Tax & Wealth Advisor Alert: Proposed Bipartisan Bill to Expand Research and Development Tax Credit

Late July, Senator Maggie Hassan (D-NH), a member of the Senate Finance Committee, and Senator Thom Tillis (R-NC) introduced the bipartisan Research and Development Tax Credit Expansion Act that aims to double the refundable research and development (R&D) tax credit and increase the alternative simplified credit rate for new and small businesses. If enacted, the bill would provide additional cash savings for eligible businesses that perform qualified R&D activities.

Background

While the R&D tax credit has been around for a while, historically, many small businesses and start-up companies could not immediately benefit from the R&D credit as they were not generating income in early years and thus they had no regular tax for the R&D credit to offset. Noticing this limitation, the PATH Act of 2015 added new IRC Sections to allow qualified small businesses to apply the R&D credit against their employer's payroll tax liability (up to $250,000 annually). For these purposes, a "qualified small business" is generally defined as a corporation, partnership or sole proprietorship with: (1) gross receipts of less than $5 million for the tax year and (2) no gross receipts for any tax year before the five tax years ending with the election year.

New R&D Credit Bill

The new bill aims to double the amount of R&D credit that can be used to offset an employer's payroll tax liability by increasing the annual cap from $250,000 to $500,000 and then automatically indexing for inflation. In addition, the bill would expand the number of eligible businesses that qualify for the credit by raising the maximum amount of gross receipts from $5 million to $10 million per year. It would also allow the R&D credit to offset *all* payroll taxes so businesses can apply the credit against Medicare and unemployment taxes, in addition to Social Security taxes. Lastly, the bill would increase the alternative simplified credit rate (a method used to calculate the R&D credit), which provides a credit of 14% for research that exceeds half of the average research spending from the last three years. The bill would increase the alternative simplified credit rate from 14% to 20% for new and small businesses that qualify for the credit.

Implications

If enacted, eligible taxpayers would doubly benefit by both generating a higher credit amount and being able to apply more of the credit generated against their payroll tax. Additionally, the bill would increase both the availability of the payroll offset option as well as the ability to generate cash tax savings for eligible taxpayers. The proposed Act certainly removes many

of the barriers that limit a new or small businesses' ability to claim the credit. Nevertheless, while we wait to see if Congress will approve the Research and Development Tax Credit Expansion Act, we will continue to advise our clients to ensure their R&D tax credit compliance and counsel on effective tax planning opportunities should the Act go into effect.

If you are interested in learning more about your eligibility or effective tax planning opportunities for the current and/or proposed R&D tax credit, please contact Attorney Britany E. Morrison at O'Neil, Cannon, Hollman, DeJong & Laing S.C. to discuss how we are able to assist you in your needs.

Tax & Wealth Advisor Alert:
Time to Act on Act 368: Wisconsin Pass-Through Entity-Level Tax Election

In December of 2018, Wisconsin enacted tax legislation—Wisconsin Act 368—that specifically impacted LLCs, S-Corps, and partnerships ("pass-through entities"). The Act allows pass-through entities to make an annual election to be taxed at the entity-level, rather than at the individual level. This election may provide significant tax savings to Wisconsin businesses and their owners, but this election won't work for everyone. While the new Wisconsin law certainly brings some tax saving opportunities, there are election rules and potential issues that Wisconsin owners of pass-through entities must consider before deciding whether to make the election.

Background

Historically, individuals were not limited in what they could deduct for state income and property taxes. However, starting in 2018, due to the Tax Cuts and Job Act, the deduction for state income and property taxes is now limited to $10,000. Wisconsin has attempted a creative approach with Act 368 to circumvent this limitation by allowing pass-through entities to be taxed at the entity-level. The idea is that the Tax Cuts and Job Act deduction cap applies to individuals and not businesses, so by allowing the pass-through entity to be taxed at the entity-level, the deduction is shifted from a capped deduction to an uncapped deduction.

Treatment

The new provision allows for pass-through entities to elect to be taxed at the entity-level which is a flat rate of 7.9% (the WI corporate income tax rate) rather than passing the income to shareholders to be taxed on their individual return (7.65% for individuals at the highest

income tax rates). The entity-level tax would then be deductible by the pass-through on its Federal return resulting in a decrease of Federal income and corresponding Federal tax. Therefore, even though the entity-level rate is higher than the individual rate, this could still result in beneficial tax savings if pass-through owners were previously limited by the cap.

Election

S-Corps can begin making the election beginning with the 2018 tax year, while partnerships and LLCs may make this election starting with the 2019 tax year. For S-corps, persons holding more than 50% of shares on the day of election must consent, while for partnerships, persons holding more than 50% of capital and profits interest on the day of election must consent. The advantageous feature about this election is that it is flexible, in that it can be made on an annual basis. Pass-through entities can opt in or out each year without limitation or penalty. Additionally, the election must be made on or before the due date or extended due date of the WI return.

Potential Issues

While this may sound like a straight forward decision to make the election for a Wisconsin owner of a pass-through entity, there are several potential issues to consider before making the election.

- *Tax Rate*: If taxpayers in pass-through entities are not subject to the top individual income tax rate of 7.65%, it is possible they may not receive enough of a benefit from the entity-level deduction to offset the cost of having to pay tax at a higher 7.9% rate.
- *Credits*: The only credit that pass-through entities may claim against the WI entity-level tax is the credit for income taxes paid to other states. The loss of the ability to claim manufacturing and agricultural credits in addition to research and development credits, for example, may outweigh the benefits of the election.
- *Loss Position:* The election would not be advisable for pass-through entities experiencing losses as there would be no deductible state taxes anyway and such losses would effectively be wasted.
- *Out -of-State Owners*: If the pass-through entities have a substantial number of out-of-state owners they may not benefit from the election if the owners are not allowed a corresponding exclusion or credit for the income tax being paid at entity-level in WI on their individual home state returns.
- *Lack of IRS Support*: There has been no guidance or reaction from the IRS yet, so there is a risk that future Federal laws or regulations could render this WI election ineffective. Other states have attempted workarounds and the IRS has made those ineffective by proposed regulations and notices. Although WI's workaround is a bit different than the state's that have tried, and there is support, there is still risk.
- *Legal Document Compliance*: The election may require amendments to the Wisconsin pass-through entities' operating agreement and formation documents. This should be discussed with legal counsel and the documents should be amended, if necessary, before the election is made.

Ultimately, pass-through entities in an income position that do not have any applicable WI credits or out-of-state owners have the best potential for tax savings. However, because the election does not have to be made until the extended due date, there is a real opportunity for Wisconsin owners of pass-through entities to analyze the above-mentioned issues with both tax advisors and legal counsel to determine whether the election is beneficial and/or worth the extra compliance costs before committing to the election.

If you are interested in learning more about Act 368 and WI's entity-level tax election or need assistance in tax and/or legal planning to take advantage of the election, please contact Attorney Britany E. Morrison at O'Neil, Cannon, Hollman, DeJong & Laing S.C. to discuss how we are able to assist you in your needs.

Tax & Wealth Advisor Alert:
Not Feeling so SECURE: Proposed Law Could be Costly for Non-Spouse IRA Beneficiaries

On May 23, 2019, the House overwhelmingly voted (417-3) to approve the SECURE (Setting Every Community Up for Retirement Enhancement) Act and sent it to the Senate for their approval. The bipartisan bill is grabbing headlines for its modification to many retirement issues. Among those modifications is a requirement that could be costly for non-spouse IRA beneficiaries. The requirement forces non-spouse beneficiaries of inherited IRAs to withdraw funds from their account over a 10-year period after the original owner's death rather than the beneficiaries' life expectancy, ending the beneficial tax strategy known as the "stretch IRA."

Under current law, if a person other than a spouse is named as a beneficiary of an IRA account, the beneficiary can take their IRA required minimum distributions over their life expectancy based on a table provided by the IRS. Therefore, withdrawal of the IRA account is "stretched" out over a presumably long period based on the beneficiary's life expectancy. For example, if a 25-year old inherited a $1 million IRA from his grandfather, he would take distributions over his life expectancy of 57.2 years (as provided by the IRS table). His required minimum distributions would be about $17,482 ($1,000,000/57.2), which he would need to withdraw yearly over a 57.2-year period. Each year, this would result in a federal tax bill anywhere between $548 (if he were in the lowest tax bracket) to $6,468 (if he were in the highest tax bracket). The "stretch IRA" is a beneficial tax strategy, especially for younger beneficiaries, because they have smaller required minimum distributions stretched out through their life expectancy and thus they incur smaller tax bills. Additionally, the stretch allows for tax-deferred growth over longer accumulation periods and a larger amount of

money reaching the pockets of the beneficiaries.

The proposed SECURE Act, however, would require beneficiaries to withdraw all the money in the inherited IRA account within a 10-year period from the original owner’s death rather than stretch the distributions out over the life expectancy of the beneficiary. The proposed Act allows the distributions to be whenever the beneficiary likes—the distributions can be made at regular intervals or at the end of the period—just as long as they are made sometime in the 10-year period.

Despite the flexibility in distributions, removing the stretch based on life expectancy in exchange for a 10-year period will have significant financial effects for non-spouse beneficiaries of inherited IRAs. The proposed Act will greatly accelerate tax collection, pushing the beneficiaries into high tax brackets, resulting in beneficiaries paying a substantial amount more in taxes than under the life-expectancy stretch. To illustrate, using the previously mentioned example of the 25-year old beneficiary of a $1 million IRA, if he were to take equal distributions of $100,000 over the 10-year period, in the first year alone, his income would be bumped up by $82,517 ($100,000 versus $17,482 in life-expectancy stretch), which could easily land him in a higher tax bracket. He would then have a yearly tax bill between $24,000 (if the distributions were his only income) to $37,000 (if he were in the highest tax bracket). That is an incredible difference in tax bills, not to mention the loss of tax-free compounding that was allowed for longer periods of time under the life-expectancy stretch.

If the proposed SECURE Act goes into effect, it will no doubt be costly for non-spouse IRA beneficiaries. The landscape of IRA planning will need to change, and IRA owners might consider alternative planning strategies like charitable beneficiaries or investments in life insurance policies versus IRAs to minimize taxes for their loved ones. While we wait to see if the Senate will approve the SECURE Act, we will continue to advise our clients to ensure their compliance and counsel on effective tax minimizing alternatives should the SECURE Act go into effect.

If you are interested in learning more about tax minimizing alternatives for non-spouse IRA beneficiaries, please contact Attorney Britany E. Morrison at O’Neil, Cannon, Hollman, DeJong & Laing S.C. to discuss how we are able to assist you in your needs.