A MONTHLY DIGEST OF KEY STATE, FEDERAL AND INTERNATIONAL TAX DEVELOPMENTS TO KEEP YOU ABREAST OF CURRENT AND PENDING TAX CONCERNS

TAX INSIGHTS

Highlighting tax developments of interest to today's companies on the move.

In this issue:

TAX REFORM

RSM's Dave Kautter Confirmed for Treasury's Tax Post

RSM's Patti Burquest to assume role of Washington National Tax Leader

RSM US LLP's ("RSM's") Dave Kautter, partner-in-charge of the firm's Washington National Tax practice since November 2014, was confirmed earlier today as assistant secretary of the Treasury, tax policy, a key position in the administration. The confirmation follows the President's May 10 announcement of his intent to nominate Kautter. Patti Burquest, currently principal – tax controversy services, will replace Kautter as Washington National Tax leader with RSM.

"On behalf of our 9,000+ employees across the country, I'd like to thank Dave for his outstanding service to RSM and our middle market clients and to welcome Patti in her new role as Washington National Tax leader with RSM," said Joe Adams, managing partner and CEO for RSM US LLP. "While we will miss Dave at RSM, we are proud that he was selected for this unique opportunity and that he has chosen to serve his country. With the potential for significant tax reform on the horizon, Dave's deep knowledge, experience and commitment can benefit our country, its businesses and its citizens for years to come. And we know that RSM's Washington National Tax team will be in good hands under Patti's leadership."

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"Dave is incredibly qualified for the position as assistant secretary of the Treasury, tax policy," said Jeff Johannesen, national tax leader with RSM US LLP. "He knows tax theory and is a very collegial and principled person. I'm confident Dave's collaborative approach to helping modernize the country's tax policies will put the country's and its citizens' interests first. I feel proud to have someone like Dave serving our country. At the same time, Patti is eminently qualified to serve as leader for RSM's Washington National Tax team, and we're pleased to have the opportunity to promote her from among the team, as part of our strategy to grow and develop our people. Those who've worked with Patti know that she brings significant value to our clients."

Prior to joining RSM, Kautter served as managing director of the Kogod Tax Center executive-in-residence at Kogod School of Business at American University (AU). Prior to his work at AU, he spent more than 30 years at a Big Four firm, where he served as director of national tax for more than 13 years. He also worked on Capitol Hill as tax legislative counsel. He is a high honors graduate of the University of Notre Dame, and received his J.D. from Georgetown Law Center.

Burquest has more than 25 years of experience managing IRS examination and appeals matters. She is a former national principal-in-charge of the tax controversy practice for a Big Four firm. Previously, she was with the IRS Chief Counsel's office where she served as a national office attorney and technical advisor to the IRS Chief Counsel and to the Special Counsel (Large Case). Burquest holds a Master of Laws, a Juris Doctor and a B.A. from the University of Florida.

THE REAL ECONOMY

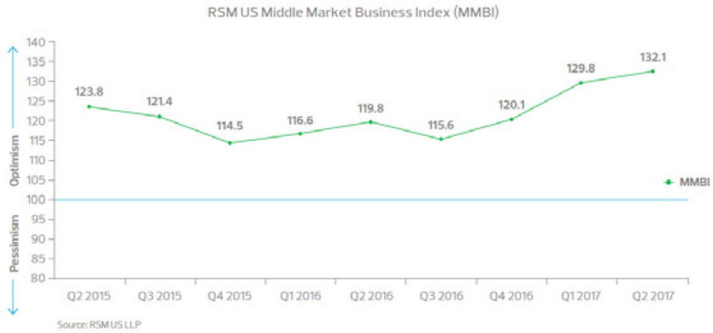
RSM US Middle Market Business Index Hits Another New High

[View video]

The RSM US Middle Market Business Index posted a record high of 132.1 in the second quarter. This is the second consecutive record-high reading for the index and reflects underlying improvement in economic conditions during the past year, as well as strong corporate earnings and respondent expectations for significant tax reform and regulatory relief this year.

[Download the full second quarter 2017 report]

Since the first quarter of 2015, RSM has collected data on middle market firms through quarterly surveys administered by Harris Poll. The survey is conducted four times a year, in the first month of each quarter: January, April, July and October. The survey panel, the Middle Market Leadership Council, consists of 700 middle market executives, and is designed to accurately reflect conditions in the middle market. The data for each quarter are weighted to ensure that they correspond to the U.S. Census Bureau data on the basis of industry representation.



A reading above 100 for the MMBI indicates that the middle market is generally expanding; below 100 indicates that it is generally contracting. The distance from 100 is indicative of the strength of the expansion or contraction.

[Read more about how the index is constructed]

TRENDING IN TAX

Failure to obtain true ownership led to huge tax on sale-leaseback

By: Stefan Gottschalk, Senior Director; Rob Alinsky, Associate

The Tax Court in June 2017 entered two orders finalizing amounts owed by Exelon in a recent Tax Court case.[1] Their sum is about $526 million—tax deficiency of about $438 million, plus penalties of about $88 million.[2] In its Form 10-K filed with the Securities and Exchange Commission, Exelon stated that it plans to file an appeal.

The September 2016 decision in this case[3] highlights the risks that accompany claiming ownership of property for tax purposes (Tax Ownership) when another party bears the lion's share of the economic benefits and burdens of property ownership. Similar Tax Ownership issues arise in many property transactions where both the purchaser and seller have some continued interest in the property.

Tax deferral dispute in the Exelon case

Exelon's predecessor, Unicom (the former parent company of Commonwealth Edison), sold power plants for about $4.8 billion in 1999, generating about $1.6 billion of gain. It sought to defer tax on this gain by qualifying for like-kind-exchange treatment under section 1031 of the Tax Code.

The like-kind-exchange rules permit deferral of federal income tax that otherwise would be triggered on the sale of some types of business or investment property. Use of this like-kind-exchange tax deferral benefit is particularly common in the real

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estate industry. Qualifying for the benefit requires acquiring replacement property of like-kind to the property sold. For example, a real estate seller may sell one real property and acquire different one without triggering current tax, if various requirements are met.

Unicom sought to defer taxation of its $1.6 billion gain on the power plant sales under the like-kind rules. It also sought to obtain cash up front and a predictable return on its investment. With the help of its tax advisors, it entered into a number of power plant sale-leaseback transactions. These transactions were intended to both qualify to defer taxation of the $1.6 billion gain and meet with Unicom's economic preferences. The IRS, however, concluded that they did not qualify for the desired tax deferral because Unicom did not obtain Tax Ownership of the replacement power plants. The Tax Court agreed.

1 *Exelon Corp. v. Comm'r*, T.C., Docket Nos. 29183-13 and 29184-13 (Orders entered June 22, 2017)

2 In addition, interest accrued on the tax deficiencies; the Tax Court Orders did not include the interest amounts

3 *Exelon Corp. v. Comm'r*, 147 T.C. No. 9 (2016)

To read more, go to: http://rsmus.com/what-we-do/services/tax/lead-tax/tax-mergers-and-acquisitions/failure-to-obtain-true-ownership-led-to-huge-tax-on-sale-leaseba.html

Are you taking full advantage of the tooling R&D tax credit?

By: Mark Chaberski, Partner

Given the relative unpredictability of the economy, companies large and small need to increase cash flow. An often overlooked method to increase cash flow is through federal and state research and development (R&D) tax credit.

Automotive manufacturers and suppliers have a unique opportunity to increase their R&D credit thanks to a misunderstood and underutilized provision associated with tooling.

In a 2009 tax case, the tax court held that a manufacturer of automotive parts may categorize the cost of tooling developed to make the parts as a supply when calculating the R&D credit.[1] These allowable costs include both internal and third-party engineering costs to design the tooling as well as the costs for both the soft tooling and the production of hard tooling.

Qualifying for the credit

To qualify these costs in the R&D calculation, two basic requirements are needed:

- **The taxpayer needs to bear the economic risk that the tooling will perform adequately.** This requires the taxpayer to be responsible for producing the part to the customer specification. The taxpayer cannot transfer this risk to the tool and die maker or any other outside contractor. Generally, this requirement is easily met.
- **The taxpayer must transfer ownership of the tool to its customer.** This requirement prohibits the taxpayer from owning the tool. The Internal Revenue Code (IRC) section 41 prohibits tangible depreciable property from being used to calculate the R&D credit.[2] In *TG Missouri Corp. v. Comm'r*, the IRS argued that tooling cannot be included in R&D calculation since it is depreciable property. IRC section 41 states supplies cannot be included in the R&D calculation that are "subject to the allowance for depreciation."[3]

The tax court disagreed with the IRS's reading of IRC section 41, ruling that it is not the character of the asset (depreciable or not depreciable) that determines its qualification for the credit, but rather who owns the asset. Similar to many automotive manufactures, TG Missouri Corp. retained tooling in its facility and produced parts for its customers. However, the tooling was not owned by TG Missouri Corp. Since the tooling was not a fixed asset on the company's financial statements, it was not considered depreciable by TG Missouri Corp. and was therefore qualified as an R&D supply.

The tax court clarified that metal stampers and injection molders are allowed, under the correct facts and circumstances, to substantially increase their R&D credit by including tooling-related expenses. These expenses include the cost of production molds that are paid for by the customer (in some arrangements other than a pure time and material one) but used by the taxpayer.

Automotive manufacturers and suppliers who want to increase cash flow should have their R&D credit reviewed, paying particular focus to whether or not tooling can be included in the calculation.

1 TG Missouri Corp. v. Comm'r, 133 T.C. No. 13 (2009)

2 IRC section 41(b)(2)(C)(ii)

3 Ibid.

More improvement categories bring more confusion and more opportunity

By: Chris Atwell, Senior Director; Justin Silva, Senior Manager; and Christian Wood, Principal

At first glance, the Protecting Americans from Tax Hikes (PATH) Act of 2015 looks like an effort by Congress to make permanent, several temporary provisions of the federal income tax code, including shorter lives for certain types of non-residential real property and the higher section 179 deduction limits, in order to provide some certainty to taxpayers. But the PATH Act also yielded a few surprises, one of which was the application of bonus depreciation, which was extended by the Act through 2019, to a new category of assets.

The PATH Act made permanent the 15-year life assigned to qualified retail improvements, qualified restaurant property, and qualified leasehold improvement property[1]. It also introduced a new asset category, qualified improvement property (QIP),

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to be eligible for bonus depreciation beginning Jan. 1, 2016[2]. QIP is broadly defined as interior improvements to non-residential real property placed into service after the building is originally placed into service. The types of improvements that are eligible for QIP treatment are somewhat similar to qualified leasehold improvement property (QLI), with several exceptions:

- There is no requirement that the improvements be related or pursuant to a lease;
- The building to which the improvements are being made can be less than three years old; and
- The improvements can be made to common areas used by all of the building's occupants.

Expenditures attributable to any elevator or escalator, the enlargement of a building, or the internal structural framework of the building are not eligible for QIP treatment. These limitations are similar to ones for QLI.

1 Code Sec. 168(e)(3)(E).

2 Code Sec. 168(k)(3).

To read more, go to: http://rsmus.com/what-we-do/services/tax/lead-tax/accounting-methods-and-periods/more-improvement-categories-bring-more-confusion-and-more-opport.html

IRS Partnership Audit Rules

VIDEO | June 30, 2017

Download report

The IRS Is Targeting Partnerships — Is Yours Next?

With the enactment of the Bipartisan Budget Act of 2015, the private capital industry should expect major changes to the way the IRS audits. Donald Susswein of RSM and noted tax attorney Fred Witt outline these changes and what they mean for managers of private funds.

North Carolina General Assembly overrides veto of two-year budget bill

By: Craig Ridenour, Partner; Sherri York, Partner; and Jon Miller, Principal

The North Carolina General Assembly passed a $23 billion budget bill for the 2017-2018 and 2018-2019 fiscal years over the veto of Gov. Roy Cooper. The North Carolina House undertook the final vote to override the veto on June 28 after the senate had voted to do so the day prior. Senate Bill 257, now Session Law 2017-57, went into effect on July 1, 2017. The bill includes several taxation and revenue law changes that have multiple effective dates.

It was reported that the governor based his decision to veto the bill, in part, due to the reductions in the corporate income tax rate and the subsequent loss in revenue that could have been used for other purposes. The bill immediately lowers the rate of tax for C corporations from the current 4 percent rate to 3 percent in tax years beginning on or after Jan. 1, 2017. Effective for tax years beginning on or after Jan. 1, 2019, the tax rate would drop another half of a percent to 2.5 percent.

The budget bill also lowers the personal income tax rate from the current 5.499 percent to 5.25 percent, effective for tax years beginning on or after Jan. 1, 2019. The standard deduction would also increase for tax years beginning on or after Jan. 1, 2019. Single taxpayers and those that are married filing separately would see an increase of $1,250 in their standard deduction, to $10,000. Married taxpayers filing jointly would receive a $2,500 increase to $20,000 while those filing as head of household would see their standard deduction increase by $1,000, to $15,000. Meanwhile, the bill would repeal the child tax credit effective in tax years beginning on or after Jan. 1, 2018 and replace it with a corresponding deduction. The deduction would total $2,500 for those making up to $40,000 and then begin to phase out as personal income increases. The child tax deduction would phase out completely for those making in excess of $120,000.

To read more, go to: http://rsmus.com/what-we-do/services/tax/state-and-local-tax/sales-and-use-tax/north-carolina-general-assembly-overrides-veto-of-two-year-budge.html

California guidance on the Other State Tax Credit and deductions

By: Kimberly Kleca, Manager; Dale Divers, Senior Director

The California Franchise Tax Board (FTB) released Legal Ruling 2017-01 on Feb. 22, 2017, providing general guidance on how to determine if a taxpayer is eligible for the Other State Tax Credit (OSTC) or a deduction for taxes paid to another state under the California Revenue and Taxation Code (CRTC). The Legal Ruling also provides examples addressing taxes paid to Arizona and business taxes paid to Kentucky, New York State and City, Tennessee, and Texas. The Legal Ruling is effective for taxable years beginning on or after Jan. 1, 2016.

For California residents, the state will generally tax all income from all sources. To avoid double taxation, California generally allows an OSTC for individuals, estates, and trusts for net income taxes imposed by and paid to another state on income that is also subject to tax in California. (See Cal. Rev. & Tax Code 18001 – 18011; Cal. Code of Regs., tit. 18 sections 18001-1, 18001-2; FTB Sch. S.) The OSTC is also available for California nonresidents and may vary depending on the residency and status of the taxpayer. If the OSTC is not available, and subject to exceptions, a taxpayer (both individuals and/or entities) may claim a deduction. (Cal. Rev. & Tax. Code sections 17201, 24345).

The Legal Ruling provides that the characterization of the tax as eligible for the OSTC, or is deductible, is by its operation, not

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its labels. A tax is analyzed by applying general tax law, including applicable federal and California authorities.

In order to determine whether an OSTC or deduction is permitted, the taxpayer should look to the deduction rules first. If it is determined that the tax is not a tax on, or according to, or measured by income, then the analysis ends, and the taxpayer may claim a deduction for the tax, assuming all other requirements are met, but cannot claim the OSTC.

There are generally three types of taxes paid to other states: Gross Receipts Tax, Gross Income Tax, and Net Income Tax.

- A gross receipts tax is a tax imposed on gross income and a return of capital, which includes cost of goods sold.
- A gross income tax is a tax imposed on gross income only, with any return of capital (such as cost of goods sold) excluded from the tax base.
- A net income tax is a tax imposed on the income that remains after gross income is reduced by deductions, credits, or exemptions. (See FTB Notice 2010-2).

When a tax is not a single, indivisible tax, but rather a conglomeration of "separate and independent taxes," the character of each of the separate taxes is analyzed independently.

If it is determined that:

1. the tax is properly characterized as a tax on, or according to, or measured by income (which includes both gross and net income taxes), and
2. the tax is properly characterized as net income tax, then
3. the taxpayer may claim an OSTC as long as the tax is imposed by and paid to the another state by an individual, an entity taxed as a partnership, or a corporation in connection with "carrying on a trade or business" or "for production of income" with certain exceptions. (See Cal. Rev. & Tax. Code, §§ 17201, 24345; *Beamer, supra*, at 474.)
4. However, if the tax is imposed by and/or collected by a county, city, or other locality, the OSTC is not available but can claim the deduction.

To read more, go to: http://rsmus.com/what-we-do/services/tax/state-and-local-tax/income-and-franchise/california-guidance-on-the-other-state-tax-credit-and-deductions.html

EVENTS AND WEBCASTS

Retirement plan issues and insights

LIVE WEBCAST | November 02, 2017

Attend our webcast series addressing the key challenges and opportunities found in designing, implementing and maintaining company retirement plans.

The economy's impact on retirement plans
An RSM economist discusses how the U.S. economy is affecting retirement planning.
Thursday, Nov. 2, 2017

Register

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How can you create a plan design that attracts and retains highly compensated employees? What are the opportunities in non-qualified plans?
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Fiduciary rules in the new world: Top 10 ways to reduce your liability
What fiduciary responsibilities do you have as a plan sponsor? Where are the blind spots and risks?

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Top 10 retirement plan internal control pitfalls—and how to avoid them
A lively examination of a number of widespread mistakes and oversights that companies make—and how to avoid them

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Tax planning in anticipation of reform: What you should know (and do)

RECORDED WEBCAST | July 18, 2017

Join Charlie Ratner as he walks through the broad implications to you of potential tax reform and how to be ready to act if and when reform occurs.

In this one hour session, he covers:

- How to review your income and gift tax returns for issues and opportunities
- The implications of tax reform for income, estate, charitable giving and life insurance planning
- Steps to consider now for proactive planning in each of these important areas

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FROM THE BLOG

EU value added tax refund potential for pharmaceutical companies

Avoiding IRS penalties: Substantial compliance with foreign returns

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