Tax Digest

A periodic newsletter highlighting developments of interest to today's companies on the move.

July 2014

FEDERAL

Proper tax return disclosure avoids imposition of 50 percent excise tax

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By providing proper and complete tax return disclosure of basic information, taxpayers can avoid future penalty assessments involving various issues. In a 2014 case, the Tax Court upheld the IRS's determination that the taxpayer was subject to an excise tax equal to 50 percent of the value of company stock allocated to a disqualified person. However, the court concluded the assessment was unenforceable as the statute of limitations had expired. The technical issue in the case involved an employee stock ownership plan (ESOP) and the status of certain corporate shareholders as disqualified parties under the unique rules concerning ownership of ESOPs. Despite arguments by the taxpayer to the contrary, the court agreed with the IRS that the shareholders were not *qualified* parties, thereby subjecting the taxpayer to a 50 percent excise tax. The court found, however, that tax returns filed by the S corporation and the ESOP had fully disclosed the ownership details such that the IRS had been provided with sufficient notification of the ownership issue giving rise to the excise tax. Because the notice of assessment was issued after the three-year statute of limitations period had expired, the court concluded the penalty was unenforceable. The message to taxpayers is that proper disclosure of information can often be critical to start the running of the statute of limitations and avoid assessments.

Affordable Care Act penalties: How much will employers pay?

Jill Harris, Director, Washington National Tax

According to a report issued by the Congressional Budget Office (CBO), the U.S. government is expecting to receive a revenue surge of $457 billion dollars during the next 10 years due to the Affordable Care Act (ACA). Individuals will pay about two-thirds of this total, with employers contributing the other one-third. Effective Jan. 1, 2014, the ACA requires most U.S. residents to obtain health insurance or pay a penalty. The CBO estimates that penalties paid by individuals without health insurance will total $46 billion over the 2015-2024 period. Furthermore, the CBO anticipates that employers will pay workers higher taxable wages in lieu of providing group health insurance during the next few years, thus generating about $242 billion of taxes on this additional compensation. Employers are projected to contribute $169 billion to the federal coffers due to the pay-or-play penalty for failing to offer health insurance that meets ACA standards and the "Cadillac" tax on high-cost health coverage. Therefore, prudent employers should take action now to assess their exposure to these penalties and determine the financial impact of the ACA on their companies.

Are S corporation officers and board members independent contractors or employees?

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The IRS has long had an interest in worker classification issues. However, that interest has typically been focused on lower-level service providers. But what about board

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members and part-time officers? Are there circumstances where these individuals must be classified as employees? A senior stakeholder liaison of the IRS Small Business/Self-Employed Division recently discussed this issue in the context of S corporations. According to this individual, corporate officers are always employees, regardless of the circumstances. Board members, however, may be either employees or independent contractors depending on the time spent and the nature of their work. Although these conclusions should not necessarily be taken as fact, it is noteworthy that the IRS is indicating that S corporations should expect to see this issue raised on audit with increasing frequency. For this reason alone, it is important to consider how entities are classifying these individuals to be sure the classification is defendable based on current guidance in this area.

Businesses currently owe billions in delinquent payroll taxes–and the IRS will be collecting from "responsible persons"

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In response to advice resulting from an audit performed by the Treasury Inspector General for Tax Administration, the IRS will in 2015 implement a series of procedures designed to further improve the timeliness of case actions against delinquent payroll taxpayers. When a business does not remit payroll taxes, the IRS has the authority to assess all "responsible persons" for the unpaid payroll taxes via the Trust Fund Recovery Penalty (TFRP), regardless of whether the business is ongoing or has ceased operations. A responsible person is an officer, director, shareholder or employee of a corporation, or a limited partner, member or employee of a partnership, LLC or proprietorship who is required to collect, account for, and remit payroll taxes who willfully fails to perform these duties. A determination of delinquent tax liability is dependent on the facts and circumstances of each case. In order to avoid TFRP action, responsible persons should verify that all payroll tax payments and filings have been made on a timely basis. Taxpayers who are currently the target of a TFRP action should consult with their tax advisor to determine the best strategy for moving forward with the TFRP process.

IRS releases procedures to comply with final UNICAP regulations

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On May 6, 2014, the IRS released guidance for taxpayers to comply with final regulations related to the capitalization of sales-based royalties and vendor charge-backs allocable to inventory property. These procedures allow taxpayers to make automatic method changes to properly account for these items as part of their inventory capitalization method. In many cases, taxpayers may be allocating and capitalizing certain amounts into their year-end, on-hand inventory that may now be fully allocable to sold inventory (and thus deductible as part of cost of goods sold) under the final regulations. Taxpayers should consult with their tax advisors to determine the impact and potential method changes that may be available to take advantage of the final regulations.

IRS study of employment tax returns identifies risk areas for employers – Part III

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This last article in a three-part series on employment tax risk categories identified by the IRS National Research Program (NRP) focuses on worker classification issues. Worker classification deals with the determination of whether a worker is considered an employee or independent contractor. Because an employee's compensation is subject to various employment taxes and withholding while independent contractors may be subject to backup withholding, this determination can have significant consequences. Furthermore, the classification of individuals as full-time or full-time-equivalent employees is of increasing importance due to the employer mandate insurance rules under the Patient Protection and Affordable Care Act. The NRP has found that many companies intentionally misclassify workers to avoid the burden of employment tax reporting and withholding. Consequently, the IRS is aggressively conducting employment tax audits and seeking to reclassify workers and assess penalties and interest.

Two settlement programs exist for companies seeking to properly reclassify workers. The Classification Settlement Program is available for companies currently under employment tax audit. This program allows the business to enter into a closing agreement with the IRS and pay a reduced amount of employment tax (often only a single year or reduced percentage of the total liability), as long as the business classifies its workers as employees in the future. The second program, the Voluntary Classification Settlement Program, was launched in late 2012, and allows businesses that are not under employment tax audit to seek proper employee classification. By paying 10 percent of the employment tax liability that would have been due in the most recent tax year, the business gains audit protection for prior tax years and is not liable for penalties and interest on the employment tax liability. This program does not have a termination date, and the IRS does not share reporting information with state or local taxing authorities. Since the NRP identified worker classification as a high-risk category, taxpayers can expect increased audit concentration in this area. Businesses should review their employee and independent contractor determination policies and consult with their tax advisors to assess and mitigate potential audit exposure.

Personal goodwill: Alive and well

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In general, goodwill stemming from a shareholder's personal reputation and skills, unless otherwise transferred to the corporation, represents personal goodwill. Personal goodwill can provide tax-efficient opportunities in merger and acquisition (M&A) transactions by alleviating corporate-level tax upon a sale or transfer, yet still providing an acquirer with an amortizable tax shield. Further, the gain on a sale of personal goodwill generally represents capital gain subject to a preferential capital gains tax rate, as opposed to a higher ordinary rate for the receipt of compensation. A recent Tax Court decision establishes that, under the right facts and circumstances, personal goodwill is alive and well. In this case, the lack of an employment agreement and noncompete agreement supported the conclusion that the goodwill did not belong to the company and was in fact solely that of the shareholder. The court opinion is good news after recent IRS wins against taxpayers involving purported personal goodwill. Taxpayers wishing to assert the existence of personal goodwill need to assure they have properly documented their positions, with the appropriate defenses ready if the IRS seeks to challenge them.

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Trusts offer asset protection for inherited IRAs

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The recent U.S. Supreme Court decision in *Clark v. Rameker*, denying bankruptcy exemption to inherited IRAs, has renewed interest in asset protection planning for IRAs likely to be transferred to heirs at death. Treasury regulations permit a trust to hold an IRA and qualify for a stretch payout. There are generally four criteria for qualifying a trust as a "designated beneficiary" of an IRA account. The trust must be valid under state law and must be irrevocable at death. The administrator of the IRA account, typically a bank or brokerage institution, must have a copy of the trust agreement. Lastly, the ultimate beneficiary of the account must be identifiable. The IRS' interpretation of this last requirement is that all beneficiaries must be individuals, and the life expectancy of the oldest trust beneficiary determines the payout period of the IRA account. Some trusts are designed to accumulate the account distributions, while others distribute the required distributions from the IRA to the trust beneficiaries at least annually. A charitable beneficiary will cause the trust to fail the designated beneficiary test since all trust beneficiaries must be individuals. Trusts created for multiple generations, including so-called "dynasty trusts," also cause problems under the last prong of the IRS' four requirements. However, a knowledgeable attorney can draft around this issue.

INTERNATIONAL

IRS expands amnesty for offshore income

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On June 18, 2014, the IRS released the latest revisions to its ongoing amnesty program for taxpayers with offshore accounts. The revisions expand the *streamlined* filing procedures by allowing both resident and nonresident taxpayers to seek relief and by eliminating the requirement that unpaid tax not exceed $1,500. Under the new rules, resident taxpayers who qualify will pay only a 5-percent penalty on the highest balance of their offshore accounts, while nonresident taxpayers will face no penalty. Of course, taxpayers must still pay any back taxes and interest. Taxpayers who previously did not meet the $1,500 threshold should consider filing under the new streamlined procedures along with taxpayers who have filed "quietly" (i.e., by filing amended returns outside of any existing amnesty program). In addition, taxpayers who are currently seeking relief under the general offshore voluntary disclosure program should consider requesting relief under the new streamlined procedures. Only individuals who have *not* willfully failed to report their prior-year income (or failed to disclose offshore accounts) may apply under the streamlined procedures. While there is no deadline to apply for relief under the streamlined procedures, a taxpayer cannot take advantage of the program if the IRS contacts the taxpayer prior to the taxpayer filing his or her application for relief. On July 1, 2014, key provisions of the Foreign Account Tax Compliance Act (FATCA) will come into effect, providing the IRS with significant amounts of new information that it will likely use to charge taxpayers with noncompliance. Taxpayers should act quickly because the IRS is likely to increase its enforcement efforts once FATCA becomes fully operational.

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STATE & LOCAL

Arizona court strikes down rental car tax earmarked for stadium funding

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On June 16, 2014, the Maricopa County Superior Court issued a decision striking down the Arizona Sports and Tourism Authority (AzSTA) tax, which is imposed on car rentals and earmarked to retire the debt incurred from the development and construction of the University of Phoenix Stadium. Interestingly, the court declined to decide the case on the grounds that the imposition of the tax was facially non-neutral. Instead, the court held that, due to the stadium funding earmark, the tax violated Article 9, section 14 of the Arizona Constitution, which provides that "[n]o moneys derived from fees, excises, or license taxes relating to registration, operation, or use of vehicles on the public highways or streets" may be used for any purpose other than specified highway-related purposes. The court's decision marks another instance in a growing national trend where taxpayers are successfully challenging the imposition of taxes on grounds independent from the mechanics of the tax itself. Although this decision is likely to be appealed by the Arizona Department of Revenue, taxpayers that paid the AzSTA tax should consider filing protective refund claims.

Pennsylvania Supreme Court upholds PIT assessment against nonresident partners

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On June 17, 2014, the Pennsylvania Supreme Court issued a decision holding that nonresident individual partners in a non-Pennsylvania limited partnership had purposefully availed themselves of Pennsylvania's market within the meaning of the Due Process Clause of the U.S. Constitution and were subject to Pennsylvania personal income tax (PIT) on their distributive share of partnership income. In coming to this conclusion, the court determined that the partners had purposefully availed themselves of Pennsylvania's market in their individual capacity because the sole purpose and activity of the partnership was to own, operate and earn income from Pennsylvania property. The court left unclear, however, whether it would have arrived at the same conclusion had the partnership owned property throughout the United States, one parcel of which happened to be in Pennsylvania. Partnership investors should consider the court's conclusion and this open issue when analyzing the risks associated with investing in limited partnerships with Pennsylvania activities.

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