Tax Digest

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

March 2015

FEDERAL

IRS issues small taxpayer relief under the tangible property regulations

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The IRS recently issued guidance that allows certain taxpayers, specifically those with total assets of less than $10 million or average gross receipts of $10 million or less for the prior three tax years, elective relief from filing accounting method changes in implementing the tangible property regulations. The guidance allows taxpayers to focus on implementing the regulations while not having to contend with the burden of preparing the accounting method changes if the taxpayer cannot benefit from a section 481(a) adjustment or audit protection. While the guidance alleviates the need to file accounting method changes in certain circumstances, it does not eliminate the need for all taxpayers to ensure compliance with the regulations. For more information, see our frequently asked questions.

Avoid distributing property with a built-in loss from an S corporation

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S corporations contemplating a distribution of loss property should consider other options to preserve the benefits of these losses. In recently published advice, the IRS concluded that although the loss on such a distribution is disallowed, the loss nonetheless constitutes a nondeductible, noncapital expense that will reduce both the shareholder's basis in the S corporation stock and the S corporation's accumulated adjustments account (AAA). The issue under review involved an S corporation that transferred corporate-owned real estate with a built-in loss to a partnership owned by its shareholders. Though the S corporation's loss on the distribution was disallowed, the shareholders did not reduce their basis in the S corporation stock and the S corporation did not reduce its AAA by the disallowed loss. The IRS memorandum explained that by failing to make these adjustments, the taxpayer could convert what is otherwise meant to be a permanent disallowance into a future deductible item. As a consequence, the taxpayer was required to make these adjustments. This guidance is a useful reminder that S corporations should be careful when making distributions of built-in loss property and should look for alternative ways to recognize or preserve the unrealized loss.

The keys to speedy audits by tax authorities

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Businesses generally desire to hasten audit activities undertaken by tax authorities. In addition to generating cost savings, quickly concluding audit activities prevents auditors from analyzing areas of the accounting records they had no initial intention of testing and discussing matters with employees, detracting from employee productivity and perhaps creating curiosity that could add time to the audit. One key to concluding an audit quickly is to ensure filed returns are "audit ready" in the event a taxing authority selects the return for examination. Taxpayers should have tax records readily available in one location. For issues expected to be focused on in the event of an audit, additional supporting documentation should be obtained, reviewed and retained. Taxpayers can identify industry and

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jurisdictional issues by reviewing tax authorities' websites and news releases, as well as online tax publications and articles, and proactively shore up any weak documentation and support. Having the necessary documentation with which to immediately respond to a tax auditor's inquiries reduces communication lag time, evidences cooperation and commitment to a prompt resolution, and helps to establish the bona fides of particular transactions or positions taken on tax returns. Additionally, it is helpful to identify company personnel who may have knowledge about specific items that could be examined and preserve their knowledge through memorandums. If an employee or executive with this knowledge leaves the company, the company should document the individual's recollection of events through signed statements that can be retained with the tax records or make arrangements to assure the individual's help if needed in regard to matters that could come up on a tax audit.

Low-rate environment provides tremendous gift planning opportunities

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The IRS establishes a rate under section 7520 which is used to discount the value of annuities and life estates to present value. For March 2015, the rate is 1.8 percent, the lowest rate in more than a year and a half. This low rate provides tremendous opportunities to use vehicles such as grantor retained annuity trusts (GRATs) to pass substantial value to beneficiaries at little to no gift tax cost. For example, when calculating this retained grantor annuity, the IRS assumes trust assets will produce a return equal to the section 7520 rate applicable to the month of the transfer of assets to the GRAT. If the assets held in the GRAT outperform this rate (currently a modest 1.8 percent), the value in excess of this rate will pass to the trust beneficiaries with no further gift tax consequences. Since this low-rate environment will not last forever, now may be the time to act if you are exploring gift planning strategies. In light of the complexity of specific rules and opportunities related to GRATs, taxpayers should consult with a qualified tax advisor to ensure proper execution.

IRS targets special assets held in self-directed IRAs

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Ever since Mitt Romney disclosed in 2012 that his IRA was worth between $20 million and $100 million, accountants and attorneys have speculated as to how such a retirement account could be amassed, given the contribution limitations for IRAs and 401(k) accounts. Evidently, the IRS is interested, too. In an effort to determine which taxpayer IRAs hold special assets, including real estate, stock or other interests in a corporation or partnership that are not readily tradable on an established market, the IRS has refined Form 5498, *IRA Contribution Information*, to require IRA custodians to report the classes and values of such assets. Box 15a requires each IRA custodian to report the fair market values of certain specified assets as of Dec. 31, 2015. In box 15b, the IRS requires the custodian to code in the types of hard-to-value assets held in the IRA. IRA owners with accounts holding special assets should take this opportunity to consult with the trustee or custodian of their IRAs regarding the valuation of these assets. It is likely that there will be valuation expenses, and the IRA owner should know whether the account or the account holder will be responsible for the expenses.

Do your employees have a home?

Anne Bushman, Senior Manager, Washington National Tax

The IRS seems to be increasingly auditing employee expense reimbursements with a view towards reclassifying reimbursements as wages. This is particularly true in industries such as transportation and information technology consulting where employees spend long periods of time away from the locations they consider home. Generally, reimbursable travel expenses paid under an accountable plan are deductible by employers as non-wage expenses and excludible from employees' income, but what constitutes a reimbursable travel expense is not always intuitive. Specifically, to qualify for reimbursement, the employee must be traveling "away from home." A person's home for tax purposes is defined as his or her regular or principal place of business or, if he or she does not have a regular place of business, his or her real and substantial place of abode. Certain traveling employees that do not regularly return to a specific work location may not have a tax home and, therefore, may not qualify for reimbursement of travel expenses. Alternatively, a traveling employee may spend so much time on an away-from-home assignment that the away-from-home work location becomes his or her tax home despite the maintenance of a residence in another city. Improper classification of employees' tax homes can lead to substantial employment tax liabilities for an employer and large income and employment tax adjustments for an employee. Each employee arrangement should be carefully reviewed in comparison to the tax home rules to protect employers and employees from additional liabilities.

INTERNATIONAL

BEPS country-by-country reporting exemption threshold announced

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As part of its Base Erosion and Profit Shifting (BEPS) initiative, the Organisation for Economic Co-operation and Development (OECD) has announced a safe harbor threshold that will likely provide relief for middle market multinational groups from the requirement to provide certain transfer pricing documentation and perform expensive country-by-country (CBC) reporting. As proposed, multinationals with less than €750 million in consolidated revenue would generally be exempt from CBC reporting. Ensuring exemption status will be crucial for many middle market companies. The United Kingdom, France and Spain have already implemented legislation based on the BEPS proposals, and more countries are likely to follow. The U.K. tax authorities estimate that compliance with CBC reporting will cost U.K.-based multinational groups £200,000 annually. As countries begin to adopt CBC reporting and other measures, multinational entities should take the opportunity to assess their risk profiles and prepare to comply with new legislation. While the final report for the OECD's BEPS initiative has not yet been issued, it is apparent that some countries have chosen to get an early start. Thus, multinational companies should quantify potential exposure now.

Mexican tax authorities introduce expansive new reporting rules

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Beginning Jan. 1, 2015, Mexican taxpayers must report certain relevant transactions. Based on a list recently published by Mexico's Tax Administration Service (SAT, in Spanish), the principal types of relevant transactions include: complex financial transactions, transactions with related parties, transactions with foreign parties (whether related or not), certain ownership restructurings, and other listed significant transactions. The deadline for reporting relevant transactions carried out during 2014 is April 30, 2015, and subsequent reporting must be done on a quarterly basis. U.S. companies with Mexican subsidiaries that carry out, or have carried out, any relevant transactions should be aware of their filing requirements and report them on a timely basis. Failure to meet this new reporting requirement in a timely manner can result in fines of $5,000 or more per unreported transaction. Additionally, failure to report relevant transactions considerably increases the risk of a direct audit by SAT agents. U.S. companies with Mexican subsidiaries should conduct a thorough review of their 2014 activities in order to understand their potential exposure.

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STATE AND LOCAL

California proposed market sourcing provisions may affect PE fund managers

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In November 2014, the California Franchise Tax Board released a third draft of proposed amendments to its regulations regarding the market-based sourcing of receipts from sales other than sales of tangible personal property, which, if adopted, may open the door to additional taxation of private equity (PE) management companies in California. These proposed amendments, which pertain to the sourcing of revenues earned by asset management companies, are expected to be applicable to tax years beginning on or after Jan. 1, 2015. However, if approved, a taxpayer may, under certain circumstances, also elect to apply the amendments retroactively to tax years beginning on or after Jan. 1, 2012. Additionally, coupled with California's economic nexus standards, the proposed regulation amendments may result in a tax return filing requirement that did not previously exist for PE fund managers. Those who practice in this area should closely monitor the status of the proposed regulations and begin to assess the effect as it relates to a management company's apportionment formula and required California tax filings. Based on informal conversations with the state, we expect final regulations to be issued by year-end, with a Jan. 1, 2015, effective date.

Georgia DOR successfully disavows sales and use tax regulation

Dave Elder, Director, West Palm Beach, Florida

On Feb. 11, 2015, the Georgia Tax Tribunal held that a construction contractor is subject to Georgia sales and use tax on tangible personal property either purchased in Georgia or stored in Georgia warehouses for subsequent transportation outside the state for use in the performance of construction contracts for the U.S. military in Afghanistan. The tribunal came to this conclusion because the contractor (1) did not qualify for the sale for resale exclusion as the *per se* consumer of the property, and (2) the Georgia Department of Revenue's regulation providing a clearly applicable exclusion for property temporarily stored in Georgia while in interstate commerce was inconsistent with Georgia statutes and, therefore, not controlling. This decision marks another instance in a growing body of rulings across the states sustaining challenges to the application of administrative regulations that are inconsistent with statutory authority. However, this particular decision was unusual because the taxpayer argued that the department's regulation should be granted deference, while the department sought to disavow its own administrative guidance. The Georgia Tax Tribunal's cautionary statement sums up the matter perfectly: "This case is thus illustrative of the dangers of unthinking reliance on the language of a regulation or undue deference to asserted administrative expertise."

Will New Hampshire be a bellwether on bitcoin?

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On Feb. 17, 2015, the New Hampshire House Ways and Means Committee decided to retain in committee for further action legislation that would require the state treasurer to develop an implementation plan for the state to accept bitcoin as payment for taxes and fees beginning July 1, 2017. Although this bill has a long way to go before it reaches Governor Hassan's desk, it is interesting to see that a bipartisan group of New Hampshire legislators, in recognition of the growing number of businesses accepting bitcoin as a seamless substitute for legal tender, appears to be looking at bitcoin as currency. By contrast, most of the other states that have opined on bitcoin and the IRS have viewed bitcoin as noncurrency intangible property. The treatment of bitcoin as currency as opposed to noncurrency intangible property can affect a wide variety of matters, including the application of currency gain rules, whether bitcoin has basis, whether the use of bitcoin generates gain or loss, the application of information reporting rules, and the treatment of bitcoin for sales and use tax purposes as currency or property used in barter.

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