Tax Digest

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

May 2013

FEDERAL

IRS issues updated directive to exam agents on tangible asset and repair regulations

Kate Abdoo, Manager, Washington National Tax
Natalie Tucker, Director, Washington National Tax

On March 22, 2013, the IRS issued a directive providing administrative guidance to agents conducting examinations of the repair versus capitalization issue under sections 162(a) and 263(a). This directive replaces a previous directive and follows amendments to the temporary regulations regarding the deduction and capitalization of expenditures related to tangible property which delayed the effective date of the temporary and pending final regulations until taxable years beginning on or after Jan. 1, 2014. As in the prior directive, the new directive provides for the suspension of exam activity for positions taken on original returns relating to repair expenditures and correlative dispositions of tangible depreciable assets and applies to exams for tax years beginning before Jan. 1, 2014. The directive should provide comfort for taxpayers currently under exam for years in which repair expenditures and correlative dispositions were recognized. Taxpayers not currently under exam are encouraged to evaluate existing methods to determine whether filing Forms 3115 to adopt the temporary (or pending final) regulations during tax years beginning on or after Jan. 1, 2012, or before Jan. 1, 2014, is advantageous.

Book publisher not eligible to claim DPAD for creating electronic version of book

Tom Windram, Partner, Washington National Tax
Steve Pashley, Manager, Washington National Tax

The IRS recently concluded that a book publisher did not qualify for the domestic production activities deduction (DPAD) related to its activity of producing electronic versions of books that it subsequently sent to a third-party book manufacturer for printing and binding. The taxpayer created an electronic version of the books that it published and sent these versions to a third-party book manufacturer, which mass-produced and bound the books. The taxpayer claimed that its activities of creating the electronic version of the book qualified for the DPAD. The IRS reviewed the taxpayer's activities and concluded that creating an electronic version of the book did not result in qualified production property because the electronic version of the book was not tangible personal property, computer software or a sound recording.

IRS provides guidance on treatment of payments for the transfer of patent rights

Natalie Tucker, Director, Washington National Tax
Nick Gruidl, Partner, Washington National Tax

The IRS recently ruled that with respect to an agreement for the transfer of patent rights, both parties must treat the agreement consistently as either a sales or license agreement. Further, the IRS indicated that in determining the proper categorization of such an agreement, unless contract terms are ambiguous, the terms dictate whether the agreement is for the sale or license of intangible property. Finally, the IRS provided that taxpayers are prohibited from treating a properly categorized sales agreement as a

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license agreement (or vice versa), even if such treatment is consistent and agreed upon between the parties after execution of the agreement. This represents a significant issue for taxpayers that enter into agreements for the transfer of intangible rights where inconsistent treatment provides taxpayer-favorable results to each party. Taxpayers with existing agreements providing for the transfer of intangible property are encouraged to consult with their tax advisors to determine whether their present treatment is proper.

New guidance issued on the deductibility of prepaid FDIC assessments

Natalie Tucker, Director, Washington National Tax

The IRS recently confirmed that prepaid FDIC assessments (covering estimated assessments from the fourth quarter of 2009 to the fourth of quarter 2012) do not fall within the 12-month rule of Reg. section 1.263(a)-4(f). The prepayment must be capitalized under Reg. section 1.263(a)-4 and deducted over the useful life of the assessment period (i.e., as the taxpayer's obligation accrues quarterly during the three-year period covered by the prepayment). Taxpayers that presently treat portions of their prepaid FDIC assessment as deductible prior to the year in which the quarterly obligation accrues should consider changing their accounting method to properly treat the prepaid FDIC assessment as a capitalized cost to be taken into account over the assessment term's useful life. Because such a change will result in an unfavorable section 481(a) adjustment, it is critical that taxpayers consider filing for a change in accounting method, as doing so will ensure audit protection that will prohibit the IRS from challenging prior-year treatment.

Increase flexibility in acquisitions

Rick Bailine, Principal, Washington National Tax

For the past 40 years, the single most common form for a corporate acquisition has been the forward triangular merger (FTM). This type of acquisition allows a separation between the acquiring corporation and the target corporation, resulting in the assets of the former typically not being subject to the liabilities of the latter. Certain tax rules, however, make both pre-acquisition and post-acquisition planning difficult. To accomplish an FTM, the acquiring corporation must create a (or have a previously existing) wholly owned subsidiary that is a bona fide C corporation (Sub). The target corporation merges into the Sub, and the target corporation ceases to exist. Because the assets and liabilities of the target corporation pass to the Sub, the acquiring corporation is kept separate from these items. With the advent of the limited liability company (LLC), prospective acquirers have a new and more flexible tool with which to structure an acquisition. The same result as above is obtained if the acquiring corporation instead creates a (or has a previously existing) wholly owned LLC that is a disregarded entity. If this is the case, the target corporation can merge into the LLC, and this will be treated for tax purposes as if the target corporation had actually merged into the acquiring corporation. This type of merger is the single most flexible type of corporate acquisition, and it facilitates pre-acquisition and post-acquisition planning. Yet, for liability purposes, the assets and liabilities of the target corporation are still isolated from the acquiring corporation because these are owned by the LLC.

Withholding the additional 0.9 percent Medicare tax

Steve Levin, Director, Washington National Tax

Commencing this year, individuals must pay an additional 0.9 percent Medicare tax on employment income in excess of a specified threshold amount based on the individual's income tax filing status. Although imposed on the individual, employers are required to withhold the additional 0.9 percent Medicare tax for any employee who is paid wages in excess of $200,000 in a calendar year. The employer must begin withholding the additional

Medicare tax in the pay period that the wages paid to the particular employee first exceed $200,000. The employer is not required to notify the employee when it begins withholding the additional tax, and the withholding requirement exists regardless of whether the individual is liable for the additional Medicare tax. Individuals will credit the additional Medicare tax withheld against the total tax liability shown on the individual's income tax return (Form 1040). Employers should confirm their payroll personnel are prepared for this new withholding requirement.

New "begun construction" rules for renewable energy tax credits

Tom Windram, Partner, Washington National Tax
Steve Pashley, Manager, Washington National Tax

The American Taxpayer Relief Act of 2012 (ATRA) extended the section 45 renewable electricity production tax credit (PTC) for qualified wind facilities through the end of 2013. The PTC also includes biomass and certain other renewable energy sources. ATRA also extended the ability to elect the section 48 investment tax credit in lieu of the PTC. Additionally, ATRA replaced the requirement that a qualified facility had to be placed in service before the credit expiration date with a new requirement that construction of the facility must begin before the credit expiration date, which is now Jan. 1, 2014. The IRS recently released guidance with respect to the new "begun construction" requirement. This new guidance provides two methods for establishing that construction has begun by Dec. 31, 2013, either by (1) starting physical work deemed to be of a significant nature, or (2) meeting a safe harbor by paying or incurring 5 percent or more of the total project costs. The IRS guidance details the activities and costs included under each of these methods for determining whether the begun construction requirement is met. Taxpayers should consult with their tax advisors to understand how to comply with this new guidance.

INTERNATIONAL

Government officials say time is running out to disclose offshore income

Ramon Camacho, Principal, Washington National Tax

Earlier this month, government officials stated that time is running out to take advantage of amnesty programs available to taxpayers that have undisclosed offshore income or accounts. The current Offshore Voluntary Compliance Program (OVDP), while currently open indefinitely, is not available if the IRS contacts the taxpayer before entering the program. Officials have noted that a wealth of information is flowing to the government and have expanded their investigations as a result. Taxpayers, whether individuals or entities, with previously unreported foreign assets, accounts or income should take steps as soon as possible to properly report such activity because the OVDP program may end at any time. Several options may exist for taxpayers if the IRS has not yet contacted them; including enrollment in the OVDP or filing amended tax returns along with delinquent forms if no unpaid tax liability exists. In some cases, taxpayers may wish to consult an attorney to receive advice regarding potential criminal and civil liability.

STATE AND LOCAL

Idaho legislation creates broad property tax exemptions

Bob Weigel, Director, St. Louis, Mo.

On April 3, 2013, Idaho enacted H0315, implementing two broadly applicable personal property tax exemptions. The first exemption applies to any item of taxable personal property that is purchased on or after Jan. 1, 2013, and has an acquisition cost of $3,000 or less. For the purpose of this exemption, "acquisition cost" is defined as all costs required to put the item of taxable personal property into service and includes the purchase price, the cost of freight, shipping, installation, engineering, erection and assembly, and the amount of sales and use taxes paid on the item. The term "item of taxable personal property" is defined as equipment, machinery, furniture or other personal property that is functioning at its highest and best use for the purpose for which it was designed and constructed and is generally capable of performing that function without being combined with other items of personal property. The second exemption applies to the first $100,000 of a taxpayer's total taxable personal property located in a taxing county that is not otherwise exempt from taxation, not including vehicles, recreational vehicles, aircraft and boats that are not registered with Idaho and for which registration fees have not been paid. A taxpayer must file an application to claim this second exemption. Because the first exemption makes property with an acquisition cost of $3,000 or less "otherwise exempt from taxation" for the purposes of the second exemption, the benefit of these two exemptions can potentially be combined.

Indiana DOR finds alternative apportionment factor was appropriate and could be used to create filing responsibility

Mark Soltys, Director, Elkhart, Ind.

On March 27, 2013, the Indiana Department of Revenue (DOR) determined that a media corporation engaged in television and motion picture production and distribution was correctly assessed additional income tax based on the application of an "audience factor" method of apportionment for sales of services and the inclusion of affiliated entities without physical presence in Indiana in the corporation's Indiana consolidated return because the affiliated entities had an audience in Indiana. In its returns, the media corporation utilized the state's standard "costs of performance" method for sourcing affiliate and advertising receipts and excluded two affiliated entities from its Indiana consolidated return because they did not have the requisite presence in the state. The DOR found that the use of the standard method did not fairly represent the activities of the media corporation in the state and that it was appropriate to apply an audience factor to source the media corporation's affiliate and advertising receipts. Further, the DOR found that the two affiliated entities excluded from the media corporation's original returns should have been included in the media corporation's Indiana consolidated group because the application of the audience factor to the two affiliated entities created sales factor numerators for both group members, which was sufficient to establish a filing requirement.

New York enacts budget legislation with various tax measures

John Fielding, Director, New York, N.Y.

On March 28, 2013, Governor Cuomo signed legislation enacting numerous tax measures. With respect to key revenue raisers, the legislation extends the sunset date for the 8.82 percent top personal income tax rate for individuals earning more than $1 million and married couples earning more than $2 million from Dec. 31, 2014, to Dec. 31, 2017; extends the limitation on charitable deductions for taxpayers earning more than $1 million by three years; and further restricts the deductibility of related-party royalty payments. On the beneficial side of the equation, the legislation likewise extends the personal income tax rate reduction for those earning between $40,000 and $300,000 per year and reduces the corporate income tax rate for qualified manufacturers from 3.25 to 2.4 percent over three years. Additionally, small businesses that have annual income of less than $250,000 will be eligible for a tax exemption equal to 3 percent of income in FY 2014-15, 3.75 percent in FY 2015-16, and 5 percent in FY 2016-17 onward. Finally, the 2 percent assessment on the sale of electricity and gas by New York utilities will be phased-out, and two new employment tax credits for employers that hire veterans and youths will be made available.

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For additional information or change of address, contact Hyong Sik Yoon or Kiho Choi at (213)480-9100 or e-mail them at hyongsikyoon@ckpcpas.com or kihochoi@ckpcpas.com.

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