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**VIA ELECTRONIC DELIVERY & FIRST-CLASS MAIL**

Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2016-26)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: Recommendations for 2016-2017 Priority Guidance Plan Pursuant to Notice 2016-26

Dear Ladies and Gentlemen:

Pursuant to the Request for Comments contained in Notice 2016-26 (the "Notice"), alliantgroup, L.P. respectfully submits the following recommendations for items to include in the 2016-2017 Priority Guidance Plan (the "Plan"). alliantgroup is a national tax consulting services firm that works with CPA firms and their clients. alliantgroup, through its national office, operating as alliantNational, provides tax consulting services on a variety of complex topics of tax. In the course of working with CPA firms and clients, alliantgroup has observed several areas of tax law and administration that currently burden businesses or can benefit from clear guidance. We believe that solutions to these issues exist that will alleviate taxpayer burden and will streamline tax administration. We have included several of these recommendations below. We look forward to working with the IRS, Office of Chief Counsel, and Office of Tax Policy on these and other matters.

## I. Clarify Research Credit for Startup Companies

In December 2015, Congress enacted the Protecting Americans from Tax Hikes Act ("PATH"). As part of PATH Congress amended section 41(h) to allow startup companies to offset payroll tax liability with research credits ("payroll tax credit"). Treasury has not yet issued guidance interpreting and administering the payroll tax credit. We urge Treasury to issue guidance in this area to clarify a variety of provisions. We believe that adoption of the below changes will honor Congressional intent and incent small business research activities. We offer our assistance in working to craft implementing and clarifying guidance in this area.

Under section 41(h), startup companies that are qualified small businesses may claim the payroll tax credit. The PATH Act defines a qualified small business as a corporation, partnership or person with gross receipts of less than $5,000,000 for the taxable year and that

did not have gross receipts for any taxable year preceding the 5 taxable year period ending with the taxable year. The bill does not define gross receipts, only stating that gross receipts are determined under the rules of section 448(c)(3), without regard to subparagraph (A). Section 448(c)(3) provides for annualizing gross receipts for short taxable years, reducing gross receipts by returns and allowances, and it states that references to an entity include references to predecessors of the entity. Notably, the PATH Act does not establish a specific de minimis rule for gross receipts and it does not exclude any amounts from the definition of gross receipts, other than returns and allowances. We believe clarification of the definition is warranted. As set out below, Congressional intent to assist small startups would be frustrated if all revenue sources were taken into consideration and if there was no ability to disregard small amounts in prior years before real gross receipts from business operations begin.

### *A. Conform Section 41(h) Definition of Gross Receipts to Treas. Reg. § 1.41-3(c) Definition*

We suggest that Treasury issue guidance that conforms the section 41(h) definition of gross receipts to the definition in Treas. Reg. § 1.41-3(c). Under that regulation there is an exclusion of several amounts from the definition of gross receipts, including gross receipts earned in any year prior to the first year in which the taxpayer earns more than $25,000 in gross receipts other than investment income.[1] Treasury implemented the regulation in 2001 to make it easier for startup companies to calculate the fixed base percentage using the startup rules.[2] For example, a company may only compute its fixed base percentage using the startup rules if it didn't have any QREs or gross receipts in certain years in the 1980s. Without a de minimis gross receipts rule, Treasury recognized that many companies with pre-operating investment income and gross receipts in the 1980s would not be able to benefit from the startup fixed base percentage calculation. Similarly, many startup companies with de minimis pre-business operating income will be unable to benefit from the payroll tax credit absent Treasury's extending Treas. Reg. § 1.41-3(c) to section 41(h).

While clarification would be helpful, Treas. Reg. § 1.41-3(c)(2) already applies to all of section 41 and thus extends to the treatment of gross receipts for purposes of the payroll tax credit. Section 41(c)(3)(B)(iii) gives Treasury the authority to issue regulations "providing that de minimis amounts of gross receipts…shall be disregarded" for purposes of the fixed base percentage calculation. While this section is more specific in its application, a plain reading of the resulting regulation extends the gross receipts de minimis rule definition to all of section 41. Paragraph (c)(1) of the regulation states that "*for purposes of section 41*, gross receipts means the total amount, as determined under the taxpayer's method of accounting, derived by the taxpayer from all its activities and from all sources." [emphasis added] Paragraph (2) goes on to exclude amounts from the definition of gross receipts for purposes of paragraph (c). The excluded amounts modify the paragraph (c)(1) definition of gross receipts and therefore similarly apply "for purposes of section 41" as a whole, which includes the newly amended section 41(h).[3] Additionally, the reference in section 41(h) to section 448(c)(3) does not

[1] *See* Treas. Reg. § 1.41-3(c)(2)(vi).
[2] *See* T.D. 8930. The startup fixed base percentage calculation generally produces smaller base amounts and alleviates credit substantiation burdens by not requiring a taxpayer to refer to records from the 1980s.
[3] Further, in the preamble to the final regulations issued in T.D. 8930, Treasury stated that it would not exclude from gross receipts items not derived in the ordinary course of business. Treasury reasoned that a taxpayer might include

override the Treas. Reg. § 1.41-3(c) definition of gross receipts. Section 448(c)(3)(C) does not define gross receipts but instead lists principles under which gross receipts are to be determined. These principles are not inconsistent with the exclusions in Treas. Reg. § 1.41-3(c). However, for the sake of clarity, we suggest that guidance be issued to make clear that Treas. Reg. § 1.41-3(c) and the excluded amounts apply to section 41(h).

### *B. Exclude Government and Nonprofit Grants and Tax Incentives from Definition of Gross Receipts*

We suggest that guidance be issued to exclude some or all government and nonprofit grants and tax incentives from the definition of gross receipts for purposes of the payroll tax credit. These amounts are not included among the excluded amounts in Treas. Reg. § 1.41-3(c). When Treasury issued T.D. 8930 and the gross receipts exclusions, gross receipts were only relevant for computing the research credit under the regular methodology and the computation formula required companies with large gross receipts to incur correspondingly large amounts of QREs to generate a substantial credit. In the preamble to T.D. 8930, Treasury stated that "in determining its research budget, a business may take into account any expected income stream, regardless of whether or not the income is derived from sales or from other active business activities." Treasury needed to make sure that companies consistently spent a meaningful portion of their entire income stream on research activities. However, for purposes of the payroll tax credit, gross receipts are relevant for determining whether a company qualifies to claim the credit. Senator Coons (D-DE), the key sponsor of the payroll tax credit, stated that the purpose of the provision is "provide a mechanism for companies doing R&D to get a tax credit to support their activity prior to them having significant taxable income."4 The gross receipts test helps to identify whether a company has matured sufficiently in its business operations to a point where it generates taxable income. Accordingly, gross receipts ought to be defined more narrowly to ensure that young companies that do not generate taxable income may still benefit from the research credit even if they derive revenue from certain sources. Government and nonprofit grants and tax incentives are uniquely suited for exclusion in the startup context. Those payments are targeted to provide a small business the capital to begin business. To have those amounts prevent a startup from utilizing a targeted federal incentive based on the same policy principle would be inconsistent with the stated Congressional purpose of the payroll tax credit. The award of a government or nonprofit grant or tax incentive demonstrates a company's promise for technological innovation, and shows that the company is precisely the type of small business that the research credit is meant to incentivize.

### *C. Narrowly Apply Controlled Group Rules to Section 41(h)*

The PATH Act provides for the application of controlled group rules in determining eligibility for the payroll tax credit. The PATH Act provides that "all persons or entities treated as a

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royalties received in the 1980s as derived in the ordinary course of business, thus lowering the fixed base percentage, but exclude interest income received in the years preceding the credit year as not derived in the ordinary course of business, thus decreasing the base amount. By conflating gross receipts for purposes of the fixed base percentage and the average annual gross receipts for the prior four years, Treasury contemplated that its definition of gross receipts extended to all of section 41.

[4] *See* "Sen. Chris Coons' R&D Tax Credit Bill Passes Congress." Delawareonline at http://www.delawareonline.com/story/news/2015/12/18/coons-tax-credits-included-year-end-bill/77505662/

single taxpayer under subsection (f)(1) shall be treated as a single taxpayer for purposes of this subsection." Section 41(f)(1)(A) states that "all members of the same controlled group of corporations shall be treated as a single taxpayer." Section 41(f)(5) gives "controlled group of corporations" the same definition as under section 1563(a) with certain modifications. As such, the research credit requires aggregation of gross receipts and qualified research expenses for parent / subsidiary, brother / sister and combined group controlled groups of corporations. Section 41(f)(1)(B) and Treas. Reg. § 1.41-6(a)(3)(ii) apply similar principles for aggregating gross receipts and qualified research expenses among unincorporated trades or businesses under common control. Section 1563(b)(2) excludes several entities from a controlled group of corporations, including an entity which is a member of a group "for less than one-half the number of days in such taxable year…" Section 41 does not incorporate section 1563(b), or any similar provision regarding unincorporated trades or businesses, and, therefore, if a company is a controlled group member for just one day during the taxable year, the company is included in the controlled group.[5]

We urge Treasury and the IRS to issue guidance applying aggregation principles more narrowly for purposes of the payroll tax credit than are applied for purposes of section 41 generally. Until the enactment of the payroll tax credit, the controlled group rules in section 41(f) only applied to the computation of the research credit. The legislative history to section 41 makes clear that the controlled group rules were "intended to prevent artificial increases in research wage expenditures by shifting expenditures among commonly controlled or otherwise related persons."[6] Section 41(h)(5) incorporates controlled group rules for purposes of qualification for the payroll tax credit. While it may make sense to broadly apply the controlled group rules to prevent companies from claiming artificially inflated research credits, it also makes sense to apply the rules narrowly for purposes of the payroll tax credit to ensure that deserving startups qualify.

### *D. Gross Receipts and "Serial Entrepreneurs"*

We suggest that Treasury and the IRS consider how the gross receipts and 5 year rules should apply in the case of so-called "serial entrepreneurs." In particular, how should gross receipts of related sole proprietorships and single member corporations be counted? Within the startup realm, many individuals start several businesses over the course of just a few years. Sometimes these "serial entrepreneurs" dissolve one business and start another and sometimes they let a prior attempted business remain in existence though dormant and start new ones. Under the section 41(h)(5) aggregation rules, an unintended consequence of such a practice might be to fail the gross receipts tests. We believe that Treasury and the IRS should consider whether this is a reasonable result if the entities with gross receipts in the look-back years are unrelated in their business operations to the new entity generating the credit. We urge Treasury to adopt guidance that disregards gross receipts of functionally unrelated companies for purposes of the look-back rule and we suggest that Treasury incorporate principles similar to the passive activity grouping rules to determine whether companies are functionally unrelated.[7]

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[5] *See* Treas. Reg. §1.1563-1(a)(1)(ii).
[6] Senate Report 97-144 (1981).
[7] *See* Treas. Reg. § 1.469-4(c)(2).

### *E. Payroll Tax Credit and Recordkeeping Requirements*

In recognition of the record keeping burdens that small businesses bear, we ask that Treasury and the IRS issue guidance adopting reasonable substantiation and record keeping expectations for purposes of the payroll tax credit. Such guidance would honor Congressional intent, as section 41(h)(6)(B) authorizes Treasury to promulgate "regulations to minimize compliance and recordkeeping burdens under this subsection."[8]

## II. Research Credit

### A. *Treatment of Taxpayers Amongst Industries*

There remains concern that the examination function at the IRS may treat qualifying taxpayers differently based on industry. Project qualification, substantiation requirements, and the determination of qualified research activities are sometimes applied in very different ways for qualifying taxpayers. We ask that Treasury and the IRS provide guidance on an industry by industry basis demonstrating ways in which taxpayers across a wide array of industries might qualify for the research credit. Industry-based guidance regarding qualification would help to provide a consistent treatment under the law.

## III. Section 831 and Diversification Requirements

### A. *Reinsurance*

The PATH act amended section 831 of the Internal Revenue Code to add a diversification requirement for section 831(b) captive insurance companies. Captive insurance companies must now meet one of two tests to qualify for section 831(b) treatment. Under one test, the diversification requirement is met if no more than 20 percent of the net written premiums, or, if greater, direct written premiums, of such company for the taxable year is attributable to any one policyholder. The PATH act also added controlled group rules making clear that for purposes of the first diversification test all policyholders which are related, within the meaning of section 267(b) or 707(b), or are members of the same controlled group, are treated as one policyholder. However, neither the PATH Act nor section 831(b) clarify whether reinsurance pools are considered one policyholder. Many captive insurance companies receive more than 20% of their net written premiums from reinsurance pools, which are composed of many different companies. Many captive insurance companies would not meet the diversification test if the reinsurance pool is considered one policyholder. Applying a look-through principle to the reinsurance pool is consistent with Congressional intent of ensuring enhanced risk distribution in certain instances. We urge Treasury to issue guidance stating that in the case of reinsurance pools and the first diversification test look-through principles apply to disregard the reinsurance pool as a policyholder and treat the members of the pool as the policyholders. This is consistent with existing Revenue Rulings in the area.

### *B. Alternative Diversity Test*

[8] *See* PATH Act of 2015, Section 121(c), enacting I.R.C. § 41(h)(6)(B).

The PATH act established an alternative test for satisfying the diversification requirement under section 831(b). The second test requires that:

> no person who holds (directly or indirectly) an interest in such insurance company is a specified holder who holds (directly or indirectly) aggregate interests in such insurance company which constitute a percentage of the entire interests in such insurance company which is more than a de minimis percentage higher than the percentage of interests in the specified assets with respect to such insurance company held (directly or indirectly) by such specified holder.

Specified holder "means, with respect to any insurance company, any individual who holds…an interest in such insurance company and who is a spouse or lineal descendant…of an individual who holds an interest…in the specified assets with respect to such insurance company." Specified assets means "with respect to any insurance company, the trades or businesses, rights, or assets with respect to which the net written premiums (or direct written premiums) of such insurance company are paid." De minimis is defined as 2 percentage points or less.

Applying these definitions, the test essentially requires that no spouse or lineal descendant of a captive insurance company owner own a percentage interest in the captive that exceeds his or her interest in the underlying insured company by more than 2 percentage points. Guidance is requested in two areas. First, the bright line 2% rule ignores the complexity of this area and further amplification and flexibility is necessary. Second, the statute does not clarify how to calculate the percentage interest in the specified assets where more than one operating company pays premiums into a single captive insurance company. In such a circumstance the diversification test may be evaluated in several ways and it would be helpful if clarification on permitted methodologies were issued. We believe that Treasury's issuance of guidance in this area will ease compliance burdens and free IRS and Treasury resources to focus on other matters.

## Conclusion

Thank you for the opportunity to comment on items to include in the Plan. We welcome the chance to meet to discuss the above comments in greater detail or to answer any questions that you may have.

Respectfully submitted,

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