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Highlights

Identity Theft Victims May Opt into IRS Program: In an effort to help victims of identity theft, the IRS has issued approximately 1.5 million six-digit Identity Protection PINs (IP PINs) for taxpayers to use in filing their federal tax return. The IP PIN is a unique number that is assigned annually to victims of identity theft with resolved cases. The IP PIN is intended to help these individuals avoid delays in filing returns and receiving refunds. The IRS is continuing the program, which was piloted last year in Florida, Georgia, and the District of Columbia. In addition, the IRS is offering the program to approximately 1.7 million taxpayers for whom the IRS suspects identity theft on their accounts. For more information on combating identity theft, see **www.irs.gov** (search for identity theft). News Release IR-2015-07.

Penalty Relief for Repayment of Advance Premium Tax Credit: As part of the tax return filing process for 2014, taxpayers who received advance payments of the premium tax credit must reconcile the amount of credit they are eligible for with the amount of advance credit received. For some taxpayers, the reconciliation process may result in an excess advance payment that must be repaid as an additional tax. This additional tax may come as a surprise to many unsuspecting taxpayers who are unable to pay the balance due when filing their return. In response, the IRS has provided penalty relief for taxpayers that have a balance due for the 2014 tax year due to excess advance payments of the premium tax credit. Penalty abatement is available for the failure to pay penalty under IRC Sec. 6651(a)(2) and the underpayment of estimated tax penalty under IRC Sec. 6654(a). Notice 2015-9 outlines the requirements to qualify and request the relief. Notice 2015-9, 2015-6 IRB. See NTA-902, in this issue, for further information.

Revised Accounting Method Change: In January of this year, the IRS issued Rev. Proc. 2015-13, which provides the procedures for obtaining advance (nonautomatic) and automatic IRS consent to change an accounting method. Rev. Proc. 2015-13 modifies and consolidates procedures previously included in Rev. Proc. 2011-14 (for automatic method changes) and Rev. Proc. 97-27 (for nonautomatic accounting method changes). Rev. Proc. 2015-13 applies to Forms 3115 filed on or after 1/16/15, for a year of change ending on or after 5/31/14. However, a revised version of the revenue procedure has been released that includes a more liberal transition rule than the one provided in the original version. The revision [section 15.02(1)] allows taxpayers to choose whether to use Rev. Proc. 2015-13 or Rev. Proc. 2011-14 for automatic accounting method changes for their 2014 tax returns. Rev. Proc. 2015-13, 2015-5 IRB 419.

Tax Preparer Directory Opens: The IRS has launched a new, online directory of return preparers to assist taxpayers in finding a credentialed tax professional. The searchable and sortable directory lists preparers with valid 2015 Preparer Tax Identification Numbers (PTINs). The data includes the name, city, state, and zip code of attorneys, CPAs, enrolled agents, and those who have completed the IRS requirements for the voluntary Annual Filing Season Program (AFSP). The directory, located at **http://irs.treasury.gov/rpo/rpo.jsf**, will be updated regularly and includes more than 666,000 preparers with active PTINs at the beginning of the filing season. News Release IR-2015-22.

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Other Current Releases

Applicable Federal Rates for: The Section 7520 rate for February 2015 is 2.0%, while the Applicable Federal Rates (AFRs) are as follows (Rev. Rul. 2015-3, 2015-6 IRB):

	Annual	Semiannual	Quarterly	Monthly
Short-term (≤ 3 years)	0.48%	0.48%	0.48%	0.48%
Mid-term (> 3 years but ≤ 9 years)	1.70%	1.69%	1.69%	1.68%
Long-term (> 9 years)	2.41%	2.40%	2.39%	2.39%

Income Tax—Child Support Payments Have Priority over Alimony: According to the terms of his divorce, an ex-husband was required to provide child support payments of $8,307 and alimony payments of $8,205 ($16,512 total) for the year in question. However, he only paid a $9,688 for both child support and alimony that year, claiming the entire amount as alimony. According to IRC Sec. 71(c)(3), if the payment is less than the full amount of required child support and alimony, the partial payment is treated first as nondeductible child support, and any excess is alimony. Thus, the Tax Court disallowed all but $1,381 of the ex-husband's alimony deduction, which was the excess amount over his required child support payment. *Joseph L. Becker*, TC Summ. Op. 2015-2 (Tax Ct.).

Income Tax—Claims for Retroactively Extended Fuel Credits: Notice 2015-3 provides the rules that taxpayers must follow to take advantage of the Tax Increase Prevention Act of 2014's retroactive extension of certain fuel credits. These requirements must be followed to make a one-time claim for a refund of, or credit for, various fuel sold or used during calendar-year 2014. Notice 2015-3, 2015-6 IRB.

Income Tax—Court Addresses Placed in Service Requirement: Certificates of occupancy had been obtained before year end for two newly completed retail store buildings allowing them to receive equipment, shelving, racks, and merchandise, as well as the required installation personnel. However, the stores had not been issued certificates of occupancy allowing customers to enter the buildings. The taxpayer argued that the properties were placed in service because they were ready and available for their intended use under Reg. 1.167(a)-11(e)(1) (e.g., to store and house equipment, racks, shelving, and merchandise). The IRS previously determined, because the two buildings were not open for business, they were not placed in service. The district court, ruling for the taxpayer, determined the buildings were substantially complete, fully functional, and that placed in service does not require the business be "open for business" for purposes of a depreciation allowance. *Stine LLC*, 115 AFTR 2d 2015-XXXX (DC LA).

Income Tax—Egg Donor's Receipts Are Taxable Compensation: A woman, who donated her eggs for use by infertile couples, received $20,000 from an egg donor company. (The term *egg donation* is misleading because participants are typically compensated for the egg stimulation and retrieval.) Although the donor received a Form 1099-MISC reporting the amount she was paid, she chose not to include the payments on her tax return. Her position, after consulting with other egg donors, was that the payments were not taxable because they were in exchange for pain and suffering endured during the lengthy egg-retrieval process, i.e., excludable damages under IRC Sec. 104(a)(2).

However, the Tax Court disagreed, concluding that, because the egg donor voluntarily signed a contract to be paid to endure the medical procedures, the amounts she received were not excludable damages. Instead, they were compensation that must be included in gross income. [**Editor's Note:** This was a landmark case because it was the first to address the tax treatment of compensation received for the sale or donation of human eggs.] *Nichelle G. Perez*, 144 T.C. No. 4 (Tax Ct.).

Income Tax—Foreign Earned Income Exclusion: The taxpayer's work schedule required him to alternate 30-day periods on and off duty. While on duty, he worked in employer-provided housing in Russia, with sporadic periods on an off-shore oil rig. During this time, the taxpayer owned a house in Louisiana, where he returned for a month at a time, six times per year, to be with his family. His driver's license, voter registration, bank accounts, motor vehicles, and business affairs were centered in Louisiana, and his family never joined him in Russia. Because the taxpayer couldn't show that his abode was in Russia, the Tax Court held that he couldn't claim the foreign earned income exclusion under IRC Sec. 911. [**Editor's Note:** For this purpose, *abode* means one's home, residence, or domicile, rather than one's principal place of business.] The Court based its conclusion on the fact that the taxpayer's strongest economic, family, and personal ties were in Louisiana, whereas his ties to Russia were only transitory. *Joel B. Evans*, TC Memo 2015-12 (Tax Ct.).

Income Tax—IRS Disagrees with Exclusion of Partner's Debt Cancellation Income: The IRS, in an Action on Decision (AOD), announced its nonacquiescence with four Tax Court cases, each of which held that a partner's exclusion of partnership debt cancellation income was excluded debt cancellation income under IRC Sec. 108(a). In each of these cases, the partner guaranteed the partnership's debt and was not in bankruptcy in his individual capacity. The partnership, not the partners, filed for bankruptcy, and none of the partners met the bankruptcy code's definition of a debtor. According to the IRS, the Tax Court's rulings were inconsistent with the structure of IRC Sec. 108 and Congressional intent, which applies only to partners who are debtors in bankruptcy. Therefore, in all of these cases, none of the partners should have been entitled to exclude his share of the partnership cancellation of debt income. AOD 2015-001.

Income Tax—Mortgage Broker Not a Real Property Broker: In a Chief Counsel Advice, the IRS recently distinguished brokerage services performed by state licensed real estate agents from those performed by mortgage brokers in qualifying for the real property trade or business exception to the Passive Activity Loss (PAL) rules under IRC Sec. 469(c)(7)(C). A real estate agent brings together buyers and sellers of real property and negotiates contracts of sale between them; whereas, a mortgage broker brings together lenders and borrowers for financing the transactions. The term *real property trade or business* is not defined in IRC Sec. 469 or the regulations. The IRS noted that Congress removed finance operations from the list of qualifying real property trade or business activities in the final enacted bill. The IRS concluded that a mortgage broker, who is a broker of financial instruments, is not engaged in a real property brokerage trade or business and, therefore, not excepted from the PAL rules. CCA 201504010.

Income Tax—Mortgage Interest Deductible Despite Not Holding Title: A taxpayer's home mortgage interest, within certain dollar limitations, is generally deductible if he is the legal or equitable owner of the property even though he is not directly liable on the mortgage [Reg. Sec. 1.163-1(b)]. The taxpayer, in a recent case, did not hold legal title, but was under an oral agreement to purchase the property from his family members. In 2010, he reported home mortgage interest expense of $35,880. Although the taxpayer did not hold legal title to the underlying property, nor did his name appear on the mortgage, the Tax Court determined that he provided clear and convincing evidence that he was an equitable owner because he paid the mortgage, taxes, insurance, and other bills associated with the property, maintained the property, and made improvements to it. Thus, he was entitled to take the mortgage interest deduction. *Qui Van Phan*, TC Summary Opinion 2015-1 (Tax Ct.).

Income Tax—Research Credit for Internal Use Software: Although IRC Sec. 41(d)(4)(E) excludes most computer software from the research credit if developed primarily for the company's own internal use, there has been confusion as to what is considered internal use software. The IRS issued proposed regulations defining internal use software and providing that certain internal use software is eligible for the research credit if it satisfies the high threshold of innovation test. Also included are rules for software that is developed for both internal use and non-internal use and a safe harbor for determining if any of the development costs are qualified research expenditures. The proposed regulations, once finalized, will be prospective only. Until then, taxpayers can choose to follow (1) these proposed regulations, (2) all the

provisions of the 2001 final regulations [Reg. 1.41-4(c)(6)], or (3) all the provisions of the 2001 proposed regulations [Prop. Reg. 1.41-4(c)(6)]. Prop. Reg. 1.41-4.

IRS Advises Taxpayers to Wait for Form 1095-A before Filing Their Returns: According to the IRS, taxpayers, who enrolled in a health plan through the Health Insurance Marketplace in 2014, should wait until they receive Form 1095-A (Health Insurance Marketplace Statement) before filing their 2014 Form 1040. The Form 1095-A will not come from the IRS, but from the Marketplace where they purchased their coverage, and should arrive by early February. It will contain information needed to calculate the taxpayer's premium tax credit and reconcile advance payments of the premium tax credit made on their behalf to their insurance provider with the premium tax credit they are claiming on their tax return. Health Care Tax Tips 2015-07.

IRS Disciplinary Actions for Preparers Using Stolen Identity: In a Program Manager Technical Advice (PMTA), the IRS determined they may adopt rules denying the e-file Provider's application or expel an individual from participating in e-filing when stolen identities are used to apply for Electronic Filing Identification Numbers (EFINs) or to e-file fraudulent returns. This determination was based on Rev. Proc. 2007-40, Sec. 7 and IRS Publication 3112, IRS e-file Application and Participation. The publication provides that the IRS may deny an applicant participation in IRS e-file for, but not limited to, the following reasons: (1) disreputable conduct or other facts that may adversely impact IRS e-file, (2) misrepresentation on an e-file application, and (3) unethical practices in return preparation. PMTA 2014-08.

IRS Improperly Levied on Estate: Following several months of collection efforts, the executor, decedent's son, and an Appeals officer (P) reached a verbal agreement to place the estate's account in currently not collectible status, but that was never formalized. An IRS settlement officer (O), assigned to an estate tax case after P was transferred out of the department, issued a notice of intent to levy on the estate. O did not fully understand the subject matter of the complex case, misinterpreted the son's financial statements, and made errors in determining the estate's value. The Tax Court determined that the IRS abused its discretion under IRC Sec. 6330 in the decision to levy because O erred in understanding the facts, did not meaningfully consider the estate's previous proposal, and did not request the estate to submit a more formal proposal. The Tax Court remanded the case for a supplemental Appeals Office hearing. *Estate of Martha E. Sanfilippo*, TC Memo 2015-15 (Tax Ct.).

IRS Warns Taxpayers about Unscrupulous Tax Return Preparers: Bad preparers remain on the "Dirty Dozen" list of tax scams. Good practitioners often hear horror stories of victims in their communities. IRS Commissioner Koskinen says, "Taxpayers should be wary of anyone who asks them to sign a blank return, promise a big refund before looking at their records, or charge fees based on a percentage of the refund." Scammers often prey on those without a filing requirement (e.g., low-income individuals or the elderly), and non-English speakers who may or may not have a filing requirement. The fraudulent refunds are often deposited into the scammer's bank account instead of the taxpayers. Some scammers will deduct a large "fee" before paying victims, if they pay them at all. Taxpayers can be penalized for filing false returns or receiving fraudulent refunds. For IRS guidance on making a complaint about a tax return preparer see **www.irs.gov** (search for "complaint"). IRS News Release IR-2015-12.

President's Budget Proposal for 2016 (Green Book): On 2/2/15, President Obama released his federal budget proposals for fiscal year 2016. On that same day, the Treasury Dept. released the "General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals," commonly known as the "Green Book." The nearly $4 trillion budget proposal is intended to strengthen the middle class and help working families by providing them with more generous tax breaks, such as a new tax credit to two-earner families, an increased child and dependent care tax credit, an expanded earned income tax credit, and an improved tax credit to improve college affordability. Additionally, the proposal includes provisions intended to scale back certain tax breaks for the wealthy, close certain corporate tax loopholes while broadening the tax base, lower the corporate tax rate, target companies that shift income and assets overseas to avoid taxes, and provide the IRS with the authority to regulate all paid tax return preparers. The Green Book can be viewed at **www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2016.pdf.**

Tax Action Memo®

TAM-1713
February 10, 2015

Requesting Accounting Method Changes Required by the Tangible Property Regulations

Type of Clients: All businesses, including sole proprietors, partnerships, lessors of real property, and corporations. **Situation:** Businesses with tangible property, repairs and maintenance, or materials and supplies must change their accounting method to comply with final regulations. **Deadline:** The due date, including extensions, for filing the business' 2014 return.	**Tax Action Required:** File Form 3115 to request an automatic accounting method change as required to comply with the tangible property regulations.

Background

The final tangible property regulations are a 2014 tax return consideration that has not received much attention until fairly recently. These regulations, which generally apply to tax years beginning on or after 1/1/14, cover amounts paid to acquire, produce, or improve tangible property (see TD 9636). In doing so, they provide criteria for determining the unit of property, which is the first step for determining whether expenditures to improve tangible property must be capitalized or can be currently expensed. The regulations also change the definition of and rules for accounting for materials and supplies. A second set of final regulations (see TD 9689) provides rules for determining gain or loss upon the disposition of MACRS property, including partial dispositions of property.

Some of the favorable provisions in the final tangible property regulations are obtained by making an election on the tax return, while others require a change in accounting method. A method of accounting for tax purposes is the consistent treatment of a material item in computing taxable income. Examples of material capital items related to the tangible property regulations are *units of property*, *capital expenditures*, and *repairs and maintenance*. The final regulations reconcile previous guidance regarding the tax treatment of these material items and also add new rules. Hence, it is unlikely that a taxpayer in existence before 2014 will have accounting methods for tangible property that comply with the final regulations. As such, most taxpayers will have to receive consent from the IRS to change their accounting methods to comply with the final tangible property regulations.

Required Accounting Method Changes

The accounting method changes potentially required to comply with the final tangible property regulations are found in Rev. Proc. 2015-14 as follows:

- Section 10.11, Tangible property.
- Section 10.03, Removal costs.
- Section 6.33, Late partial disposition election.
- Section 6.38, Disposition of a building or structural component.
- Section 6.39, Dispositions of tangible depreciable assets (other than a building or its structural components).

Requesting an Automatic Change on Form 3115

Taxpayers can receive automatic consent from the Commissioner to make these accounting method changes by filing Form 3115 (Application for Change in Accounting Method). The general procedures for filing a change in accounting method are found in Rev. Proc. 2015-13. Rev. Proc. 2015-14 provides specific rules for changing a taxpayer's accounting method(s) to comply with the final tangible property regulations, including the Designated Automatic Accounting Method Change Number (DCN) for the changes potentially required. These two revenue procedures, along with the instructions to the Form 3115, provide the basis for preparing and filing Form 3115 for the tangible property regulations.

According to the instructions to Part II, Line 12, of Form 3115, if the taxpayer is not changing its overall method of accounting (cash or accrual), it should attach a detailed and complete description of all the following items:

1. The item(s) being changed.

2. The present method for the item(s) being changed.

3. The proposed method for the item(s) being changed.

4. The present overall method of accounting (cash, accrual, or hybrid).

In addition to the forgoing, Rev. Proc. 2015-14 requires taxpayers to:

1. Cite the final or temporary regulation that provides or authorizes the proposed method for the item(s) being changed.

2. Describe the unit(s) of property, building structure(s), or building system(s) used under its present and proposed methods of accounting, with a citation to the regulation under which the unit of property is permitted, if they want to change any unit(s) of property or the identification of any building structure(s) or building system(s) for determining whether amounts are deducted as repair and maintenance costs or capitalized as improvement costs.

3. Complete Schedule E of Form 3115 if they will be capitalizing amounts paid or incurred and depreciating such property under IRC Sec. 167 or 168.

Practice Tip: It is important to note that the current revision of Form 3115 is December 2009. The IRS has stated that it intends to update the Form 3115 to include references to the final tangible property regulations. Be sure to use the most current revision when you prepare the Form(s) 3115 for your client.

Rev. Proc. 2015-14, section 10.11(7)(a), contains a table listing DCNs for the various changes required by the tangible property regulations. You'll need to review this list to determine which method changes are required for your clients. Form 3115 filed to comply with the tangible property regulations will typically

request a concurrent method change for multiple DCNs from #184–193. Late partial asset disposition elections (available only through 2014) are made with DCN #196. A change from depreciating a disposed asset (or portion of an asset) to recognizing gain or loss upon a disposition is DCN #205/206.

Taxpayers should request all method changes described in Rev. Proc. 2015-14, Section 10.11, on a single Form 3115. For most taxpayers, this concurrent method change will include their method of accounting for materials and supplies (DCN #186 and 187), repairs and maintenance (DCN #184), capitalization and units of property (DCN #184), acquisition and production costs (DCN #192), and real property investigatory costs (DCN #193). Depending on the facts, some taxpayers may require additional method changes.

The Form 3115 should be attached to the taxpayer's timely-filed (including extensions) tax return for the year of change. More importantly, a copy of the Form 3115 must be filed with the IRS Office in Ogden, Utah, no later than the date the original tax return is filed.

Short Form 3115 for Qualifying Taxpayers

Most of the designated change procedures allow qualifying small taxpayers to use a *short Form 3115*. A short Form 3115 is not actually a different form, but means that the taxpayer is required to provide less information on the standard Form 3115. Generally, a *qualifying small taxpayer* is a taxpayer whose average annual gross receipts are $10 million or less for the three preceding tax years.

When a short Form 3115 can be filed, a qualifying small taxpayer should only complete the following on Form 3115:

- The identification section of page 1 (above Part I).
- The signature section at the bottom of page 1.
- Part I, line 1(a), which is the DCN for the requested change(s).
- Part II, all lines except lines 11, 13, 14, 15, and 17.
- Part II, line 13, if the change is to depreciating property.
- Part IV, lines 25 and 26.
- Schedule E, concerning changes in depreciation or amortization, if applicable.

The following are some key issues to consider while preparing a Form 3115 for a qualifying small taxpayer:

1. *Name of Filer*—Include both spouses and each SSN if filing a joint return.

2. *Name of Applicants*—One Form 3115 can be prepared for wholly-owned companies or entities in a controlled group filing an identical change if each entity is changing *to* an identical proposed method *from* an identical present method of accounting. Include each entity's name and EIN. Any Section 481(a) adjustments must be described separately for each entity. [See Rev Proc 2015-1, Sec. 15.07(4).]

3. *Accounting Method Change*—Leave this area blank since no option for "capitalization" is available. "Other" is reserved for advanced change requests.

4. *Part I, Line 1(a)*—Enter all DCN's included on a concurrent change request.

5. *Part I, Line 8*—Audit and ruling protection is normal in an automatic change request unless the taxpayer is under audit.

6. *Part I, Line 9*—If filing other Forms 3115 in consideration of the final tangible property regulations, include an explanation and cite to explain that the five-year eligibility limitation does not apply in order to prevent the application from being rejected. Also, include an explanation of any related party Forms 3115 that have been filed within the past five years, including in the current year.

7. *Part I, Line 10*—There may be pending Forms 3115 when filing a request under the tangible property regulations, so a description of the taxpayer, TIN, request change number, and specific issues should be attached.

8. *Part II, Line 12*—Include a citation to the relevant final regulation for the applicant's proposed method(s) of accounting along with a detailed description of each item being changed.

9. *Part II, Line 13*—When changing to depreciating an item that was previously not depreciated, line 13 is required to describe the trade or business in detail. Schedule E will also be required in this instance. An example where this will be applicable is when a previously expensed repair or transaction cost is capitalized under the new accounting method.

10. *Part II, Line 16*—A conference with the IRS in case of an adverse response should *always* be requested. The applicant can also attach a request to fax documents for convenience.

11. *Part IV, Line 25*—Enter the Section 481(a) adjustment and attach a description of the computation. A 481(a) adjustment will occur when writing off improperly capitalized repairs and/or capitalizing costs that were previously written off. For each capital item included in the accounting method change, list the asset's basis, accumulated depreciation, and 481(a) adjustment that results from the change. It is efficient to include Schedule E details on the 481(a) statement.

12. *Schedule E*—This schedule is required when changing to capitalizing and depreciating an expenditure, such as capitalizing a repair that was previously expensed. Combining Schedule E information on the 481(a) statement is helpful for clear and efficient presentation of the information. Schedule E preparation will likely require an answer to line 13 of Part II.

Sample Wording for Form 3115

Any application for change in accounting method must be accurate and complete, and include all relevant facts and information required by the applicable revenue procedure and Form 3115 instructions. Answering the questions carefully is essential to ensuring the IRS processes the application successfully. Providing concise answers and clean formatting are also good practices for ensuring success. Appendix 1 contains a sample format. Appendix 2 provides examples of language that might be used to provide the information required to make some of the more common automatic accounting method changes required by the final tangible property regulations.

Editor's Note: This language in Appendix 2 is based on an assumed set of facts. Your clients' fact patterns will likely be different. For example, Part II, Line 12b requires a description of the taxpayer's present accounting method. This may be different than the present accounting method described in Appendix 2.

Conclusion

Requesting an automatic method change for DCNs #184–193 on Form 3115 is the first step in complying with the final tangible property regulations, although other changes may also be required under each clients' specific facts.

Filing the Form 3115s required by the tangible property regulation may be time-consuming and cost the client additional professional fees (you shouldn't do this stuff for free), but it is necessary to take advantage of the automatic change method allowed under the tangible property regulations. Clients may not be thrilled

with this, but requests that should have been made this year that are not made until later years, may not be automatic, so making such changes could become even more costly if postponed.

Practice Tip: Recognizing that preparing the required Form 3115 can be time-consuming, especially for those unfamiliar with the form, we strongly suggest that affected returns be extended so that you can work on these returns after busy season when you'll have more time and, hopefully, less stress. Also, as we said earlier, the IRS has said that it will be updating the Form 3115 to include references to the final tangible property regulations. Hopefully, the new form will be available by this summer.

References:

IRC Secs. 167, 168, and 481(a).
Rev. Procs. 2015-13, 2015-5 IRB; and 2015-14, 2015-5 IRB.

Subscriber Note: The author of this article, Tyler Anderson, CPA, is the designated firm expert on the final Tangible Property Regulations (TPRs) at Johnson Goff & Company where he consults with small CPA firms on TPR implementation and the required Forms 3115. Tyler is a contributor to the Arizona Society of CPA's and has presented publicly on issues of the tangible property regulations. He can be reached at (480) 948-0060 or at *tylera@johnsongoff.com*.

Appendix 1

Sample Format for Form 3115 Attachments

Note: The following is a sample format of an attachment to Form 3115.

Name of Taxpayer
Identification Number
Attachment to Form 3115, Part II, Line 12

Item(s) being changed:_____
_____

Present method for item(s) being changed:_____
_____

Proposed method for item(s) being changed:_____
_____

Regulation authorizing the proposed method:_____

Present overall accounting method:_____

Appendix 2

Sample Language for Form 3115 Attachments

Note: The sample language in Appendix 2 is based on an assumed set of facts. Your client's fact patterns will likely be different. The language in the client's Form 3115 should be adapted to fit the client's unique situatuion.The taxpayer in this Appendix intends to make the following automatically approved accounting method changes:

Number	Description of Change
184	Change to Deducting Repairs, Capitalizing Improvements, and Identifying Units of Property
186	Change to Deducting Nonincidental Materials & Supplies to When Used or Consumed
187	Change to Deducting Incidental Materials & Supplies to When Paid or Incurred
192	Change to Capitalizing Acquisition or Production Costs and Depreciating, if Applicable

ABC Incorporated
75-1234567
Attachment to Form 3115, Part II, Line 12
Explanation of Present and Proposed Method of Accounting

Items Being Changed: The taxpayer is changing its methods of accounting to comply with the final tangible property regulations via the following concurrent automatic method changes under Rev. Proc. 2015-14, Sec. 10.11(5).

Present Method for Items Being Changed:

Taxpayer currently uses the following methods of accounting:

Repairs & Maintenance: Expenditures that bring tangible property back to their normal operating condition are deducted as ordinary business expenses under IRC Sec. 162.

Capital Expenditures: Large capital expenditures are normally capitalized.

Improvement Costs: Generally, asset upgrades, additions, and enhancements are capitalized.

Unit of Property (UOP): Each itemized fixed asset on taxpayer's depreciation schedule is generally considered to be a unit of property.

Routine Maintenance: The safe harbor of Reg. 1.263(a)-3(i) is not currently being utilized, nor *could* it have been used. However, normal expenditures that keep property in its ordinarily efficient operating condition are deducted as ordinary and necessary business expenses.

Capitalization Criteria: The taxpayer analyzes the facts and circumstances and to determine whether an expenditure should be capitalized. For instance, expenditures for assets with a useful life greater than one year are typically capitalized.

Appendix 2

Sample Language for Form 3115 Attachments (Continued)

Materials & Supplies: Nonincidental materials and supplies expenditures are currently deducted in the year paid or incurred. The costs of incidental supplies are deducted in the year consumed.

Acquisition Costs: Amounts paid in connection with the acquisition of an asset generally are capitalized as part of the new fixed asset. These costs are deducted if the asset is not actually acquired.

Proposed Method for Items Being Changed:

Taxpayer proposes to adopt the rules contained in the final tangible property regulations as follows:

DCN #184	
Reg. 1.263(a)-1(a)	General rule for capital expenditures
Reg. 1.162-4(a)	Deduct repairs and maintenance
Reg. 1.263(a)-3	Amounts paid to improve tangible property
Reg. 1.263(a)-3(b)	Definitions, amounts paid to improve property
Reg. 1.263(a)-3(d)	Requirement to capitalize improvement costs
Reg. 1.263(a)-3(e)	Determining the unit of property
Reg. 1.263(a)-3(g)(1)	Certain costs incurred during an improvement
Reg. 1.263(a)-3(i)	Safe harbor for routine maintenance on property
Reg. 1.263(a)-3(j)	Capitalization of betterments
Reg. 1.263(a)-3(k)	Capitalization of restorations
Reg. 1.263(a)-3(l)	Capitalization of adaptations to a new or different use
Reg. 1.263(a)-3(l)(2)	Capitalization of new or different building adaptations
Reg. 1.263(a)-3(o)	Treatment of capital expenditures
Reg. 1.263(a)-3(p)	Recovery of capitalized amounts
DCN #186	
Reg. 1.162-3(a)(1)	Nonincidental materials and supplies
Reg. 1.162-3(c)	Materials and supplies definition
DCN #187	
Reg. 1.162-3(a)(2)	Incidental materials and supplies
Reg. 1.162-3(c)	Materials and supplies definition
DCN #192	
Reg. 1.263(a)-2	Amounts paid to acquire or produce tangible property
Reg. 1.263(a)-2(d)	Requirement to capitalize acquired or produced property
Reg. 1.263(a)-2(e)	Defense or perfection of title to property
Reg. 1.263(a)-2(f)	Transaction costs to facilitate acquisition
Reg. 1.263(a)-2(g)	Treatment of capital expenditures
Reg. 1.263(a)-2(h)	Recovery of capitalized amounts

Taxpayer proposes to change to the following specific methods of accounting:

Repairs and Maintenance: Under Reg. 1.162-4, taxpayer will currently deduct repair and maintenance expenditures related to tangible property that otherwise would not have to be capitalized under Regs. 1.263(a)-1, 1.263(a)-2, 1.263(a)-3, or any other regulation.

Capital Expenditures: Taxpayer will employ the general rules and definitions related to acquisition and improvement expenditures under Reg. 1.263(a)-1, along with Regs. 1.263(a)-2, 1.263(a)-3, and Reg. 1.162-4, to determine when an expenditure should be expensed or capitalized.

Appendix 2

Sample Language for Form 3115 Attachments (Continued)

Improvement Costs: Taxpayer will adopt Reg. 1.263(a)-3, along with Regs. 1.263(a)-1, 1.263(a)-2, and 1.162-4, to determine when an expenditure should be expensed or capitalized.

Unit of Property: Taxpayer will employ the criteria in Reg. 1.263(a)-3(e) for determining a unit of property (UOP). Each building and its structural components will be treated as a UOP.

Routine Maintenance: Taxpayer will adopt the routine maintenance safe harbor in Reg. 1.263(a)-3(i) as its method of accounting for routine maintenance expenditures.

Capitalization Criteria: Taxpayer will follow the Reg. 1.263(a)-3 restoration, adaptation, and betterment qualitative criteria and improvement cost criteria, along with all other final tangible property regulations, in determining whether an expenditure should be expensed or capitalized.

Nonincidental Materials and Supplies: Taxpayer will deduct amounts paid to acquire or produce nonincidental materials and supplies expenses in the tax year in which they are first used or consumed in the taxpayer's operations under Reg. 1.162-3(a)(1).

Incidental Materials and Supplies: Taxpayer will deduct amounts paid to acquire or produce incidental materials and supplies for which no record of consumption is kept or physical inventories are taken at the beginning and end of the tax year, in the tax year they are paid under Reg. 1.162-3(a)(2).

Acquisition Costs: Taxpayer will capitalize production, transaction, and facilitative acquisition costs under Reg. 1.263(a)-2, and will adopt the "whether and which" rule of Reg. 1.263(a)-2(f)(2)(iii) for handling investigatory costs.

Present Overall Accounting Method: Taxpayer uses the accrual method of accounting.

ABC Incorporated
75-1234567
Attachment to Form 3115, Part IV, Line 25 and Schedule E
Explanation and Computation of Section 481(a) Adjustment and Change in Depreciation or Amortization

A Section 481(a) adjustment is required to account for amounts that were capitalized under the taxpayer's former accounting method but are treated as currently deductible repairs under the final tangible property regulations (Reg. 1.162-4). Likewise, an adjustment is required for costs that were expensed under the taxpayer's former accounting method but are capitalized under the final tangible property regulations [Reg.1.263(a)-2]. The Section 481(a) adjustments for each DCN are as follows:

1. DCN #184: Under its previous accounting method, the taxpayer capitalized as 39, 27.5, 15, 10, and five-year property various expenditures totaling $60,931 from 1991 through 2013. Accumulated depreciation on those assets was $15,231 as of December 31, 2013. Under the final tangible property regulations, these amounts should have been deducted currently as Section 162 repair and maintenance expenses. This results in a negative Section 481(a) adjustment of $45,700 ($60,931 − $15,231).

2. DCN #192: Under its previous accounting method, the taxpayer deducted transaction costs of $2,387 related to the acquisition of nonresidential real property as Section 162 ordinary and necessary business expense. Under the final tangible property regulations [Reg. 1.263(a)-2)] these costs should be capitalized as 39-year property. Accumulated depreciation on that amount would have been $245 as of December 31, 2013, resulting in a positive Section 481(a) adjustment of $2,142 ($2,387 − $245).

See the following for a detailed computation of the adjustment:

ABC Incorporated — 75-1234567													
Form 3115, Schedule E										Form 3115, Part IV			
Line 4(a)			Line 7(b)	Line 7(d)		Line 7(e)		Line 7(f)		Line 25			
Property Description	Date Placed in Service	Treatment under Proposed Accounting Method	Rev Proc 87-56 Asset Class	Depreci-ation Method As Filed	Depn Method under Proposed Method	Recovery Period (yrs) As Filed	Recovery Period (yrs) under Proposed Method	Applicable Convention As Filed	Proposed Applicable Convention	Cost Basis	Accum Depn Through 12/31/2013 As Filed	Accum Depn Through 12/31/2013 under Proposed Method	Positive (Negative) 481(a) Adjustment
1. Adjustment to deduct repair and maintenance items under the proposed accounting method (DCN 184)													
Leasehold Repair	7/1/2013	Repair	57.0	150DB	*	15	*	Half Year	*	2,058	1,038	*	(1,020)
Air Conditioner	8/29/2009	Expense	57.0	200DB	*	5	*	Half Year	*	495	481	*	(14)
Compressor Pump	12/31/2012	Repair	57.0	200DB	*	5	*	Half Year	*	4,580	2,748	*	(1,832)
Painting	5/31/2013	Maintenance	57.0	200DB	*	5	*	Half Year	*	1,686	—	*	(1,686)
Dishwasher	12/1/2013	Expense	57.0	200DB	*	5	*	Half Year	*	351	—	*	(351)
Floor Finish	3/7/2013	Maintenance	57.0	200DB	*	5	*	Half Year	*	584	—	*	(584)
Office Refresh	5/23/2005	Maintenance	57.0	S/L	*	39	*	Mid-Month	*	25,489	6,430	*	(19,059)
Reseal Floors	12/1/2011	Maintenance	57.0	200DB	*	10	*	Half Year	*	3,545	1,032	*	(2,513)
Relocate Heater	11/30/2007	Expense	57.0	S/L	*	39	*	Mid-Month	*	3,500	460	*	(3,040)
Roof Metal	7/4/2012	Repair	57.0	S/L	*	39	*	Mid-Month	*	500	16	*	(484)
Garage Door	10/1/2004	Repair	57.0	S/L	*	27.5	*	Mid-Month	*	606	203	*	(403)
Dryer	1/26/2012	Repair	57.0	200DB	*	5	*	Half Year	*	469	357	*	(112)
Security Alterations	10/1/1991	Expense	57.0	S/L	*	39	*	Mid-Month	*	2,067	1,096	*	(971)
Windows (2 of 12)	7/4/2011	Repair	57.0	S/L	*	27.5	*	Mid-Month	*	835	33	*	(802)
Lighting Overhaul	8/31/2011	Maintenance	57.0	S/L	*	39	*	Mid-Month	*	9,695	342	*	(9,353)
Service A/C	2/1/2012	Maintenance	57.0	S/L	*	27.5	*	Mid-Month	*	1,290	51	*	(1,239)
Door Hardware	3/18/2012	Repair	57.0	S/L	*	27.5	*	Mid-Month	*	799	31	*	(768)
Insect Screen	7/11/2012	Expense	57.0	S/L	*	27.5	*	Mid-Month	*	324	13	*	(311)
Storefront Glass	12/13/2013	Repair	57.0	S/L	*	15	*	Half Year	*	2,058	900	*	(1,158)
Total Adjustment to taxable income										60,931	15,231		(45,700)
2. Adjustment to properly capitalize facilitative transaction costs under the proposed accounting method (DCN 192)													
Closing Costs	8/1/2012	Building	57.0	**	S/L	**	39	**	Mid-Month	2,387	**	245	2,142
Total Adjustment to taxable income										2,387		245	2,142
* Depreciation under the proposed accounting method is not applicable. Instead, the taxpayer will deduct these expenditures according to the rules in the final tangible property regulations.										**Total Negative 481(a) Adjustment**			**$ (43,558)**
** Depreciation as filed is not applicable as the taxpayer deducted these expenditures under its former accounting method).													

Tax Action Memo®

TAM-1714
February 10, 2015

Why Business Co-owners Need Buy-sell Agreements

Type of Clients: Individuals who are business co-owners. **Situation:** Co-owners should have buy-sell agreements in place. **Deadline:** ASAP since you never know what tomorrow will bring.	**Tax Action Required:** During tax busy season, communicate with clients who could benefit from buy-sell agreements, and help them get the ball rolling sooner rather than later.

Background

You probably have clients who are co-owners of valuable small-sized and medium-sized businesses. They should have buy-sell agreements in place. For those who don't, use tax season conversations to educate them about why buy-sell agreements should be set up sooner rather than later. Here are the talking points.

A well-drafted buy-sell agreement can help your business co-owner client: (1) transform his or her business ownership interest into a much more liquid asset, (2) prevent unwanted changes in ownership, and (3) avoid expensive and time-consuming estate tax valuation hassles with the IRS after the client's death.

Buy-sell Agreement Basics

Buy-sell agreements are legal contracts that come in three basic types.

1. *Cross-purchase Agreements*. A *cross-purchase* buy-sell agreement is a contract between each co-owner and all the other co-owners. When a triggering event occurs with respect to a co-owner (death, retirement, etc.), the remaining co-owners are legally obligated to buy out the withdrawing or deceased co-owner's interest in the business.

2. *Redemption Agreements.* A *redemption* buy-sell agreement, also known as a *liquidation agreement*, is a contract between the business entity (corporation, partnership, or LLC) and all the entity's co-owners. When a triggering event occurs, the entity is legally obligated to buy out the withdrawing or deceased co-owner's interest in the business (i.e., the entity redeems the interest).

3. *Hybrid Agreements.* A *hybrid* buy-sell agreement is a mixture of the first two. For example, after a triggering event occurs with respect to a co-owner, a hybrid agreement might give the remaining co-owners first right of refusal to buy out the withdrawing or deceased co-owner's interest (i.e., a cross-purchase deal). If this right is not exercised, the entity itself becomes legally obligated to buy out the withdrawing or deceased co-owner's interest (i.e., a redemption deal). Alternatively, the hybrid agreement could be the other way around. The entity could be given the first right of refusal (a redemption deal) with the remaining co-owners becoming legally obligated to buy out the withdrawing or deceased co-owner's interest if the entity doesn't exercise its right (a cross-purchase deal). You get the idea.

To be more precise, most buy-sell agreements grant the remaining co-owners (with a cross-purchase arrangement) or the business entity (with a redemption arrangement) a right of first refusal to buy out the withdrawing or deceased person's ownership interest. If that right is not exercised, the interest can be sold to an outside party. However, if no outside party steps forward, the remaining co-owners (under a cross-purchase deal) or the entity (under a redemption deal) become legally obligated to buy out the withdrawing or deceased co-owner's interest.

All three types of buy-sell agreements have three primary goals: (1) to make sure there is a willing buyer for ownership interests when triggering events occur, (2) to prevent co-owners from transferring their ownership interests to others who are outside the existing ownership group without the consent of that group, and (3) to provide greater certainty about the federal estate tax outcome after the death of a co-owner.

Warning: When installing a buy-sell agreement for an existing entity, the agreement must be coordinated with the entity's pre-existing documents and contracts. For example, the buy-sell agreement must be consistent with a corporation's articles of incorporation or an LLC's operating agreement. Also, the buy-sell agreement must not violate other pre-existing contracts such as franchise agreements, leases, and loan covenants. For this reason, it may be necessary to obtain consents from affected third parties (lessors, lenders, etc.) to successfully implement the buy-sell agreement. In other words, all relevant documents and contracts should be reviewed (and possibly modified) in conjunction with installing the buy-sell agreement.

Important Details for Buy-sell Agreements

As part of drafting a buy-sell agreement, your client and the other co-owners must specify the triggering events they want included in the document. Attainment of a stipulated retirement age, death, and disability almost certainly should be designated as triggering events. Other triggering events that may or may not be appropriate are bankruptcy, the desire to withdraw from the business for any reason, and loss of a license to practice a profession. The spouses of married co-owners may also be co-owners as a matter of state law (especially in community property states). In such case, the divorce of a co-owner should probably be included as a triggering event.

The next important detail is to make sure the buy-sell agreement specifies an acceptable method (or methods) for valuing ownership interests when triggering events occur. Commonly used valuation methods include the fixed per-share price, appraised FMV, and formula based on a multiple of earnings or cash flow.

As discussed later, it is also important to use a valuation method that will pass muster with the IRS for federal estate tax purposes.

Finally, the agreement should specify how amounts will be paid to withdrawing co-owners or their heirs under various types of triggering events. For example, when buyouts of deceased co-owners' interests will be fully funded with life insurance proceeds, it may be feasible to make lump sum payments for buyouts triggered by death. However, it may be necessary to pay on the installment plan for buyouts triggered by other events (such as attainment of a stated retirement age, disability, etc.).

Funding Buy-sell Agreement with Life and Disability Insurance

Life Insurance. Since the death of a co-owner is the most obvious triggering event (and often the most catastrophic one), life insurance policies usually form the financial backbone of the buy-sell agreement. In the simplest case of a cross-purchase agreement between only two co-owners, the drill involves having each co-owner purchase an insurance policy on the life of the other person. When one co-owner dies, the survivor collects the life insurance death benefit and uses the money to buy out the deceased co-owner's interest.

The life insurance premiums are, of course, nondeductible [IRC Sec. 264(a)(1)]. However, life insurance death benefit proceeds are always federal income tax free, as long as the survivor was the original purchaser of the policy [IRC Sec. 101(a)]. Here's the rub. The dreaded "transfer-for-value" rule can come into play when co-owners swap existing policies on their own lives to set up a cross-purchase arrangement (e.g., Albert trades his existing $200,000 policy on his own life for Barbara's existing $200,000 policy on her own life when establishing a cross-purchase agreement for their 50/50 business). When the transfer-for-

value rule applies, life insurance death benefit payments are taxable for federal income tax purposes. Ouch! The transfer-for-value rule can also rear its ugly head when co-owner A names co-owner B as the new beneficiary of co-owner A's existing policy on his own life in connection with setting up a cross-purchase agreement. [See IRC Sec. 101(a)(2), Reg. 1.101-1(b)(4), and Ltr. Rul. 7734048.]

Client Advice: When possible, each co-owner should buy a new policy on the life of each other co-owner. This avoids the transfer-for-value problem and locks in federal-income-tax-free treatment for all life insurance death benefit proceeds received under the cross-purchase agreement. When existing life insurance policies must be used to fund the cross-purchase agreement (for example, because one or more co-owners are now uninsurable), exceptions to the transfer-for-value rule can often be utilized to avoid triggering taxable income from death benefit proceeds.

To form the financial backbone of a redemption buy-sell agreement, the business entity itself will typically buy policies on the lives of the co-owners. When one co-owner dies, the life insurance death benefit proceeds are used to buy out his or her ownership interest. Regardless of whether the entity purchases new policies or the co-owners transfer existing policies on their own lives to the entity, there is generally no transfer-for-value problem in the redemption scenario. So, the death benefit proceeds will be free of any federal income tax [IRC Sec. 101(a)(2)(B)].

Disability Insurance. Disability insurance policies on the co-owners can be used to help fund buyouts triggered by co-owners becoming disabled. Premiums are nondeductible, but benefit payments received under a disability policy are generally federal income tax free [IRC Secs. 104(a)(3) and 265(a)(1)].

Redemption Agreements Can Create Unwanted Tax Complexities and Other Side Effects

The federal income tax consequences of redemption agreements are generally more complicated (and often more unfavorable) than the federal income tax consequences of cross-purchase agreements. This is true for C and S corporations, partnerships, and multimember LLCs alike. However, redemption agreements are especially problematic for C corporations.

- C corporation ownership of life insurance policies used to fund a stock redemption agreement can cause exposure to the corporate AMT. This is because life insurance death benefit proceeds are included in the ACE adjustment when calculating the corporate AMT [Reg. 1.56(g)-1(c)(5)(v)]. Fortunately, "small" corporations (generally those with average annual receipts not exceeding $7.5 million, based on the three preceding tax years) are not exposed to the corporate AMT, nor are newly formed C corporations during their initial year. Therefore, this concern may not apply to your client.
- C corporation ownership of disability insurance policies used to fund a stock redemption agreement can also cause exposure to the corporate AMT because disability insurance benefit payments are also included in the ACE adjustment [Reg. 1.56(g)-1(c)(6)(iii)]. As mentioned, however, "small" and newly-formed C corporations are exempt from this concern.
- C corporation stock redemption payments pursuant to a buy-sell agreement may be treated as dividends to the extent of the corporation's current or accumulated earnings and profits [IRC Secs. 301(c)(1) and 316(a)]. A redemption taxed as a dividend often results in more tax than a sale or exchange, since the owner's basis in the stock cannot offset the proceeds. This is particularly critical if the redemption occurs shortly after the shareholder's death. Since the tax basis of the redeemed stock is stepped up to FMV at the shareholder's death under IRC Sec. 1014, the redemption generally results in little or no gain if the transaction is treated as a sale or exchange. In contrast, if the payment is taxed as a distribution in redemption of stock, the entire amount is taxed (to the extent of earnings and profits), with no offset for the estate's (or heir's) basis in the stock.

Last but not least, buyouts under a redemption agreement can have the unintended consequence of increasing the older generation's ownership percentage when a younger-generation owner dies or withdraws. This can be counterproductive when the older generation prefers a reduced ownership percentage for estate-tax-avoidance reasons. This issue potentially applies to C and S corporations, partnerships, and multimember LLCs alike.

Client Advice: For the preceding reasons, cross-purchase agreements are usually preferred to redemption agreements.

Think about Funding Angles in Advance

Buyouts triggered by a co-owner's death can (should) be funded with life insurance. That's usually relatively easy to arrange, assuming the aforementioned transfer-for-value and corporate dividend problems can be avoided. Funding buyouts triggered by other events is more challenging—a funding mechanism for each triggering event should be carefully thought out and coordinated with the nature of the event.

For example, the co-owners may decide that a buyout triggered by a co-owner's divorce should be funded via installment payments over a stipulated number of years at a stipulated interest rate. All the details should be spelled out in the buy-sell agreement. But, what happens if another co-owner gets divorced before the first divorce-related buyout has been fully paid for? Good question. These sorts of contingencies should be identified and dealt with in the buy-sell agreement.

The fact is, a buy-sell agreement is only as good as the funding mechanisms that stand behind the agreement's promise to make buyout payments. Put another way, buy-sell agreements won't work unless there are pre-arranged sources of money to make them work when triggering events occur.

Properly Drafted Agreements Deliver Estate Planning Benefits

For a co-owner of a successful small-sized or medium-sized business, the value of the business ownership interest often comprises a big chunk of his or her estate. In the absence of a buy-sell agreement, this scenario may create two major problems for the co-owner's heirs.

1. There may be no market for the deceased co-owner's interest. Of course, this is an especially dire outcome when the interest must be sold to pay estate taxes. This is less of a concern with today's relatively generous federal estate tax exemption ($5.43 million for 2015). However, the estates of some business co-owners can certainly be bigger, and there's no guarantee that today's relatively favorable federal estate tax regime will remain in place.
2. The co-owner's heirs may be lined up for a hassle with the IRS over valuing the ownership interest for federal estate tax purposes.

Thankfully, these problems are cured by installing a well-drafted buy-sell agreement. First, the agreement ensures that the deceased co-owner's interest can be sold for a reasonable price (the one set by the agreement). Second, the price set by a properly drafted buy-sell agreement will establish the value of the ownership interest for federal estate tax purposes. The steps involved to create "estate tax certainty" are beyond the scope of this release. For more information, see *PPC's Guide to Buy/Sell Agreements***.**

Client Advice: In a nutshell, the buy-sell agreement must set a reasonable price for the ownership interest. Otherwise, the IRS can, for federal estate tax purposes, completely disregard the price set by the agreement (IRC Sec. 2703). That would not be good!

Conclusions

Co-owners of valuable businesses should have buy-sell agreements almost always. A well-drafted agreement provides financial protection and estate tax certainty. However, these agreements are complicated. Typically, a host of business, family, and financial considerations must be taken into account to get things right. While this release is a good primer, the full story is much longer. For expert guidance, see *PPC's Guide to Buy/Sell Agreements***.** Meanwhile, the subject of installing a buy-sell agreement can be broached in client conversations during tax busy season. Tell them not to wait, or it could be too late! (See Appendix 1 for a sample client letter and Appendix 2 for a checklist of factors indicating a need for a buy-sell agreement.)

References:

IRC Secs. 55, 56, 101(a), 104(a)(3), 264(a)(1), 265(a)(1), 301, 316, and 2703.

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 Importance of a Buy-sell Agreement

Dear Client:

It is important that businesses with more than one owner (such as your business) have a written buy/sell agreement specifying what happens when an owner withdraws from the business. A buy/sell agreement is a contract between the owners (or the owners and the business entity itself) that establishes rules and restrictions applicable to changes in ownership.

The typical buy/sell agreement provides that an owner's interest in the business will be sold (or at least offered for sale) at a specified price to the other owners and/or to the business entity itself upon the occurrence of specified events. This prevents unwanted persons from becoming members of the ownership group and ensures a ready market for closely held ownership interests. It also provides liquidity to a deceased owner's family and assures the remaining owners that they will be able to continue the business without interference from the family of the deceased owner. Buy/sell agreements also offer estate planning benefits by establishing a value for the business prior to an owner's death.

Common methods for determining the purchase price under a buy/sell agreement include (1) establishing a fixed price in the contract, (2) requiring an independent appraisal, or (3) specifying a formula such as a percentage of book value. Events that trigger a buy/sell agreement are specified by the owners in the contract. Generally, buy/sell agreements are triggered by any circumstance that might cause an owner to dispose of an ownership interest—such as death, disability, bankruptcy, or retirement.

The best time to establish a buy/sell agreement is now, before a problem develops. If you currently do not have a buy/sell agreement for your business, I would be happy to discuss their merits with you and help you and your attorney in formulating the terms of the agreement. If you already have a buy/sell agreement in place, I suggest that we review it together to ensure that it is current and includes appropriate provisions to protect you in the event of an ownership change. Please call me at your convenience so we can discuss this matter further.

Best Regards,

Appendix 2

Checklist of Factors Indicating a Buy-sell Agreement Is Advisable

___ **Liquidity of Ownership Interests Is Desired:** If the owners want to ensure a ready market for their ownership interests (in the event of death, disability, retirement, etc.), a buy-sell agreement is advisable. This provides liquidity to the heirs of a deceased or disabled owner, and can be particularly important for heirs or retiring owners with noncontrolling minority interests.

___ **Owners Want to Eliminate Uncertainty about Ownership Transfers:** Co-owners may be comfortable with a fellow owner's plans to transfer ownership—for example, to a well-regarded child in the event of death or disability. However, a buy-sell agreement between the parent and the child (with an option on the part of the remaining owners to buy the interest if the child does not) removes the uncertainty that exists if a will or other document is being relied on to effectuate the transfer. Wills can be changed at the last minute or challenged by heirs or potential heirs. A binding buy-sell agreement can establish the rights and obligations of the various parties.

___ **Future Ownership Conflicts Can Be Foreseen:** If it is anticipated that the remaining owner (or owners) would have difficulties coexisting with the family of a deceased or withdrawing co-owner (such as a spouse, son, or daughter who would inherit an interest), a buy-sell agreement can ensure that the remaining owners gain control over the interest of the deceased or withdrawing owner. Note that owners and their advisers should not overlook the possibility that a former spouse could wind up with an ownership interest in a divorce settlement.

___ **Valuation for Estate Tax Purposes Is Desired:** When owners are interested in establishing the value of their ownership interests for federal and state estate tax purposes, a buy-sell agreement can be used if certain requirements are met.

___ **Ownership by Outsiders Is Undesirable:** This factor is most commonly present in closely-held family businesses, but it can arise in any closely-held business when the existing owners are a tight-knit group. It is worth noting that in the event of insolvency of an owner, a creditor may become a member of the ownership group. A buy-sell agreement ensures that ownership interests cannot fall outside the existing group without the group's approval.

___ **Heirs of Owners Have No Interest in Ownership:** This factor can arise because the heirs feel the business is too risky or because they have no desire to participate.

___ **Ownership by Nonparticipants Is Not Desirable:** While a key person may be acceptable as a shareholder, ownership by a spouse or other beneficiary of the key person may not be acceptable.

___ **Owners Want to Assure Affordability and Certainty of Ownership Transfers:** A buy/sell agreement can set out terms that assure affordability for purchases of ownership interests. A redemption agreement that is not funded by insurance can, for example, provide for an installment payout to preserve cash flow that is essential for the ongoing success of the business. When life insurance is used to fund a buyout, a buy/sell agreement is essential to tie the receipt of the insurance proceeds to the obligation to pay those proceeds to the heirs of the decedent. It is particularly important for cross-purchase agreements involving several owners to obligate the surviving owners to use the insurance proceeds for the buyout.

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TO: All Professional Tax Personnel
FROM: William R. Bischoff, CPA

NTA-902
DATE: February 10, 2015

RE: IRS Offers Penalty Relief for Tax Underpayments Caused by Overpaid Premium Tax Credits

Background

The Affordable Care Act established the so-called Premium Tax Credit (PTC), which is available to eligible individual taxpayers starting in 2014 (IRC Sec. 36B). So, 2014 Forms 1040 are potentially affected. The PTC is a refundable credit that is intended to make health insurance more affordable for individuals who do not have access to other qualifying affordable coverage. The only problem is that some taxpayers will wind up owing money to the government because advance PTC payments made on their behalf during 2014 exceeded their allowable credit, which was not known until tax return time. In that case, the taxpayer can owe penalties in addition to the extra tax hit. However, in recently released Notice 2015-9, the IRS offers some penalty relief. Here is the story, after first covering some necessary background information.

Premium Tax Credit (PTC) and Advance Payment Basics

In general, a taxpayer is eligible for the PTC in 2014 if household income was between 100% and 400% of the Federal Poverty Line (FPL), access to affordable employer-sponsored coverage was not available, and they get their insurance coverage through the Health Insurance Marketplace (or Exchange). The allowable credit amount can vary widely depending on the taxpayer's specific circumstances. See IRS Publication 974 (Premium Tax Credit) for more details.

Taxpayers who qualified for the PTC for 2014 could have arranged for the credit to be paid in advance to the health insurance provider to lower their monthly premiums. Alternatively, they could wait to claim the credit on their 2014 Form 1040. If the advance payment option was chosen, any difference between the total amount of advance credit payments and the allowable PTC amount is reconciled on the 2014 return by filling out new Form 8962 [Premium Tax Credit (PTC)]. Form 8962 and its instructions add up to a daunting 17 pages. Enjoy!

In some cases, advance PTC payments will exceed the allowable PTC because the advance payments were based on guesstimates, and the actual allowable credit is not known until tax return preparation time. Subject to certain limitations, the excess advance PTC payment amount is treated as an amount of tax due and is reported on Line 46 of Form 1040 or Line 29 of Form 1040A.

Unfortunately, tax underpayments caused by excess advance PTC payments can also trigger penalties. The good news is that the IRS has provided some penalty relief in Notice 2015-9. More on that later.

Note: If advance PTC payments were made on your client's behalf last year, the amount of those payments should be reported by the applicable Health Insurance Exchange on new Form 1095-A (Health Insurance Marketplace Statement). The client should have received the Form 1095-A by early February. The IRS recommends that taxpayers wait to file their returns until they have received Form 1095-A (Health Care Tax Tips 2015-07).

How Excess Advance PTC Payments Can Trigger Penalties

If excess advance PTC payments result in or increase the taxes due with taxpayer's return, the Section 6654(a) penalty for under payment of estimated tax payments can be triggered. However, IRC Sec. 6654(e)(3) authorizes the IRS to waive the penalty in appropriate circumstances. This penalty ceases to apply on the tax return due date without considering extensions (generally April 15 because almost all individuals are calendar-year taxpayers).

Excess advance PTC payments can also trigger the Section 6651(a)(2) penalty for failure to pay the amount of tax shown on a return on or before the tax return due date. However, the failure-to-pay penalty is not imposed if the taxpayer can show that the failure was due to reasonable cause and not willful neglect. The failure-to-pay penalty is imposed at the rate of .05% per month, and it starts running on the tax return due date without considering extensions (generally April 15). It ends when the taxpayer pays the tax underpayment.

Finally, excess advance PTC payments can trigger the Section 6601 interest charge for tax underpayments. Interest starts running on the tax return due date without considering extensions (generally April 15) and ends when payment is made.

Notice 2015-9 Offers Limited Penalty Relief

In Notice 2015-9, the IRS provides a procedure under which many taxpayers with excess advance PTC payments for the 2014 tax year can obtain relief from the penalty for underpaid estimated tax payments and the failure-to-pay penalty.

Relief from the penalty for under payment of estimated tax payments for the 2014 tax year is available for taxpayers who: (1) have underpayments attributable to excess advance PTC payments, (2) are otherwise current with their federal income tax filing and payment obligations, and (3) report the amount of the excess advance PTC payments on their timely-filed (including extensions) 2014 return (using Line 46 of Form 1040 or Line 29 of Form 1040A).

Note: In an informal email communication with the National Association of Computerized Tax Processors (NACTP) dated January 27, 2015, an IRS official indicated that, if a taxpayer has underpayment of estimated tax penalties attributable to both an excess advance payment of the PTC and normal underpayment of estimated tax, the IRS will waive *all* of the underpayment of estimated tax penalty provided they otherwise meet the previously stated requirements.

Relief from the failure-to-pay penalty is available to taxpayers who: (1) are otherwise current with their tax filing and payment obligations, (2) have a balance due for the 2014 tax year due to excess advance PTC payments, and (3) report the amount of excess advance PTC payments on their timely-filed (including extensions) 2014 return (using Line 46 of Form 1040 or Line 29 of Form 1040A).

Taxpayers will be treated as current with their federal income tax filing and payment obligations if, as of the date they file their 2014 returns, they: (1) have filed all currently required federal tax returns or have filed extensions for such returns, and (2) have paid the tax due or entered into an installment agreement (which is not in default), an offer in compromise, or both to satisfy any unpaid tax liability. If the taxpayer has not paid a tax due because there is a legitimate dispute regarding the existence of or proper amount of the tax liability, the amount in dispute will be treated as being current until the dispute is resolved.

Warning: Notice 2015-9 offers no relief from the Section 6601 interest charges on tax underpayments. Thus, the interest charges on unpaid balances will start running on April 15, even if the taxpayer qualifies for relief from the underpaid estimated payments and failure-to-pay penalties under Notice 2015-9.

Procedures for Claiming Notice 2015-9 Relief

Procedures taxpayers should follow to take advantage of the penalty relief offered by Notice 2015-9, are as follows:

- *Relief from under Payment of Estimated Tax Penalty.* To request a waiver of the Section 6654(a) penalty for under payment of estimated taxes pursuant to Notice 2015-9, taxpayers should check box A in Part II of Form 2210, complete page 1 of Form 2210, and include Form 2210 with their return along with the statement: *Received excess advance payment of the premium tax credit.* Taxpayers need not attach documentation for the amount of advance payments or explain the circumstances under which they received excess advance payments. Taxpayers also need not calculate the amount of the estimated tax penalty caused by the excess advance PTC payments. Just fill out Form 2201 as instructed, and that is it.

- *Relief from Failure-to-pay Penalty.* In general, the IRS will automatically assess the Section 6651(a)(2) failure-to-pay penalty and send a notice demanding payment. To claim the penalty relief offered by Notice 2015-9, an eligible taxpayer should respond to the notice by submitting a letter to the address listed in the notice that contains the following statement: *"I am eligible for the relief granted under Notice 2015-9 because I received excess advance payment of the premium tax credit"*. Taxpayers who file their 2014 returns by 4/15/15 are entitled to relief under Notice 2015-9, even if they have not paid the tax liability caused by the excess advance PTC payments by the time they request relief. Taxpayers filing their returns after 4/15/15 must pay that liability by 4/15/16 to be eligible for relief under Notice 2015-9.

Note: The Section 6601 interest charge on tax underpayments will accrue from 4/15/15 until the liability is paid. Notice 2015-9 offers no relief from this interest charge. Furthermore, the relief provided in Notice 2015-9 applies only for the 2014 tax year and does not extend the time to file a tax return. To obtain an automatic extension of time to file, taxpayers must file Form 4868 (Application for Automatic Extension of Time to File U.S. Individual Income Tax Return).

Conclusion

In most cases, the penalties that result from excess advance PTC payments will be relatively small amounts, but a penny saved is a penny earned. Thank you, IRS!

References:

IRC Secs. 36B, 6601, 6621, 6651, and 6654.
Notice 2015-9, 2015-6 IRB.

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National Tax Advisory®

TO: All Professional Tax Personnel
FROM: William R. Bischoff, CPA

NTA-903
DATE: February 10, 2015

RE: Partnership Technical Terminations' Effect on Capitalized Start-up and Organizational Costs

Background

Under IRC Sec. 195, partnerships can elect to currently deduct up to $5,000 of start-up expenditures in the tax year when the active conduct of business commences. Costs in excess of $5,000 can be amortized over 180 months, starting in the month active business commences. Under IRC Sec. 709, similar treatment applies to partnership organizational expenses.

A partnership terminates for federal income tax purposes if no part of any of its business, financial operation, or venture continues to be carried on by any of its partners in a partnership [IRC Sec. 708(b)(1)(A)]. This rule applies if the partnership's business is discontinued, or if for some reason the partnership is discontinued and the business is carried on via some other type of entity (for example, a corporation). It also applies if the partnership simply goes out of existence after distributing all its assets and liabilities to the partners in liquidation.

Technical Termination Basics

Under a lesser-known rule, a partnership also terminates for federal income tax purposes if, within any 12-month period, there is a sale or exchange of 50% or more of the partnership's capital and profits interests [IRC Sec. 708(b)(1)(B)]. This type of termination is commonly called a *technical termination*, since it usually will not result in a termination under applicable state law.

After a technical termination occurs, a new partnership consisting of the new partners is deemed to come into existence for federal income tax purposes. The regulations describe a series of events that are deemed to occur after a technical termination. First, the assets and liabilities of the old terminated partnership are deemed to be contributed to the new post-termination partnership in exchange for 100% ownership interests in the new partnership. This step is tax-free under IRC Sec. 721. Immediately after, the old partnership is deemed to distribute the interests in the new partnership to the new partners (the ones that caused the technical termination) and the continuing partners (the pretermination partners that are still on board in the new partnership) in complete liquidation of the old partnership. In effect, the interests in the old terminated partnership are exchanged for interests in the new post-termination partnership. The old partnership recognizes no gain or loss on the deemed distribution of partnership interests to its partners, and the tax basis of the continuing partners in their interests in the new partnership is the same as their basis in the old partnership [IRC Sec. 731(b)].

Any depreciable property retained by the new post-termination partnership is treated as new property placed in service by that partnership [IRC Sec. 168(i)(7)]. As a result, the depreciation recovery periods, methods, and conventions for the remaining basis of the new partnership's depreciable property are restarted. This rule generally serves to lengthen the depreciable lives of property after a partnership termination, which is unfavorable, and which is often the biggest reason for wanting to avoid the occurrence of technical terminations.

The partnership's tax year closes for all partners on the date the terminating event takes place [Reg. 1.708-1(b)(3)]. A final return for the old terminated partnership should be filed for the short period ending on the termination date. The initial tax year of the new post-termination partnership begins on the following day. The new partnership must determine its allowable tax year-end under the applicable rules and generally must file an initial short-period return. (See IRS Notice 2001-5.)

The new post-termination partnership chooses its own tax accounting methods and makes its own tax elections. It is not bound by, nor does it benefit from, the old terminated partnership's tax elections. For example, the new partnership must decide whether to make the usual first-year tax elections and whether to make the Section 754 optional basis adjustment election. The partner-specific basis adjustments resulting from a Section 754 election made by the old terminated partnership carry over to the new post-termination partnership regardless of whether or not the new partnership makes a Section 754 election [Reg. 1.743-1(d)].

Finally, the new post-termination partnership retains the same name and taxpayer ID number as the old terminated partnership (IRS Notice 2001-5).

Warning: Because a technical termination may not be detected until a considerable amount of time has elapsed, the deadline for filing the first short-period tax return is frequently missed. This can result in losing the ability to make beneficial first-year tax elections. This is one more reason to stress to partnership clients the importance of keeping you informed of any partnership interest transfers.

Impact of Technical Terminations on Capitalized Start-up and Organizational Costs

In the past, some partnerships have taken the position that a technical termination allows the terminated partnership to currently deduct any unamortized Section 195 start-up expenses and any unamortized Section 709 organizational expenses. The IRS disagrees, and in December of 2013 issued proposed regulations (found in REG-126285-12) stating that the new post-termination partnership that is deemed to come into existence after a technical termination must continue to amortize any capitalized Section 195 and Section 709 expenses over the same 180-month period that was being used by the terminated partnership. This clarification has now been issued in the form of amended final regulations that apply to technical terminations that occur on or after 12/9/13. [See amended Regs. 1.195-2, 1.708-1, and 1.709-1 in TD 9681.]

Conclusion

In general, there's not much to like about partnership technical terminations. With the new IRS prohibition against deducting unamortized start-up and organizational costs, there's even less to like. For more information on all the tax ramifications of technical terminations, see *PPC's 1065 Deskbook*.

References:

IRC Secs. 168, 195, 708, 709, 721, 731, and 754.
IRS Notice 2001-5, 2001-1 CB 327.