2016 Year-End Tax Planning for Businesses

The time to consider tax-saving opportunities for your business is before its tax year-end. Some of these opportunities may apply regardless of whether your business is conducted as a sole proprietorship, partnership, limited liability company, S corporation, or regular corporation. Other opportunities may apply only to a particular type of business organization. This *Tax Letter* is organized into sections discussing year-end, and year-round, tax-saving opportunities for:

- All businesses
- Partnerships, limited liability companies, and S corporations
- Regular (C) corporations

Tax planning for businesses also requires consideration of the tax consequences to the individual owners. Accordingly, we suggest you also review our December *Tax Letter* entitled *2016 Year End Tax Planning for Individuals*.

This *Tax Letter* only discusses federal tax planning. However, state taxes also should be considered because the tax laws of many states do not follow the federal tax laws. Your client service professional may be consulted for guidance regarding individual state tax planning or multi-state tax planning opportunities when your business operates in more than one state.

This *Tax Letter* includes a discussion of a number of tax incentives that have been enacted or extended by legislation over the last several years. The most significant change is that, at the end of 2012, Congress made permanent an individual rate structure, including the special capital gains and qualified dividend rates, consisting of a combination of the structure in effect prior to 2001 and the temporary structure in effect from 2001 through 2012. Federal tax law now provides for a 39.6% tax rate on high-income individuals, and a maximum 20% tax rate on long-term capital gains and qualified dividends.

In December 2015, the House and Senate passed the *Protecting Americans from Tax Hikes Act of 2015* (the PATH Act) and President Obama signed the PATH Act into law on December 18, 2015. The PATH Act did considerably more than the typical year-end tax legislation to extend expiring tax provisions seen in prior years. It made permanent over 20 key tax provisions, including the research tax credit, enhanced section 179 expensing, and the 100% gain exclusion for qualified small business stock. It also extended other provisions, including bonus depreciation, for five years, and revived many others for two years. In addition, many expiring tax provisions were enhanced while being extended further or made permanent.

The year 2016 was the fourth year in which a tax imposed on individuals, estates, and trusts was effective. Enacted in 2010, a 3.8% tax is imposed on the net investment income of these taxpayers in excess of specified threshold amounts. Although the tax is not imposed on C corporations, S corporations, or entities classified as partnerships for federal tax purposes, the tax could apply to dividends from C corporations and to certain income from flow-through entities that is allocated to taxpayers subject to the tax. The 2010 legislation also increased the employee's share of the hospital insurance tax from 1.45% to 2.35% on wages and in excess of certain thresholds, thus increasing the total combined employee and employer tax rate to 3.8% on such wages. A comparable change was made to the tax on self-employment income.

In April 2016, the Internal Revenue Service and Treasury Department issued proposed regulations under section 385 addressing the characterization of certain related-party debt instruments as debt or equity for United States tax purposes. The proposed regulations under section 385 would authorize the Service to treat certain related-party interests in a corporation as indebtedness in part and stock in part for federal tax purposes, and establish threshold documentation requirements that must be satisfied in order for certain related-party interests in a corporation to be treated as indebtedness for federal tax purposes. Additionally, the proposed regulations would treat certain related-party interests as stock that otherwise would be

treated as indebtedness for federal tax purposes. These proposed regulations have been controversial and generated a number of comments letters raising concerns about the new rules. In addition, certain members of Congress have asked for the proposed regulations to be revised and reissued as proposed regulations and for a delay in finalizing such regulations. However, on October 13, 2016, the Service issued final and temporary regulations under section 385 which basically adopted the rules contained in the proposed regulations, with the exception of a "bifurcation" rule, along with certain exemptions for cash pools, short-term loans, foreign-to-foreign transactions, regulated financial entities, and pass-through entities. The final and temporary regulations also provide documentation relief for debt issued by domestic corporations.

A complete discussion of these new taxes is beyond the scope of this letter. For a more complete discussion of the tax on net investment income, see our *2016 Year-End Tax Planning for Individuals*.

Finally, the November 2016 national elections could usher in significant changes in tax law and administration. Although the Republican Party maintained control of the House of Representatives and the Senate, the margins of control have been slightly reduced. In addition, the Republican Party will control the White House for the first time in eight years. In view of the possibility of tax changes in 2017 and beyond, it is impossible to predict what changes may be made and when such changes might become effective. The balance of this letter has been prepared on the assumption that no significant changes will be enacted or become effective in 2017. However, appropriate consideration should be given to the possibility of such changes.

Tax Saving Opportunities for All Businesses

2016 Versus 2017 Marginal Tax Rates

Whether you choose to accelerate taxable income into 2016 or defer it until 2017 depends, in part, on the marginal tax rate for each year projected for your business. Generally, unless your 2016 marginal tax rate will be significantly lower than your 2017 marginal tax rate, you should defer taxable income to 2017.

The marginal tax rate is the rate applied to your next dollar of income or deduction. Projections of your business's 2016 and 2017 income and deductions are necessary to determine the marginal tax rate for each year.

Your client service professional can be consulted to recommend how your business can shift income and deductions between these years to minimize your tax liability. (Also see our *2016 Year-End Tax Planning Letter for Individuals*.)

In addition, the circumstances of an individual taxpayer may cause the marginal or effective tax rate to be higher in one year than in the other year. While the maximum marginal federal tax rate is 35% for C corporations, the maximum marginal federal tax rate for individuals is nominally 39.6%. Moreover, the combined effect of certain phase-out provisions for high-income individuals and the additional 3.8% tax on net investment income could push the effective marginal tax rate on high-income individuals to levels approaching 45%. If the relevant tax rate is expected to be approximately the same for each of 2016 and 2017, consider taking advantage of various tax rules that allow taxable income or gain to be deferred, such as sales of stock to an employee stock ownership plan, like-kind exchanges, involuntary conversions, and tax-free merger and acquisition transactions.

Cash Versus Accrual Accounting

Except for farming businesses and certain qualified personal service corporations, taxable (C) corporations and partnerships that have a C corporation as a partner must use an accrual method of accounting if their average annual gross receipts for the three prior taxable years are more than $5 million, regardless of the type of business in which they are engaged. If their average annual gross receipts are $5 million or less, C corporations and partnerships that have a C corporation as a partner can use the cash method of accounting unless they have inventories, in which case they must use an accrual method of accounting.

All other taxpayers, including S corporations and C corporations that are qualified personal service corporations, can use the cash

method of accounting regardless of their average annual gross receipts. However, if they have inventories, they must use an accrual method for purchases and sales, with the exception of certain qualifying small business taxpayers having average annual gross receipts for the prior three taxable years of not more than $10 million. Supplies consumed in the rendering of services are not inventory. In addition, some taxpayers in certain businesses have been successful in persuading courts that certain types of tangible property transferred to customers in connection with the provision of services are not inventory if the property is incidental to the performance of services.

The Internal Revenue Service has provided a de minimis exception with regard to the use of an accrual method of accounting. Under this exception, a taxpayer can use the cash method of accounting if it has average annual gross receipts of $1 million or less. If the taxpayer has inventories, it can deduct the cost of the inventory only when sold.

Planning Suggestion: A corporation that must change to an accrual method because its average annual gross receipts for the three prior taxable years exceed $5 million should consider an S corporation election if an accrual method is undesirable, assuming it is otherwise qualified to be an S corporation. An S corporation election, to be effective beginning with the current taxable year, must be made by filing Form 2553, Election by a Small Business Corporation, on or before the 15th day of the third month of the taxable year for which it is to take effect. (The Service has the authority to grant relief for a late or improperly filed Form 2553, even for a prior year.) Please consult your client service professional to determine whether an S corporation election is appropriate for your corporate business.

A business using an accrual method that qualifies to use the cash method may obtain permission from the Service to change to the cash method by filing an IRS advance consent Form 3115, Application for Change in Accounting Method, no later than the last day of the year of change. (An automatic consent procedure is available for certain qualifying small business taxpayers having average annual gross receipts for the prior three taxable years of not more than $10 million to change to the cash method.) On the other hand, a business currently using the cash method that wishes to voluntarily change to an accrual method may, in certain circumstances, do so by filing an automatic consent Form 3115 with its timely-filed (including extensions) federal income tax return (which, in most cases, will be the 2016 return). An accrual method may be desirable, for instance, if accrued expenses exceed accrued income.

Any change of accounting method must be made in compliance with IRS approval procedures. Your client service professional can be contacted for further information.

Advance Payments

Cash-method taxpayers recognize revenue when cash is actually or constructively received. Accrual-method taxpayers recognize revenue upon the earliest of when (1) payment is earned through performance, (2) payment is due, or (3) payment is received. However, under a 2004 revenue procedure, payments received by an accrual-method taxpayer in advance of services being performed or goods being delivered can be deferred to the next succeeding taxable year if such payments are reported on the taxpayer's "applicable" financial statements as deferred revenue, or if earned in a later taxable year in the absence of

applicable financial statements. Deferral is also available for advance payments received for the use of intellectual property, certain guaranty or warranty contracts, and the sale, lease, or license of computer software. If an accrual-method taxpayer wishes to change its present method of accounting for recognizing advance payments to a method consistent with the one-year deferral method described in the revenue procedure, generally such change can be made by filing an automatic consent Form 3115 with its timely-filed federal income tax return (including extensions). Similarly, a cash-method taxpayer desiring to change to an overall accrual method, as well as adopt the one-year deferral method for advance payments, may file a single combined automatic consent Form 3115.

In addition, under existing income tax regulations, advance payments received by an accrual-method taxpayer with respect to an agreement (*e.g.*, a gift card) for the sale of inventoriable goods may be deferred for two years unless required to be included in income earlier for financial statement purposes. Qualifying taxpayers wishing to change to this method of accounting are required to file an advance consent Form 3115 with the Service no later than the last day of the year of change and attach an annual information statement with the federal income tax return.

Related-Party Transactions

Accrual-method taxpayers may not deduct salaries, bonuses, interest, rent, or other expenses owed to related cash-method parties until payments are made.

Related parties include:

- An individual and his or her more than 50%-owned corporation;
- Partnerships and their partners;
- S corporations and their shareholders;
- Two corporations having more than 50% common ownership; and
- A corporation and a partnership, if the same persons own more than 50% of each entity.

Unrelated Party Compensation

Accrued compensation, including bonuses and vacation pay which are payable to unrelated employees, reduces an employer's taxable income. However, these deductions are also subject to restrictions. For accrual-method employers, the fact of the liability to pay the compensation must be fixed and determinable by the end of the taxable year to generate a deduction for compensation accrued by the employer's year-end. The Service issued additional guidance in recent years on the application of these requirements to bonus plans. Please consult with your client service professional before year-end to determine if your bonus plan or plans meet these requirements.

In addition to the foregoing requirements, for the accrual-method employer to obtain a current deduction for compensation, the 2016 accrued compensation must be paid to unrelated employees (and cash-method independent contractors) within 2½ months after the end of the taxable year. Otherwise, this compensation is treated as deferred compensation and is deductible only when paid.

Note: Vested deferred compensation, although not currently deductible, is considered "wages" for FICA and FUTA tax purposes. Note also that under the section 409A deferred compensation rules discussed below and in our 2016 year-end *Tax Letter for Individuals*, certain items with deferred payment dates will now be currently taxed to the employee (with a corresponding deduction to the employer).

Planning Suggestion: Employers with taxable years that end in October, November, or December 2016 should pay accrued compensation to unrelated employees in early 2017 (within 2½ months of the employer's year-end) in order to obtain the following advantages:
- 2016 deduction for employers; and
- 2017 income for employees.

Deferred Compensation

The American Jobs Creation Act of 2004 created section 409A which imposes restrictions on the timing of distributions from, and contributions to, deferred compensation plans. While employers should have modified their existing deferred compensation plans by December 31, 2008, to conform to the section 409A rules, provisions for new plans must be in full operational compliance for all years. Companies should review plans and arrangements, especially those created during 2016, to ensure compliance with section 409A.

Companies that are noncompliant with these new rules will not incur penalties directly; however, the participants in the plans will be subject to immediate taxation of plan balances plus an additional 20% tax penalty and interest. Companies also have a reporting requirement with respect to amounts either contributed to a plan or distributed from a plan during the taxable year. Plans that may be affected by these rules include salary deferral plans, incentive bonus plans, severance plans, discounted stock options, stock appreciation rights, phantom stock plans, and restricted stock unit plans.

The Service issued guidance that provides businesses with a correction program if problems are discovered during the year the deferral starts or in later years. In 2010 the Service issued additional guidance that allowed taxpayers to correct certain plan-document failures by December 31, 2011, with no penalties in certain instances. Corrective action for plans implemented during 2016 should be completed by December 31, 2016.

Deductible Versus Capitalized Intangible Costs

In an effort to provide more certainty as to whether various costs, especially costs that provide a benefit beyond the current taxable year, can be deducted or are required to be capitalized, the Service issued comprehensive final regulations in December 2003, regarding the treatment of costs to acquire or create intangible assets. For example, under these regulations:

- Employee compensation is deductible even if the employee's functions relate to acquiring or creating intangible assets, such as contract rights.
- Prepaid expenses generally are capitalized unless the amounts are paid or incurred to obtain a right or benefit not extending beyond the earlier of 12 months or the end of the following taxable year and otherwise meet the general timing of deduction rules.
- Fees paid to outside vendors such as investment banks, accountants, attorneys, or other consultants for professional services rendered in connection with acquisitions, mergers, reorganizations, restructurings, recapitalizations, stock issuance, and other transactions generally are capitalized. For certain "covered transactions," however, certain investigatory costs incurred prior to a bright-line date may be currently deductible. In addition, for the same covered transactions, a taxpayer may make a safe-harbor election to treat 30% of success-based fees as facilitating the transaction (and thus capitalized) and the remaining 70% of the fees as not facilitating the transaction (and thus not required to be capitalized under these rules).

Your client service professional can be consulted for information about how to change your tax method of accounting to comply with these regulations.

Service Contract Ratable Accrual Safe Harbor

Last year, in an effort to reduce controversy, the Service issued Rev. Proc. 2015-39 to provide a safe harbor for accrual basis taxpayers to deduct costs of certain qualifying "ratable service contracts" for services provided within 3½ months of payment. Under the safe harbor, a service contract is a ratable service contract if: (1) the contract provides for similar services on a regular basis, such as daily, weekly, or monthly; (2) each occurrence of the service provides independent value; and (3) the term of the contract does not exceed 12 months. Examples of 12-month service contracts that will meet the definition of a ratable service contract include daily janitorial services, landscape maintenance, information technology (IT) support, and hardware maintenance services (*e.g.*, monthly copier machine maintenance).

Under the ratable service safe harbor, an opportunity exists to deduct the portion of the services provided within the 3½-month period following the prepayment date to the extent that the contract qualifies as a ratable service contract and the prepayment is fixed at year-end.

Example: A calendar year taxpayer prepays on December 1 landscape maintenance services provided in December through February. The contract for service does not exceed 12 months. The costs are eligible to be deducted under the ratable service safe harbor.

Planning Suggestion: Costs for qualifying ratable services provided after year-end but within 3½ months after payment may be deductible in the taxable year of payment. If you have previously incurred such costs but not deducted the costs until the year the services were delivered, you may be eligible to request a change in accounting method to deduct the costs currently. Arrange for a review to identify currently deductible ratable service costs.

Your client service professional can be consulted for information about how to change your tax method of accounting to comply with these regulations.

Start-Up and Organizational Expenditures

A business may elect to deduct start-up expenditures, and a partnership or corporation may elect to deduct organizational expenditures, in the taxable year in which the business begins, of an amount equal to the lesser of (1) the amount of such expenditures, or (2) $5,000, reduced by the amount by which such expenditures exceed $50,000. The remainder may be amortized over a 180-month period.

In prior years, it was necessary for a taxpayer to attach a separate election statement to its timely-filed return in order to make the election. Final regulations (as well as the temporary regulations that preceded them) provide that a taxpayer is no longer

required to file a separate election statement. Instead, the taxpayer is deemed to have made the election unless it chooses to forgo the deemed election by clearly electing to capitalize its organizational expenditures on a timely-filed return.

Depreciation Deductions

The timing of asset acquisitions is critical to obtain maximum depreciation deductions. Using other depreciation rules to your advantage will also reduce your taxes.

> ***Planning Suggestion:*** If you expect to buy property in 2017, you may benefit by accelerating the purchase so that you place the property in service in 2016.

With the PATH Act's extension of bonus depreciation (*i.e.*, additional first-year depreciation) through 2019 (at a 50% rate for 2015-2017, a 40% rate for 2018 and a 30% rate for 2019), taxpayers will benefit additionally by making qualified purchases and placing the assets into service in 2016-2017. The benefit of bonus depreciation is described more completely below.

Caution: Generally, no depreciation is allowable if the property is placed in service and disposed of in the same taxable year.

AMT Depreciation

The alternative minimum tax ("AMT") is imposed on corporations and individuals and is added to the regular tax if and to the extent the tentative AMT exceeds the regular tax. AMT is based on alternative minimum taxable income ("AMTI"), which consists of a taxpayer's regular taxable income increased by various adjustments to items that for regular tax purposes result in the deferral of income (*e.g.*, accelerated depreciation) and by various tax preference items.

"Small corporations," corporations with average gross receipts of less than $7.5 million for the prior three taxable years (less than $5 million for the corporation's first three-taxable-year period), are exempt from AMT. S corporations are not directly subject to the AMT, but must report their AMT adjustments and preference items to their shareholders so that they, in turn, can determine their own liability for the AMT.

> ***Planning Suggestion:*** If AMT is anticipated, and you are not able to claim the bonus depreciation deduction (discussed below), you may wish to consider leasing instead of purchasing depreciable property, because depreciation computed for regular tax purposes may have to be adjusted for AMT purposes. Your client service professional can discuss with you the advantages and disadvantages of this and other possible measures to avoid the AMT.

Asset Expense Election

Generally, prior to the PATH Act, if you purchased depreciable tangible personal property (including off-the-shelf computer software), you could elect to treat up to $25,000 as a deduction for property placed in service in taxable years beginning in 2015. However, the benefits of this election began to phase out if more than $200,000 of qualifying property is placed in service. (The maximum amount that can be expensed ($25,000) is reduced on a dollar-for-dollar basis for eligible property placed in service in

excess of $200,000.) This asset expense election was further increased for qualifying property placed in service by a qualifying "enterprise zone business." More generous allowances were in effect, on a temporary basis, for prior years. For 2015, the maximum deduction decreased to $25,000 from the $500,000 amount applicable in 2014, with the benefits phased out for property purchases over $200,000, also down from $2,000,000,

The PATH Act permanently extended the asset expense election and set the expensing limit for 2015 retroactively at $500,000 with a $2 million overall investment limit before phase out (both amounts are indexed for inflation beginning in 2016). The PATH Act also made permanent the special expensing limit for qualified real property and removed the $250,000 cap on such expenditures beginning in 2016.

Bonus Depreciation

From time to time, Congress has enacted "bonus" depreciation provisions to give businesses additional first-year depreciation deductions, and thus to provide significant incentives for making new investments in depreciable tangible property. In 2011 and 2012 (as well as the last three months of 2010), certain property was eligible for a 100% bonus depreciation deduction. Beginning in 2013, the bonus depreciation rate was reduced to 50%. In order to qualify for bonus depreciation, the property must be new; used property will not qualify. The bonus depreciation provision expired at the end of 2014 and was originally not available for 2015 asset purchases. However, the PATH Act extended bonus depreciation retroactively to the beginning of 2015 at the 50% rate and phasing down over time through 2019 (at a rate of 50% for 2015-2017, 40% for 2018, and 30% for 2019).

The aggregate deduction provided by the asset expense election and bonus depreciation for 2016 is illustrated by the following example:

With bonus depreciation and section 179 expensing election:

Corporation X purchases and places in service new machinery (five-year property) in its calendar 2016 taxable year with a cost of $1,000,000. Corporation X is entitled to deduct the first $500,000 under the section 179 expense election and a bonus depreciation deduction in 2016 for 50% of the remaining $500,000 purchase cost, or $250,000. After applying the bonus depreciation deduction, Corporation X is entitled to a further depreciation deduction in 2016 of $50,000 (20% of $250,000). Thus the total depreciation deductions for 2016 are $800,000.

Because the PATH Act was signed into law in December 2015, the retroactive extension of 50% bonus depreciation came too late for some fiscal year taxpayers that had already filed federal tax returns for taxable years beginning in 2014 and ending in 2015, and for taxpayers with a taxable year of less than 12 months beginning and ending in 2015. Consequently, these taxpayers may have failed to claim bonus depreciation on their tax returns for qualifying property placed in service in 2015. Recently, the Service issued relief guidance in Rev. Proc. 2016-48 to provide affected taxpayers with procedures for claiming, or not claiming, the 50% bonus depreciation on such property.

Please consult your client service professional for further information regarding bonus depreciation.

> ***Planning Suggestion:*** Plan purchases of eligible property to assure maximum use of this annual asset expense election and bonus depreciation as the amount of bonus depreciation is being phased down beginning in 2018, and eliminated in 2020.

Leasehold Improvements

Tax consequences should be considered when negotiating a lease. Generally, the cost of leasehold improvements must be depreciated over 39 years rather than over the lease term. However, when the lease terminates, the tenant may deduct any unrecovered cost.

The PATH Act permanently extended the special rule for qualified leasehold, restaurant, and retail improvement property. Such property is depreciated over 15 years using the straight-line method, rather than over 39 years. Qualified leasehold improvement property is any improvement to the interior portion of nonresidential real property made under or pursuant to a lease by the lessee, sublessee, or lessor. The improvement must be part of the interior of the building that is used exclusively by the lessee or sublessee and must be placed in service more than three years after the date the building was first placed in service.

Personal Property Versus Real Property

For regular tax purposes, real property depreciation deductions are available over 27½ years for residential rental property and 39 years for nonresidential property. However, depreciation deductions may be accelerated for real property components that are essential to manufacturing or other special business functions.

Example: Taxpayer constructed a $10 million manufacturing facility, which was placed in service during 2016. The design required an overhead crane, a special reinforced foundation to support equipment, and other specific features to accommodate the manufacturing process. A cost segregation study revealed that approximately $5 million of the facility's cost can be recovered over seven years instead of 39 years for regular tax purposes (without considering the bonus depreciation provisions described above).

Planning Suggestion: Arrange for a cost segregation study to identify personal property and determine optimum depreciable lives for both new and prior acquisitions and construction. The position of the Service is that the present depreciation method for property previously misclassified can be changed, and the full amount of any prior depreciation understatement can be deducted in the current year. Your client service professional can be consulted for further information and assistance.

De Minimis Expenses, Deductible Repair and Maintenance Costs Versus Capital Costs, Partial Disposition of Property

In 2013, the Service and Treasury issued final regulations that introduce a number of new provisions addressing the capitalization of acquired, produced, or improved property, including repair and maintenance costs. These new regulations are mandatory beginning in 2014. Major areas and new provisions of the regulations include:

- De minimis expensing safe harbor election;

- Small taxpayer safe harbor expensing election;
- Deductible routine maintenance safe harbor for equipment and buildings;
- Deductible repairs/capital improvements to property;
- Election to conform to financial accounting to capitalize deductible repair and maintenance expenses; and
- Partial disposition of property.

The Service has informally stated in public forums that it is expecting virtually all businesses to file accounting method changes and make new elections as a result of these new Regulations. Please contact a client service professional to discuss further.

De Minimis Expensing Safe Harbor Election

Taxpayers can now elect annually to expense costs beneath a specified dollar amount: up to $5,000 with an applicable financial statement ("AFS") or up to $2,500 without an AFS. The de minimis safe harbor may be followed up to the $5,000 level if the taxpayer:
1) Has an AFS (financial statements audited by an independent CPA firm or issued to a federal or state agency),
2) Has a de minimis expensing policy in writing as of the beginning of the year (January 1, 2016, or the first day of the 2016 taxable year for fiscal year-end taxpayers) specifying a dollar amount beneath which amounts will be expensed for non-tax purposes,
3) Follows the de minimis expensing policy on the AFS, and
4) Elects annually to apply the de minimis expense safe harbor.

If these criteria are met, then taxpayers may also deduct such amounts for tax purposes.

Taxpayers can also make the de minimis safe harbor election without an AFS at a reduced amount. Without an AFS, the specified dollar amount threshold drops from $5,000 to $2,500, and the de minimis expensing policy is not required to be in writing.

In November 2015, the Service increased the de minimis expensing threshold for businesses without an AFS from $500 to $2,500. The new $2,500 threshold takes effect for taxable years beginning on or after January 1, 2016. In addition, the Service stated in Notice 2015-82 that it will provide audit protection to eligible businesses by not challenging use of the new $2,500 threshold in taxable years prior to 2016. This is welcome relief to many small businesses that do not have audited financial statements.

The de minimis safe-harbor dollar limitation is applied at the invoice level for the purchase of an asset as it is normally purchased (or per item as substantiated on the invoice). Anti-abuse provisions will prevent taxpayers from subdividing the acquisition of property into multiple invoices to lower invoice amounts beneath the de minimis expense policy dollar limit.

Example: Taxpayer has an AFS and a policy in writing to expense for non-tax purposes amounts not to exceed $5,000. Taxpayer purchases and expenses for non-tax purposes 100 computers for $250,000, $2,500 each as substantiated on the invoice. Taxpayer can deduct for tax purposes the entire $250,000 purchase as long as the same amount is expensed on its AFS.

Repair and Maintenance versus Capital Improvements to Property

For regular tax purposes, costs must be capitalized that result in a betterment or restoration, or adapt property to a new or different use. Costs not meeting these criteria are potentially eligible for current deduction as a repair and maintenance

expense. These criteria can lead to a more generous repair and maintenance deduction for tax purposes compared to the book treatment, capitalizing such costs.

Example: Taxpayer incurred $500,000 in costs for a $10 million facility to repair walls, replace broken light fixtures, apply new paint inside and out, repair a damaged floor, and reseal the floor. Such costs are potentially deducible as repair and maintenance expenses for tax purposes.

Planning Suggestion: Deductible costs capitalized in current and prior taxable years can be deducted in the current year, net of any prior depreciation claimed. Arrange for a fixed asset review to identify deductible repair and maintenance costs. Your client service professional can be consulted for further information and assistance.

Remodel Safe Harbor for Restaurants and Retailers

In November 2015, the Service issued Rev. Proc. 2015-56, which provides a safe-harbor method of accounting for most retailers and restaurants that incur refresh or remodel expenditures on qualified buildings. This procedure is significant as restaurants and retailers can now deduct 75% of qualified remodel-refresh expenses, as opposed to capitalizing and depreciating the costs over 15 or 39 years. Deductible expenses include everything from painting interior walls to making changes to exterior facades.

In general, most restaurant and retail buildings are eligible, including leased spaces; however, a remodel must meet certain criteria to qualify for the safe harbor. The project must alter the physical appearance and/or layout of a qualified building for an eligible purpose, such as maintaining a contemporary and attractive appearance or standardizing the consumer experience across multiple units.

To qualify, a company must have “applicable financial statements,” which are audited financial statements in most instances.

Planning Suggestion: Retailers and restaurants that have incurred deductible remodel-refresh costs capitalized in current and prior taxable years can deduct those costs in the current year, net of any prior depreciation claimed. Arrange for a fixed asset review to identify deductible remodel-refresh costs. Your client service professional can be consulted for further information and assistance.

Partial Disposition of Property

Historically, taxpayers were only permitted to dispose of property when the entire asset was disposed of. This created an unfavorable situation where a significant portion of an asset, but not the entire asset, was disposed of.

> ***Example:*** Taxpayer constructs a building for $1,000,000 and places it into service in 2000, depreciating it over 39 years. In 2010, the taxpayer spends $75,000 to replace the entire roof structure including the surface membrane, insulation, and all structural decking. Assume the taxpayer must capitalize the $75,000 cost as an improvement and depreciate the cost over 39 years as a new building asset. However, under the old rules, the taxpayer now has two roofs capitalized, the new roof as well as the original roof cost included in the $1,000,000 construction cost.

> ***Planning Suggestion:*** The new regulations allow taxpayers to elect, per asset, to claim a “partial disposition,” and recognize a gain or loss on the partial disposition--the cost of the replaced component less any accumulated depreciation claimed on that component--in the year of the replacement. The new component parts of the asset must be capitalized and depreciated as new assets where a gain or loss is recognized on the partial disposition.

Taxpayers can only elect to claim a partial disposition, recognizing the gain or loss on the disposition, in the year the disposition occurs.

Your client service professional can be consulted for further information and assistance.

Research Tax Credit (“RTC”)

The RTC is available for taxpayers that make investments to try to develop or improve their products, manufacturing processes, or software. In 2012 corporations in almost every industry reported over $10 billion in federal RTCs.

Many sizable RTC opportunities, however, go unnoticed or unclaimed because many taxpayers:

- Believe they must be doing basic or revolutionary research to qualify, even though most of the $10 billion relates to the kind of general product, process, and software-development and software-improvement activities most manufacturers and many companies in other industries perform;
- Miscalculate their credits--sometimes by a factor of thousands--because the rules for calculating the credit are complicated and not fully accounted for in the software used by even the largest of companies and accounting firms to prepare tax returns; or
- Continue to believe that old and higher standards for qualification and documentation apply, even though they have been

officially abandoned, *e.g.*, the "discovery test" and pre-filing documentation requirements.

And recent developments have made claiming RTCs even simpler and more promising.

- **Permanent Extension and Modification of RTC.** The PATH Act retroactively and permanently extended the RTC for 2015 and beyond. In addition to being made permanent, for taxable years beginning after December 31, 2015, the RTC will have two added benefits. First, eligible small businesses (those that are privately held and with $50 million or less in average gross receipts for the three preceding taxable years) may utilize the RTC against their AMT. Historically, businesses could only use the RTC to offset ordinary tax liability and only to the extent this liability exceeded their AMT, with one exception to this rule in 2010. Additionally, startup companies (those with gross receipts of less than $5 million for the current taxable year and no gross receipts for any tax year before the five taxable years ending with the current tax year) may utilize the RTC against employer's payroll tax (*i.e.*, FICA) up to $250,000. This is an important added benefit, as start-up companies investing in new technologies often do not pay income taxes.

- **More Software Development Now Qualifies.** In October 2016, the Treasury Department issued final regulations concerning the development of software and the RTC. Effective for taxable years beginning on or after October 4, 2016, the regulations benefit taxpayers in three ways.

  First, they adopt the January 2015 proposed regulations' narrower definition of internal-use software ("IUS"), reducing the number of activities that will be subject to the additional "high threshold of innovation" ("HTI") test that IUS software-development activities must meet. Under the final regulations, software will not be treated as IUS if it (1) is not developed for use in general and administrative functions that facilitate or support the conduct of the taxpayer's trade or business; (2) is developed to be commercially sold, leased, licensed, or otherwise marketed to third parties; or (3) is developed to enable a taxpayer to interact with third parties or to allow third parties to initiate functions or review data on the taxpayer's system. The determination of whether software is IUS depends on the intent of the taxpayer and the facts and circumstances at the beginning of the software development.

  Second, the regulations adopt the proposed regulations' understanding of the HTI test, requiring only that the software be intended to "innovative" in the congressionally-intended sense of resulting in a substantially and economically significant (1) reduction in cost, (2) improvement in speed, or (3) other measurable improvement, instead of having to be unique or novel and different in a significant a significant or inventive way from prior software implementations or methods.

  And third and importantly, the final regulations allow the HTI test to be met if the taxpayer has uncertainty regarding the software's appropriate design. The proposed regulations had required that the taxpayer have uncertainty regarding its capability to develop the software, or regarding the method by which it would do so, much more difficult standards to meet.

If your business attempts to develop or improve products, manufacturing or other processes, software, techniques, formulae, or the like – even if only incrementally – now is the time to assess whether your business is taking full advantage of this valuable incentive.

The RTC is based on three types of payments: (1) qualified research expenditures ("QREs"), *i.e.*, certain wage, contractor, supply, and computer/cloud-time-sharing expenses paid or incurred, generally, for product-, process-, and software-development and improvement activities; (2) payments to qualified organizations for basic research; and (3) payments to energy research consortia for energy research. RTCs based on QREs and basic research payments are incremental; those based on energy research payments ("ERPs") are not, equaling 20% of a taxpayer's ERPs.

For more information about the RTC, including reporting RTCs on financial statements and the availability of related tax benefits provided for by most states, more than ten of which provide *refundable* or *salable* benefits, please contact your client service professional.

Domestic Production Activities Deduction

The American Jobs Creation Act of 2004 included a tax deduction with respect to income from certain domestic production activities (section 199). For taxable years beginning in 2010 and beyond, the deduction has been fully phased in at 9% of "qualified production activities income" subject to certain limitations. Qualifying domestic production activities may include:

- Manufacture, production, growth, or extraction of tangible personal property and computer software;
- Film production;
- Electricity, natural gas, or water production;
- Construction or renovation of real property; and
- Engineering and architectural services.

The FY 2016 Omnibus Budget Reconciliation Act temporarily exempts a certain percentage of transportation costs of qualified independent refiners for purposes of the section 199 deduction. The measure applies to taxable years beginning after December 31, 2015, but is unavailable in taxable years beginning after December 31, 2021.

Computer Software Costs

The tax treatment of costs to develop, purchase, or lease computer software is as follows:

- Software development costs, including the costs of customizing and implementing purchased software, may be treated as either current expenses and deducted in full or as capital expenditures and amortized ratably over 60 months from the completion of the development or 36 months from the date the software is placed in service.
- The cost of purchased software that is separately stated from the cost of computer hardware may be amortized ratably over 36 months beginning with the month the software is placed in service.
- The cost of leased software may be deducted as paid or incurred.

If you have treated software costs differently in a prior year, a change of accounting method can be made. Your client service professional can be consulted for further information.

Employment-Related Credits

The work opportunity tax credit ("WOTC") has been available (even against the AMT) in the past to employers that pay wages to an individual who is a member of a "target group." An individual who fits into one of the following target groups qualifies for the credit: (1) qualified Temporary Assistance to Needy Families ("TANF") recipient; (2) qualified veteran; (3) qualified ex-felon; (4) designated community resident; (5) vocational rehabilitation referral; (6) qualified summer youth employee; (7) qualified food stamp recipient; (8) qualified SSI recipient; or (9) long-term family assistance recipient. The PATH Act extended the WOTC through 2019. The PATH Act also enhances the WOTC for employers that hire certain long-term unemployed individuals.

The WOTC operates as follows: if the worker works at least 400 hours in the first year, the credit is 40% of the first $6,000 of wages paid. If the worker works at least 120 hours and less than 400, the credit is 25%. Therefore, once the employee works the requisite 120 hours, he or she qualifies the previous 120 hours for the 25% credit. Once the employee works the requisite 400 hours, he or she qualifies the previous 400 hours for the 40% credit. In some cases, the employer may want to extend the tax return to qualify some workers for the 40% credit.

A welfare-to-work credit is available to employers of long-term family assistance recipients. A "long-term family assistance recipient" is a member of a family receiving assistance under TANF or successor program for specified time periods.

The amount of the credit is equal to 35% of the "qualified first-year wages" and 50% of the "qualified second-year wages." The

amount of qualified wages with respect to an individual cannot exceed $10,000 per year. Thus, the maximum credit is $8,500 per qualified employee.

If a welfare-to-work credit is allowed to an employer with respect to an individual for any taxable year, the employer cannot also take a work opportunity credit with respect to that individual for that taxable year.

Employers are also eligible to receive a tax credit equal to 25% of qualified expenses for employee child care facilities and 10% of qualified expenses for employee child resource and referral services, up to $150,000 per taxable year.

New Markets Tax Credit

The PATH Act authorized the allocation of $3.5 billion of new markets tax credits for each year from 2015 through 2019.

Passive Losses

Generally, passive losses currently offset only passive income. Unused passive losses are carried to future years. An unused (suspended) loss generally is deductible when a taxpayer disposes of his or her interest in the passive activity. Regulations define "activity" broadly, and include provisions for the "grouping" of certain undertakings into a single activity.

For the last several years, however, individual taxpayers will be required to be mindful of the passive loss rules even if their activities have consistently generated net taxable income. Income from passive activities and net gains from dispositions of interests in passive activities will be subject to the 3.8% tax on net investment income of high-income individuals. In contrast, if income from a trade or business is not from a passive activity, *e.g.*, because the individual is a material participant in the activity, this additional tax will not be imposed on the income from the activity. Taxpayers had a one-time opportunity to make new or different "grouping" elections for 2013 or 2014, or in any subsequent year in which they would first be subject to this tax.

Personal service corporations ("PSCs") are subject to the passive loss restrictions. "Closely-held C corporations" (other than PSCs) can use passive losses to offset active income except for interest, dividends, or other portfolio income. A closely-held C corporation is defined as a C corporation in which more than 50% of the value of its outstanding stock is owned by five or fewer individuals.

Planning Suggestions: Your client service professional can assist you in determining whether it would be advisable for you to transfer personally owned passive loss activities to your closely-held corporation (if it is not a PSC). Also, if you anticipate having unusable passive losses this year, those losses may be available to offset gains from partnership or S corporation distributions in excess of your basis.

Because of the possible application of the additional 3.8% tax on net investment income of high-income individuals for 2016, taxpayers should consider the effect of any grouping elections made in prior years for activities that would otherwise be considered as two or more different activities. Because of the application of this tax, taxpayers were offered one opportunity to make a new or different grouping election for 2013 or 2014. Thereafter, taxpayers may only make a grouping election in unusual circumstances. The most likely of such circumstances to occur is that the taxpayer first became subject to this tax in 2015 or a subsequent year. Your client service professional can assist you in determining whether you are eligible to make a grouping election for the year and, if so, whether to make such an election.

Passive losses of S corporations and partnerships are passed through to their owners. Special rules apply to publicly-traded partnerships.

Rental Real Estate

For real estate professionals, rental real estate activities are not subject to the passive loss rules if, during a taxable year:

- More than 50% of the taxpayer's personal services are performed in real property businesses, and
- More than 750 hours of service are performed in real property businesses.

For both of these tests, the taxpayer must materially participate in the real property businesses. If a joint return is filed, these two tests are met only if they are separately satisfied by either spouse. However, in determining material participation, a spouse's participation is taken into account. Services performed as an employee are ignored unless the employee owns more than 5% of the employer.

In determining whether a taxpayer materially participates in any of his real estate activities for purposes of applying this test, each interest of the taxpayer in rental real estate must generally be treated as if it were a separate activity. However, the taxpayer may alternatively elect to treat all of his interests in rental real estate as a single activity. The election is irrevocable but is often necessary to qualify.

A closely-held C corporation will satisfy these tests if more than 50% of its gross receipts are derived from real property businesses in which the corporation materially participates.

Real property businesses are those engaged in real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage.

Beginning in 2013, individual taxpayers with investments in rental real estate have had another potential tax consequence to consider. Even though the special rules for real estate professionals may permit an individual to treat income from rental real estate as income from a non-passive activity, such income is not necessarily exempt from the additional 3.8% tax on net investment income of high-income individuals. In order to exclude rental real estate income from this tax, the taxpayer must be able to demonstrate that the income is from the conduct of a trade or business. Your client service professional can assist you in determining whether your rental real estate income is subject to this tax.

Inventories

For taxable years beginning after 1986, specified overhead costs, which previously were deductible for tax and generally not capitalized for book purposes, have to be capitalized by being added to inventory under the section 263A uniform capitalization rules. This tax requirement increases taxable income to the extent that inventory is on hand at year-end. Special rules apply to LIFO inventories.

> ***Planning Suggestion:*** Some taxpayers either have not complied with these uniform capitalization rules, or have either included too little or too much overhead into their inventory cost. Your client service professional can help you review whether changes should be made to your inventory costing method. The Service provides incentives for voluntarily making corrective changes to accounting methods.

Inventory Shrinkage

Businesses that do not take a physical inventory count at the end of their taxable year may accrue a deduction for estimated inventory "shrinkage" at year-end. Inventory shrinkage is a catch-all amount attributable to items such as undetected theft, breakage, and bookkeeping errors, which cause a taxpayer's actual inventory to be less than the amount recorded on its books. In estimating shrinkage at year-end, businesses may take into account their experience in prior years, sometimes adjusted for special circumstances and other factors that management considers appropriate.

The adoption of a method of estimating inventory shrinkage is a change of accounting method, which requires conformity with IRS procedures. Your client service professional can be consulted for further information.

LIFO Inventories

Use of the last-in, first-out ("LIFO") method, in inflationary periods, allows a taxpayer the ability to increase deductions and lower taxable income. This is accomplished by removing the impact of inflation from ending inventory.

Planning Suggestion: Taxpayers using LIFO should monitor their inventory levels to avoid invading LIFO inventory layers and a resulting increase in taxable income.

The Service issued generally favorable LIFO rules in 2002 to allow taxpayers to elect a revised inventory price index computation method. Contact your client service professional to discuss whether this election would benefit your business.

Caution: If a corporation using the LIFO method elects to be an S corporation, it must include in income for its last taxable year as a regular corporation its "LIFO recapture amount," computed as follows:

Example	
Inventory's value at FIFO	$2,000,000
Less inventory's value at LIFO	1,600,000
LIFO recapture amount	$ 400,000

Any resulting tax (determined on a "with-and-without" basis by comparing the tax liability with the LIFO recapture amount with its tax liability without this amount) is payable in four equal installments without interest. The first installment must be paid on the due date, without extensions, of the return for the last taxable year as a C corporation. The next three installments must be paid by the due date, without extensions, of the S corporation's tax return for the succeeding taxable years.

Rescinding a Transaction

Because tax consequences are based on an annual accounting concept that uses the facts as they exist at the end of a taxable year, transactions occurring during the year may be disregarded if properly rescinded before year-end.

Example (1): A calendar-year taxpayer sells property at a gain on July 1, 2016. If the buyer and seller properly rescind the sale by December 31, 2016, the sale is disregarded for tax purposes.

Example (2): A regular corporation and its shareholders are calendar-year taxpayers. The shareholders make capital contributions to the corporation during 2016 for an expansion project which is later abandoned. If the capital contributions are properly rescinded and returned to the shareholders by December 31, 2016, the contributions will be treated as though they were never made and thus will have no tax effect. However, if they are returned after 2016, they may be treated as dividends or other taxable distributions.

Caution: State-law considerations should be taken into account in determining whether a transaction may be rescinded. In addition, the Service announced that it will no longer provide letter rulings to taxpayers on the question of whether a particular transaction may be rescinded for federal tax purposes. Although the decision was made in order to allow the Service and Treasury to study the issue further, the Service also announced in 2013 that it did not plan to issue any further published guidance on this issue for the foreseeable future. Your client service professional and your attorney should be consulted if you wish to rescind a transaction and achieve tax consequences as if the transaction and rescission had not occurred.

Tax Saving Opportunities for Partnerships, Limited Liability Companies, and S Corporations

Partnerships

Regulations governing the allocation of partnership income and loss can sometimes lead to unanticipated results. The allocation of losses may be particularly sensitive to routine changes in partnership liabilities. Even if these changes do not affect allocations, they may trigger income to the partners in certain circumstances. Contributions, distributions, and interest transfers can also present income recognition issues. Many of these issues depend on the position of the partnership at the end of its taxable year. Therefore, unforeseen tax consequences can often be mitigated with year-end planning. For example, the implementation of loan guarantees or indemnification agreements can sometimes prevent tax problems related to partnership liabilities.

On October 4, 2016, Treasury and the Service published final, temporary, and proposed regulations addressing disguised sales under section 707(a)(2)(B) and liability allocations under section 752.

- *Disguised Sale Rules:*

The regulations clarify that the preformation expenditure exception to the disguised sale rule must be applied on an asset-by-

asset basis, but the ability to aggregate assets in certain situations should alleviate the administrative burden associated with contributions of numerous assets. Careful attention to the aggregation exception should be paid in order to ensure the ability to maximize potential benefits.

The regulations add a rule coordinating application of the preformation expenditure exception and liability allocations effectively eliminating so-called “double-dip” transactions. Double-dip transactions occur where the partnership both reimburses the contributing partner’s preformation expenditures and assumes the liability used by the contributing partner to finance the capitalized expenditures.

Leveraged partnership transactions in which newly-obtained liabilities are used to fund distributions to property-contributing partners are severely affected by these rules. For purposes of calculating the amount of the debt-financed distribution exception, a contributing partner’s share of liabilities is based solely on such partner’s interest in partnership profits (excluding liabilities for which another partner bears the economic risk of loss).

While it is critical to consider the final and temporary regulations addressing disguised sales, it is important to bear in mind that the determination of a disguised sale transaction is inherently driven by facts and circumstances. Consequently, careful consideration should be given to the overall facts and circumstances to determine whether the transaction should be considered a disguised sale.

- *Determination of Recourse Liabilities:*

Temporary regulations provide rules relating to when certain obligations are recognized for purposes of determining whether a liability is a recourse liability under section 752. In particular, the rules address whether a bottom-dollar payment obligation is recognized for purposes of determining if a partner or related party bears the economic risk of loss for a liability under Treas. Reg. § 1.752-2.

With limited exceptions, the temporary regulations effectively eliminate the ability to use new bottom-dollar payment obligations to create economic risk of loss for purposes of section 752. These rules may have a significant impact on partners, including the immediate recognition of taxable income. For example:

- Without economic risk of loss, a partner will be allocated fewer partnership liabilities. Therefore, the partner’s basis will be reduced which may limit the ability of the partner to deduct allocable losses.

- Partners with negative tax capital accounts due to prior loss allocations or prior cash distributions may be required to recognize taxable income to the extent they no longer have the economic risk of loss with respect to a partnership liability.

Any payment obligation, including an obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership may be a bottom-dollar payment obligation if it meets the requirements described in the regulations.

An anti-abuse rule prevents partners from agreeing to create a bottom-dollar guarantee in order to treat a liability as a nonrecourse liability in situations where a partner actually bears the economic risk of loss for a partnership liability.

Partners who have existing bottom-dollar obligations will be able to use the former rules for a seven-year period to the extent that their allocable share of recourse partnership liabilities immediately prior to October 5, 2016, exceeds the amount of the partner’s adjusted basis at such time. However, partners will need to monitor the grandfathered amount as it will be reduced for decreases in partner’s share of liabilities and on the sale of partnership property.

• *Proposed Liability Allocation Regulations:*

The new proposed regulations would strengthen anti-abuse rules in determining whether a partner bears the economic risk of loss for partnership liabilities, and would create similar anti-abuse rules relating to a partner's deficit restoration obligation. Changes to loan guarantees and deficit restoration obligations may be necessary to avoid unfavorable tax consequences in the event the regulations are finalized.

If the proposed regulations are finalized, the allocation of liabilities by many partnerships may be altered to the extent that they run afoul of new anti-abuse provisions. Partners whose share of partnership liabilities are reduced may recognize gain on deemed distributions as a result. Taxpayers relying on allocations of recourse partnership liabilities to claim losses and support negative tax basis capital balances should consider whether changes to guarantees and similar arrangements are necessary to avoid gain recognition.

In addition, partners relying on deficit restoration obligations to support negative capital accounts may be allocated income to reduce or eliminate the negative balances if their restoration obligations are no longer respected. In particular, partners who have implemented limited or terminable deficit restoration obligations should consider whether changes to their deficit restoration obligations are necessary to avoid chargebacks of income in the event the regulations are finalized.

A partnership must generally file its federal income tax return by the 15th day of the third month following the end of its taxable year, but an automatic extension of six months is available upon request. As a result, the due date of a partnership return for the year ending December 31, 2016, can be extended until September 15, 2017.

Limited Liability Companies

Generally, the same federal tax rules that apply to a partnership also apply to a two-or-more member limited liability company ("LLC") that is properly classified as a partnership, rather than a corporation, under applicable income tax regulations. Under these same regulations, a single-member LLC owned by an individual can choose to be classified either as a disregarded entity, *i.e.*, sole proprietorship (Schedule C business), or as a corporation, and a single-member LLC owned by a corporation can choose to be classified as a disregarded entity, *i.e.*, part of its corporate owner or a division, or as a separate corporate subsidiary.

S Corporations

Although individual income tax rates are slightly higher than corporate tax rates at most income ranges, now may be the time to consider making an S corporation election for your regular corporate business, if eligible. The combined effect of corporate-level taxes on corporate income and shareholder-level taxes on dividends is often a higher rate of tax than if an S corporation election were in effect. Shareholders of existing S corporations should consider the following year-end planning tips:

- Shareholders must have basis in their stock or in loans to the corporation in order to take advantage of anticipated losses. Basis may be increased by additional capital contributions or direct shareholder loans to the corporation.
- If the corporation has earnings and profits ("E&P") on hand which were accumulated during the time it was a regular C corporation, any additional investments in the corporation by the shareholders should be made as loans, rather than as capital contributions, to avoid taxable dividends if these investments are later returned to the shareholders. Shareholder loans should always be well-documented.
- After a shareholder's basis in stock of an S corporation has been reduced to zero, the shareholder's basis in a loan to the corporation is reduced by pass-through losses and increased by the pass-through of subsequent years' income. Because loan repayments may produce taxable income for the shareholder, they should be timed, if possible, to result in the least amount of tax. Advances should be evidenced by a written document in order to obtain favorable capital gain treatment if gain will result when the loan is repaid. Delaying loan repayments beyond 12 months (for long-term capital gain treatment) will allow any gain to be taxed at the lower (20%) capital gains tax rate.
- Distributions to shareholders which exceed the corporation's accumulated adjustments account ("AAA") may result in inadvertent dividends if the corporation has E&P accumulated from the time it was a C corporation. Therefore, distributions

should be delayed if the amount of the AAA balance at year-end is uncertain.

- Dividends received by non-corporate shareholders from domestic and qualified foreign corporations are taxed at a maximum 20% rate. Accordingly, S corporations with C corporation E&P should avoid making an actual or a deemed dividend distribution of this E&P, unless there are other compelling reasons for generating taxable dividend income.
- Consider making gifts of S corporation stock to shift income between family members. Gifts of nonvoting stock may be made to keep voting control, if desired.
- Under certain conditions, an S corporation that sells appreciated property will be subject to tax on "built-in gains" (generally the property's appreciation prior to the corporation becoming an S corporation). A built-in gain is determined as follows:

Example:	
Total gain on asset's sale	$1,000,000
Less appreciation accruing while an S corporation	300,000
Built-in gain	$ 700,000

If an S corporation has sold property and recognized built-in gains, it should consider offsetting these gains by recognizing built-in losses. Alternatively, the built-in gains tax may be deferred or, in some circumstances, eliminated if the corporation's taxable income can be eliminated.

Caution: Estimated taxes must be paid on net recognized built-in gains. (These estimates cannot be based on the preceding year's tax, if any.)

Changes enacted by Congress over several recent years have temporarily suspended the application of the built-in gains tax for certain S corporations that converted from C corporation status several years ago. For taxable years that began in 2012, 2013, or 2014, the tax will not be imposed if the S corporation had completed a five-year recognition period at the time the built-in gain is recognized. Different versions of this relief applied for taxable years that began in 2009, 2010, or 2011. For taxable years beginning in 2015 or later, the PATH Act makes this change in the recognition period permanent.

Other less recent changes have made more corporations eligible to become S corporations. For instance, financial institutions not using the reserve method of accounting can become S corporations; S corporations can have up to 100 shareholders and in determining the number of shareholders, extended family groups can be treated as a single shareholder; certain tax-exempt organizations can be shareholders; S corporations can hold controlling interests in other corporations; and wholly-owned domestic subsidiaries of S corporations can be disregarded as entities separate from their parent S corporations if an election is made by the S corporation.

In addition, income allocable to an employee stock ownership plan ("ESOP") as a shareholder of an S corporation is not currently taxed, but rather is taxed to the ESOP beneficiary at the time of distribution.

Tax Saving Opportunities for C Corporations

Retention of Corporate Earnings

The present 39.6% top rate for individuals may exceed the marginal tax rate of your corporation. The disparity may be even greater if the combined effect of phase-out provisions for itemized deductions and deductions for personal exemptions, the additional hospital insurance tax on high wage-earners, and the 3.8% tax on net investment income of high-income individuals are all considered. In this case, it may be desirable to retain corporate income by deferring compensation to employee-shareholders.

Caution: A corporation that accumulates E&P beyond its reasonable business needs may be subject to an additional 20% tax on its accumulated taxable income. However, up to $250,000 in E&P may generally be accumulated before this tax applies. Special rules pertain to holding, investment, and personal service corporations.

Personal Service Corporations

PSCs are denied the benefit of the lower corporate tax brackets and are taxed at a flat 35% rate. A PSC is a corporation that performs services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting and also meets certain stock ownership tests.

PSCs and certain small businesses on an accrual method of accounting are permitted to eliminate from accrued service income an amount that, based upon experience, will not be collected.

Caution: A PSC that elected a fiscal year is subject to a "minimum distribution" requirement. Such a PSC must monitor the level of payments (compensation, rent, etc.) to employee-shareholders to avoid postponing part or all of the deduction for these payments. Therefore, if your top individual tax rate exceeds the top rate of tax applicable to your corporation, it may be advisable to terminate a fiscal-year election, if you have not done so already.

Corporate Stock and Stock Options

A corporation may obtain a deduction by the issuance of its stock or stock options to pay otherwise deductible expenses. For example, stock issued to employees or independent contractors constitutes deductible compensation when included in the employee's or independent contractor's taxable income. The taxable event generally occurs when the stock is transferred to the service provider without a substantial risk of forfeiture. In the case of stock grants, the deduction is generally available when vested and nonqualified stock options when the option is exercised. Incentive stock options ("ISO") do not generate a deduction unless the holder of the ISO shares disposes of them before the required holding periods. These disqualifying dispositions will generate a deduction to the corporation. Companies that have issued ISOs to their employees should determine whether there have been any disqualifying dispositions of the underlying stock during the year.

Caution: Corporate deductions may be lost if the equity compensation is not timely reported on a Form W-2, in the case of an employee, or a Form 1099, in the case of an independent contractor.

Caution: New rules require the IRS copy of 2016 Form 1099-MISC that reports non-employee compensation in Box 7 be filed with the Service on January 31, 2017, at the same time as the form is required to be furnished to the independent contractor.

Incentive stock options and options granted under a qualifying employee stock purchase plan ("ESPP") have a separate reporting requirement. Form 3921, Exercise of an Incentive Stock Option Under Section 422(b), and Form 3922, Transfer of Stock Acquired Through An Employee Stock Purchase Plan Under Section 423(c), must be filed not later than January 31, 2017, for 2016 ISO exercises and ESPP purchases.

Planning Suggestion: For stock vested upon transfer (including transfer via the exercise of an option), fiscal-year corporations may take the deduction in the taxable year such stock is transferred to the employee or independent contractor, rather than waiting until the next taxable year in which the employee's or independent contractor's taxable year ends. If this is a change in method of accounting, a Form 3115 will be required no later than the last day of the year of change.

Stock or stock options (warrants) issued to a lender could also result in deductible "original issue discount" as the result of allocating a portion of the issue price away from the debt instrument.

Your client service professional can be consulted for further information regarding ISOs and nonqualified stock options. Also see our discussion of stock options in our 2016 *Tax Letter for Individuals*.

Estimated Taxes

Corporate estimated tax payments may significantly affect your business's cash flow. Accordingly, planning for the lowest required payment is essential. The requirements differ for small and large corporations.

A small corporation is one that had taxable income of less than $1,000,000 for each of the three preceding taxable years. Conversely, a large corporation is one that had taxable income of $1 million or more for any of the three preceding taxable years. Taxable income, for this purpose, is computed without net operating and capital loss carryovers and carrybacks.

A small corporation may base its estimated tax payments on the preceding year's tax liability. However, a large corporation may base only its first estimated tax payment on the preceding year's tax liability. For either type of corporation, an estimate may be based on the preceding year's tax only if the preceding taxable year consisted of 12 months and the preceding year's return showed a tax liability.

Estimated tax payments that cannot be based on the prior year's tax can be based on 100% of the expected tax for the current year or tax calculated on the current year's annualized income. The annualized income method provides a safe harbor from estimated tax penalties if the expected tax for the entire year is difficult to determine. If the annualized income method is used, payments are made as follows:

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Installment Number	Annualization Period	% of Tax to Be Paid
1	1st 3 months of taxable year	25
2	1st 3 months of taxable year	50
3	1st 6 months of taxable year	75
4	1st 9 months of taxable year	100

Alternatively, a corporation may annually elect one of the following annualization periods:

Installment Number	Optional Annualization Periods		
	I	or	II
1	1st 2 months of taxable year		1st 3 months of taxable year
2	1st 4 months of taxable year		1st 5 months of taxable year
3	1st 7 months of taxable year		1st 8 months of taxable year
4	1st 10 months of taxable year		1st 11 months of taxable year

Option I or II must be elected by the due date of the first quarterly installment for each year. Form 8842, Election to Use Different Annualization Periods for Corporation Estimated Tax, can be used to make the election.

In some cases, lower payments may be made under the adjusted seasonal installment method. No estimated taxes are required for a particular year if the tax shown on the return for that year is less than $500.

Estimated taxes also are required if there is an AMT liability for the current year.

Regulations relating to corporate estimated tax payments provide a general rule that taxpayers using the annualized income method must annualize items incurred during the quarter, as well as special rules for specific deductions and extraordinary items.

Planning Suggestion: A corporation anticipating no 2016 tax should consider taking action to produce a small tax by reporting low taxable income so that estimated 2017 tax payments can be based on 2016 tax.

Examples:

- X Corporation will have a $100 net operating loss and no tax for 2016. X must pay 2017 estimated taxes based on its 2017 regular or AMT income to avoid penalties.
- Y is a small corporation. Its 2016 return will show a $500 tax liability. Y will be able to pay only $500 as 2017 estimated taxes and avoid penalties, even though its actual 2017 tax may be much higher. If Y's 2017 tax is $100,500, it would pay the $100,000 balance on April 15, 2018.

"Quick Refund" for Excess Estimated Tax

If estimated taxes paid exceed the expected annual tax, a corporation may apply for a "quick refund" (on Form 4466, Corporation Application for Quick Refund of Overpayment of Estimated Tax) of the excess tax before the tax return is filed, but only if this excess tax is at least $500 and 10% of the expected annual tax. This quick refund may be requested after the close of the corporation's taxable year, but no later than the 15th day of the fourth month following the end of the taxable year (the original due date of the corporation's income tax return). The Service must act on this refund application within 45 days after it is filed.

Example: Z, a calendar-year corporation, paid $50,000 in estimated taxes for the first three quarters of 2016. In the fourth quarter of 2016, Z incurs a large loss so that the tax due for the year is expected to be only $10,000. Z may request a $40,000 refund after December 31, 2016, and on or before April 15, 2017. The Service must act on Z's refund application within 45 days after it is filed.

Postponing Tax Payments if Net Operating Loss Expected

Generally, a taxpayer cannot obtain an extension of time for paying a tax. However, if a corporation expects an NOL for the current year, it may extend the time for paying the tax for the immediately preceding taxable year. The postponement is available only for tax payments due after this extension is filed and applies to the extent that the NOL can be carried back to preceding taxable years. Although the tax payment is postponed, interest is still charged from the original due date of the tax payment until the original due date of the current year's return.

Example: Q, a fiscal year corporation, determines that it will have an additional $30,000 tax to pay on December 15, 2016, for its taxable year ended September 30, 2016. Q also expects to have a $100,000 NOL for its year ending September 30, 2017, which may be carried back to one or more of its preceding taxable years. Q files Form 1138, Extension of Time For Payment of Taxes By a Corporation Expecting a Net Operating Loss Carryback, before December 15, 2016, to extend the time for paying the $30,000 tax otherwise due on December 15, 2016. Interest on the postponed tax payment will be charged from December 15, 2016, until January 15, 2018.

Expedited Refund Claim in Hardship Cases

If a corporation incurs an NOL in the current year, it may request a "quick refund" from a carryback of that NOL by filing Form 1139, Corporation Application for Tentative Refund, on or after the date of filing the tax return for the NOL year–but not later than one year after the end of the NOL year. Generally, the Service must act on this refund request within 90 days of its filing. If Form 1139 is not timely filed, the corporation must file an amended tax return (Form 1120X) for the prior year to carry back the NOL.

In extreme cases, where a corporation can demonstrate hardship if it has to wait even 90 days for the refund, the taxpayer also should file Form 911, Application for Taxpayer Assistance Order to Relieve Hardship. We have been successful in obtaining refunds within a week or two where a desperate need for the refund was demonstrated, such as the need to meet payroll.

Planning for Net Operating Losses

NOLs are a valuable corporate attribute. Even net operating losses that were not fully reported on a prior year return can be carried forward. However, the ability to use an NOL carryforward may be limited where a loss corporation has experienced a change of stock ownership–for example, as a result of a merger or acquisition, the issuance of new stock, or the acquisition of outstanding stock by one or more 5% shareholders. Your client service professional can assist you with the appropriate planning needed to preserve and maximize the use of NOLs by your corporate business.

Succession and Family Business Planning

Year-end is the traditional gift-giving season. This should also be a time to plan for your company's succession and the transfer of your wealth to your heirs in a manner that minimizes transfer taxes. We urge you to consult with your client service professional for ideas to preserve your family wealth.

Conclusion

Business tax planning is very complex. Careful planning involves more than just focusing on lowering taxes for the current and future years. How each potential tax saving opportunity affects the entire business must also be considered. In addition, planning for closely-held entities requires a delicate balance between planning for the business and planning for its owners.

This 2016 year-end *Tax Letter for Businesses* and our 2016 year-end *Tax Letter for Individuals* cannot cover every tax-saving opportunity that may be available to you and your business. Inasmuch as taxes are among your largest expenses, we urge you to meet with your client service professional. We can provide a comprehensive review of the tax-saving opportunities appropriate to your particular situation.