____	____
h. Has the client's participation level been confirmed? Is the real estate professional test met?	____	____	____
i. Were the passive activity loss and at risk limitations considered?	____	____	____
j. Have passive activity groupings been properly disclosed in the return?	____	____	____
k. Have any suspended losses been treated correctly upon dispositions of passive activities?	____	____	____
g. Were the PAL limitations for each Publicly Traded Partnership (PTP) calculated separately from all other passive activities?	____	____	____
7. Other Income Considerations			
a. Were state/local income tax refunds considered?	____	____	____
b. Was any alimony received reported correctly?	____	____	____
c. If taxpayer is age 70½ or older, were required minimum distributions from traditional IRAs, SEPs, and Keoghs taken?	____	____	____
d. Was the 60-day requirement for any retirement plan rollovers met?	____	____	____
e. If any traditional IRAs were converted to Roth IRAs in 2016, has an election to recharacterize the conversion been considered?	____	____	____
f. Were there any distributions from HSAs?	____	____	____
g. Was the taxability of disability or unemployment income considered?	____	____	____
h. Were kiddie tax rules considered for children under age 24?	____	____	____
i. Have any damages for unlawful incarceration been excluded from income?	____	____	____
j. Were other sources of income, such as gambling winnings, damages, or fringe benefits considered?	____	____	____
8. Adjustments to Income			
a. Have the deductions for the employer portion of SE tax and 100% of medical insurance premiums for self-employed taxpayers been considered?	____	____	____

Checklist 1—2016 Form 1040 Preparation (Long Version) (Continued)

		Yes	No	N/A
b.	Were any IRA contributions made by 4/18/17 (and Keogh/SEP/SIMPLE IRA employer contributions made by the extended due date)?	_____	_____	_____
c.	Has any self-employed Keogh/SEP contribution been limited to the appropriate percentage of net SE income less plan contributions and the SE tax deduction?	_____	_____	_____
d.	Does any alimony paid qualify for deduction?	_____	_____	_____
e.	Has a deduction been claimed for any qualifying student loan interest or tuition and fees?	_____	_____	_____
f.	Has the deduction of up to $250 out-of-pocket educator expense been considered?	_____	_____	_____

9. Deductions and Losses

		Yes	No	N/A
a.	Has the additional standard deduction for the elderly/blind been considered?	_____	_____	_____
b.	Was the standard deduction limited if taxpayer is a dependent on another's return?	_____	_____	_____
c.	Has the election to deduct qualifying casualty losses in the preceding year been considered?	_____	_____	_____
d.	Have professional fees related to Schedules C, E, and F been deducted on those schedules?	_____	_____	_____
e.	Is the client's home mortgage interest deduction affected by the $1 million/$100,000 limitation?	_____	_____	_____
f.	Was the home mortgage points deduction considered?	_____	_____	_____
g.	If personal residence debt was refinanced during the year, were any unamortized points from a previous refinancing deducted?	_____	_____	_____
h.	Were investment interest limitations considered (including the election to treat LTCGs and qualified dividends as investment income)?	_____	_____	_____
i.	Were noncash contributions properly reported and substantiated, including special rules for donations of vehicles and boats?	_____	_____	_____
j.	Was Form 8283 filed (and an appraisal obtained when required) if noncash contributions exceed $500?	_____	_____	_____
k.	Are all cash donations properly substantiated and were written statements obtained from the charities for any donations of $250 or more?	_____	_____	_____
l.	Have any qualified charitable distributions from the taxpayer's IRA been properly excluded from income and not deducted?	_____	_____	_____
m.	Were estimated tax payments made to state and local governments in the first quarter of 2016 (for 2015) deducted? (And 2016 fourth quarter payments made in January 2017 excluded?)	_____	_____	_____
n.	Has the sales tax deduction been considered?	_____	_____	_____

10. Credits, Payments, and Other Matters

		Yes	No	N/A
a.	If taxpayer was divorced during the year and made joint estimated payments before the divorce, have they been properly allocated between the former spouses?	_____	_____	_____
b.	Has the premium assistance credit for health care premiums been considered, including reconciliation with advance payments that may need to be repaid?	_____	_____	_____
c.	Was the child care credit considered for working families?	_____	_____	_____
d.	Was eligibility for the child tax credit and the adoption credit considered?	_____	_____	_____
e.	Were the American Opportunity Tax and Lifetime Learning Credits considered (including whether the student rather than parent should take the credit)?	_____	_____	_____
f.	Has the health care individual responsibility tax been considered? If the taxpayer qualifies for an exemption, has Form 8965 been attached to the return?	_____	_____	_____
g.	Were the foreign tax (Form 1116), disabled access (Form 8826), general business (Form 3800), and minimum tax (Form 8801) credits considered?	_____	_____	_____
h.	Was the credit for certain retirement savings contributions considered?	_____	_____	_____
i.	Have additional taxes on retirement plan early distributions or excess contributions been considered (Form 5329)?	_____	_____	_____
j.	Was the penalty for underpayment of 2016 tax considered and an estimate prepared for 2017?	_____	_____	_____
k.	Has AMT been considered?	_____	_____	_____
l.	Have any tax planning opportunities or leads for additional service to the client been identified and documented for follow-up after busy season?	_____	_____	_____
m.	If Schedule H (Household Employees) is needed, has it been prepared?	_____	_____	_____
n.	If the taxpayer has net investment income and modified AGI above the applicable threshold, has the 3.8% net investment income tax been calculated and reported on Form 8960?	_____	_____	_____
o.	Have inquiries been made and forms completed regarding ownership in or signature authority over foreign bank accounts or ownership of other foreign financial assets?	_____	_____	_____

Checklist 1—2016 Form 1040 Preparation (Long Version) (Continued)

	Yes	No	N/A
11. Taxpayer and Preparer Penalties			
a. Consider if substantial understatement of income tax could result from the disallowance of any deduction or loss item on the return. If so:			
(1) Does substantial authority exist for the deduction of loss item in question?	____	____	____
(2) If not, was adequate disclosure of the tax position made in the return?	____	____	____
b. Has the client been properly apprised of any controversial or aggressive tax positions? (The client should decide positions—not the preparer.)	____	____	____
c. Have client discussions regarding return positions and potential penalties been documented in the work papers?	____	____	____
d. For positions that do not meet the substantial authority standard, have the tax return disclosure requirements of the preparer penalty regulations been compiled with?	____	____	____
e. If disclosure is made on Forms 8275 or 8275-R, does the return transmittal letter so indicate? (This could avoid preparer penalties if the client later removes form.)	____	____	____
f. Have the due diligence requirements been met with respect to the earned income credit, the child tax credit (including the additional child tax credit), and the American Opportunity Tax Credit? Has Form 8867 been submitted for each credit claimed?	____	____	____

Checklist 2—2016 Form 1040 Preparation (Short Version)

Client:______________________________________Preparer:___________________Reviewer:__________

	Yes	No	N/A
Administrative Issues			
1. Engagement letter prepared?	_____	_____	_____
2. Has any work from related clients that affects this return been considered?	_____	_____	_____
3. Have related (state, local, foreign) returns been prepared or assigned for preparation?	_____	_____	_____
Filing Status, Exemptions, etc.			
1. Married filing separately, head of household, or other filing options considered?	_____	_____	_____
2. Taxpayer's social security number and name same as on social security card?	_____	_____	_____
3. For noncustodial parent, Form 8332 attached, if needed?	_____	_____	_____
4. Filing as married status if taxpayer is a legally married same-sex couple?	_____	_____	_____
5. Carryovers (NOL, passive losses, etc.) picked up from prior return?	_____	_____	_____
Wages, Salaries, Interest/Dividends, and Other Income			
1. Credit taken on Form 1040 if more than two employers and total wages over $118,500?	_____	_____	_____
2. Interest purchased between payment dates offset with bond interest income?	_____	_____	_____
3. Form 8959 (Additional Medicare Tax) attached if required?	_____	_____	_____
4. Were any state/local tax refunds considered (if deducted in prior year)?	_____	_____	_____
Capital Asset Transactions			
1. If securities were sold, was any additional basis from dividend reinvestments considered?	_____	_____	_____
2. Ordinary income recapture from prior Section 1231 losses considered?	_____	_____	_____
3. Nonbusiness bad debts, Section 1244 ordinary loss, and worthless securities deduction considered?	_____	_____	_____
Trade or Business Issues			
1. Is accrual method required?	_____	_____	_____
2. Section 179 deduction/bonus depreciation considered?	_____	_____	_____
3. Proper documentation of business use of listed property maintained?	_____	_____	_____
4. Appropriate adjustments made for abandoned assets?	_____	_____	_____
5. Hobby loss rules considered?	_____	_____	_____
6. Available exceptions to the 50% meals/entertainment rule considered [IRC Sec. 274(n)]?	_____	_____	_____
7. Qualified leasehold improvements, restaurant buildings and improvements, and retail space improvements considered for Section 179 deductions and 15-year recovery period?	_____	_____	_____
8. Substantiation available for T&E, business gifts, and listed property usage?	_____	_____	_____
9. Passive Activity Loss (PAL) limitations considered and passive activity groupings properly disclosed?	_____	_____	_____
10. Were suspended PALs, if any, deducted on disposition of activity?	_____	_____	_____
11. Has the safe-harbor deduction election been considered for a qualifying home office?	_____	_____	_____
Pass-through Entity Interests			
1. Was interest incurred to invest in a partnership or S corporation reported on Schedule E, Part II?	_____	_____	_____
2. Tax basis in S corporation interest properly disclosed?	_____	_____	_____
Adjustments to Income			
1. Deductions for employer portion of SE tax and 100% medical insurance considered for SE taxpayers?	_____	_____	_____
2. IRA and other retirement plan contributions made by appropriate due date?	_____	_____	_____
Deductions and Losses			
1. All charitable contributions properly substantiated?	_____	_____	_____
2. Any professional fees related to Schedules C, E, and F deducted on those schedules?	_____	_____	_____
Credits, Payments, and Other Matters			
1. American Opportunity Tax and Lifetime Learning credits considered?	_____	_____	_____
2. If applicable, Schedule H (Household Employees) completed?	_____	_____	_____
3. Small business health insurance credit considered?	_____	_____	_____
4. The 3.8% net investment income tax calculated and reported on Form 8960 if required?	_____	_____	_____
5. Ownership of foreign assets determined and Form 8938 attached if required?	_____	_____	_____
6. Required distributions from traditional IRAs, SEPs, and Keoghs taken if taxpayer is age $70^1/_2$ or older?	_____	_____	_____
7. Were the kiddie tax rules considered for children under age 24?	_____	_____	_____
8. Premium tax credit considered and any advance payments received reconciled and repaid as needed?	_____	_____	_____
9. Health care individual responsibility tax been considered and Form 8965 attached if the taxpayer qualifies for an exemption?	_____	_____	_____
Taxpayer and Preparer Penalties			
1. If substantial authority does not exist for substantial tax positions, was adequate disclosure made?	_____	_____	_____
2. Controversial positions and potential penalties discussed with client and documented in work papers?	_____	_____	_____
3. All tax positions not meeting the substantial authority standard are reasonable and adequately disclosed?	_____	_____	_____
4. Return was filed electronically or upon receipt of a signed request it was mailed by client?	_____	_____	_____

National Tax Advisory®

TO: All Professional Tax Personnel — **NTA-970**
FROM: Robin Tuttle Christian, CPA — **DATE:** December 20, 2016

RE: Cures Act Exempts Qualified Small Business HRAs from the Market Reform Penalty

Background

The 21st Century Cures Act (Cures Act) was signed by the president on 12/13/16. The Cures Act covers a wide range of nontax health subjects, but along with those it includes a provision exempting qualified small employer Health Reimbursement Arrangements (HRAs) from group health plan requirements and the market reform penalty. [See Act Section 18001 adding IRC Sec. 9831(d).] This is good news for small employers who want to help employees with medical expenses, but don't want the hassle and expense of furnishing a full-fledged company health insurance plan. Here's the deal, beginning with some history.

HRAs after the ACA

The Affordable Care Act (ACA) legislation established a number of so-called market reform restrictions on employer-provided group health plans, starting with plan years beginning in 2014. These restrictions generally apply to all employer-provided group health plans—including those furnished by small employers with less than 50 workers. A punitive penalty of $100 per-day per-employee (up to $36,500 per-employee over the course of a full year) applies to plans that run afoul of the market reform restrictions (IRC Sec. 4980D). Ouch!

HRAs are essentially medical reimbursement plans that contain a carryover feature. To the extent an employee has an authorized reimbursement amount under the employer plan, but has not fully drawn that amount during the year, the excess may carry forward to the next tax year.

The market reform penalty pretty much put the brakes on standalone HRAs. This is because HRAs generally are considered to be group health plans subject to market reform restrictions (Notice 2013-54). The only way for an HRA to meet the market reform restriction is for it to be coordinated with insurance coverage, so that the combined arrangement provides an ACA-approved group health plan. A standalone HRA does not meet the requirements and is, therefore, subject to the market reform penalty. While, technically standalone HRAs are still allowable under the Tax Code, they're subject to the horrific market reform penalty. No thanks!

The market reform penalty also put the kibosh on employer payment arrangements, a type of HRA long favored by small employers. With an employer payment arrangement, the employer reimburses employees for premiums they pay for individual health insurance policies (or the employer pays the premiums directly). The reimbursements are tax-free to the employee as long as the employer: (1) makes the reimbursements under a written Section 105 medical reimbursement plan and (2) verifies that the reimbursements are spent for health insurance coverage (IRC Secs. 105 and 106; Rev. Rul. 61-146).

With a few limited exceptions, employer payment arrangements fail to meet market reform restrictions because, among other reasons, group health plans that are used to purchase coverage in the individual market cannot be integrated with individual market policies. Therefore, such arrangements, while still allowable under the Tax Code, are generally subject to the market reform penalty (Notice 2013-54). Again, no thanks.

Exception for One-employee Arrangements. The market reform restrictions do not apply to HRAs with only one participating employee (Notice 2013-54). Therefore, such arrangements can be used to reimburse one employee for his or her medical costs, including individual health insurance premiums, without triggering the market reform penalty.

Qualified Small Business HRAs Now Exempt from the Market Reform Penalty

Under the Cures Act, for tax years beginning after 2016, a qualified small employer HRA is exempt from the market reform penalty. A *qualified small employer HRA* is one that meets all of the following requirements [IRC Sec. 9831(d)(2)]:

- It is maintained by an *eligible employer*—one that employs fewer than 50 employees (including full-time equivalent employees) during the prior year and does not offer a group health plan to any of its employees.

- It is provided on the same terms to all the employer's eligible employees. The HRA may exclude employees who haven't completed 90 days of service or attained age 25, part-time or seasonal workers, employees covered in a collective bargaining unit, and certain nonresident aliens. Also, benefit payments can vary based on the price of coverage in the relevant individual health insurance market due to age and family size. However, it cannot be offered on a select basis, such as to only the owner and top level employees.

- It is funded solely by employer contributions. Salary reduction contributions cannot be allowed.

- It provides for the payment, or reimbursement, of an eligible employee's (or eligible family member's) deductible medical expenses, as defined by IRC Sec. 213(d), up to $4,950 ($10,000 if the HRA covers the eligible employee's family members). The limit is prorated for employees covered by the HRA for less than an entire year and is adjusted for inflation for years beginning after 2016.

Reimbursements under the HRA May Be Taxable. Payments or reimbursements from a qualified small employer HRA aren't treated as paid or reimbursed under employer-provided health plan if, for any month in which such medical care is provided the individual does not have Minimum Essential Coverage (MEC). (*MEC* is basically health insurance coverage under an employer plan or a health plan in the individual market.) This means that the reimbursements and/or payments are *not* excludable from the employee's income under IRC Secs. 105 or 106 unless the employee (or family member) has MEC [IRC Sec. 106(g)].

Observation: Employers will presumably need to set up some sort of procedure to determine if the employee has the required MEC for the entire year. Hopefully, we'll get guidance as to what is required here.

Effect on Premium Assistance Tax Credit. Generally, an individual meeting certain income criteria, who enrolls in individual coverage through an insurance marketplace, qualifies for a premium assistance credit. The premium assistance tax credit may be reduced (or not allowed) for any month that an employee is provided benefits under a qualified small employer HRA, depending on the cost of the relevant silver-plan coverage in the marketplace and the individual's household income [IRC Sec. 36B(c)(4)].

Employer Reporting Requirements. An employer that makes a contribution to a qualified small employer HRA for any year must provide a written notice to each eligible employee no later than 90 days before the beginning of such year (or, for employees not eligible on the first day of the year, the date on which such employee is first eligible) [IRC Sec. 9831(d)(4)]. The notice must include all of the following:

- The amount of the employee's permitted benefit under the HRA for the year.
- A statement that the eligible employee should disclose this permitted benefit amount to the Exchange if the employee seeks advance payment of the premium assistance tax credit.
- A warning that an employee who does not have MEC for any month may be subject to the individual shared responsibility penalty and reimbursements under the HRA may be includible in gross income.

Under a transition rule, for 2017, the notice must be provided by 3/13/17—90 days after the Cures Act's enactment date of 12/13/16. An employer that fails to provide the required notice may be subject to a $50 per-employee, per-failure penalty, up to a $2,500 calendar year maximum for all such failures [IRC Sec. 6652(o)].

Employers must also report contributions to the HRA on their employees' Form W-2s [IRC Sec. 6051(a)(15)].

Effect on Employer Payment Arrangements. Beginning with the 2017 tax year, an eligible small employer that does not sponsor a group health plan can set up an HRA to reimburse employees for up to $4,950 ($10,000 if the HRA covers the employee's family members) of premiums, as adjusted for inflation, paid for individual health insurance policies as long as the HRA—

(1) provides coverage on the same terms to all the employer's eligible employees, and

(2) is funded solely by employer contributions.

Employees cannot use salary deferrals to make premium payments. However, employer reimbursements of premiums paid for individual health insurance policies should be excludable from the employees' income. [Because the employer is reimbursing (or paying) individual health insurance policies, the employee should meet the MEC requirement, unless the policy only covers limited-scope benefits. The employer should know about the insurance because, as discussed earlier, it must verify that the reimbursements are spent for health insurance in order for the income to excludable from income under IRC Secs. 105 and 106.]

Effective Date. The qualified small employer HRA exception and reporting requirements are generally effective for tax years beginning after 2016. However, the Cures Act provides transition relief for pre-2017 tax years.

Transition Relief for Pre-2017 Tax Years

Under a transition rule, the penalty relief provided by Notice 2015-17 is treated as applying to tax years beginning before 2017. Therefore, for pre-2017 tax years, HRAs of small employers with fewer than 50 employees won't be subject to the market reform penalty even if they aren't qualified small employer HRAs. Notice 2015-17 penalty relief was discussed in detail in NTA-905,[1] dated 3/10/15. Essentially, Notice 2015-17 offered relief from the market reform penalty for the following:

1. Employer payment arrangements sponsored by small employers with fewer than 50 full-time employees (including full-time equivalent employees) during the prior year. Technically this exemption applied to employer paid or reimbursed premiums on employees' individual health insurance policies made from 1/1/14–6/30/15, but the Cures Act extends the exemption to payments made through 2016.
2. S corporation employer payment arrangements that benefit *only* more-than-2% shareholder-employees.

[1] A copy of this article has been placed on PPC's website for the benefit of those who were not subscribers when it was originally published. To retrieve or view the article, go to **tax.thomsonreuters.com/PPCSubscriptions/TABN**. (Check the top of the first page of the most recent *Tax Action Memo* you've received for the current PTAB user name and password.) At the PTAB Online Resource Center, click on "Articles Mentioned in Previous Issues."

Conclusion

The Cures Act restores, at least in part, the ability of small employers to simply reimburse employees for premiums paid on individual policies, without having to fuss with group health plans. Thank you, Congress. Although, it may be a little late for 2017 plan years if the employer is already set up to provide group coverage, it's an option you'll want to discuss with your small business clients.

References:

IRC Secs. 36B, 105, 106, 4980D, 6051(a)(15), 6652(o), and 9831(d).
Notices 2013-54, 2013-40 IRB 287 and 2015-17, 2015-10 IRB 845.
Rev. Rul. 61-146, 1961-2 CB 25.