Tax Digest

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

August 2014

FEDERAL

Who is tracking basis in your S corporation?

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Business owners and tax practitioners have all seen this situation: A transaction is about to take place and, suddenly, the most important question to the seller is "How much am I going to pay in taxes?" With many business owners approaching retirement age, the economy strengthening, and merger and acquisition activity increasing, it is extremely important for S corporation shareholders to get caught up with basis tracking long before a transaction is ever contemplated. Unfortunately, shareholders and practitioners often place little emphasis on the need to track basis through the good years when taxable income exceeds distributions. That lack of emphasis can come back to haunt corporate controllers and accountants who dread the thought of sifting through old file draws for documents and copies of tax returns. Whether you are an owner who has switched public accounting firms over the course of your business life or you are a practitioner, it is important for all parties to understand who is maintaining shareholder basis schedules. Keeping track of basis now will minimize work down the road and help ensure that the tax consequences of a potential sale can be calculated quickly and easily.

Employee stock ownership plan loans may be prohibited transactions

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Because an employee stock ownership plan's (ESOP's) allocations of shares did not follow the terms of a loan agreement between the plan sponsor and the plan, the IRS recently concluded that these erroneous allocations caused the loan to violate the prohibited transaction rules and assessed an excise tax on the ESOP sponsor. In general, a loan between an employer (or plan sponsor) and a qualified retirement plan is a prohibited transaction, which results in an excise tax. However, if the loan meets certain requirements spelled out in IRS regulations, an exception is provided for a loan to an ESOP. To avoid the potential imposition of excise taxes when implementing an ESOP loan, the employer (or plan sponsor) and its advisors should make certain that the provisions of the loan agreement meet the requirements of the regulations and that each year's allocation of shares is carefully reviewed to ensure compliance with the loan documents.

Final regulations clarify definition of research and experimentation expenditures

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The IRS recently issued final regulations clarifying certain aspects of the tax treatment of research and experimentation (R&E) expenditures. The regulations further define activities whose associated costs qualify as deductible R&E. Additionally, these final regulations have implications for the "uncertainty test," one of four general requirements to qualify activities for the research tax credit. The regulations provide important clarification in several areas that were ambiguous under prior guidance: (1) the ultimate success, failure, sale or use of the research is not relevant in determining the eligibility of an expenditure as R&E; (2) although amounts paid for labor and materials to construct depreciable

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property are not R&E, the cost to design and develop the asset may qualify as R&E; (3) the term "pilot model" is defined as a representation or model of a product that is produced to evaluate and resolve uncertainty during the development or improvement of the product; (4) costs of producing a product after uncertainty is eliminated are not considered to be R&E; and (5) a shrinking-back rule provides that component parts of a larger product can qualify as R&E even if the overall product does not qualify. These regulations provide welcome clarity regarding R&E expenses and should assist taxpayers in identifying eligible expenditures.

IRS limits electronic refunds to combat identity theft and tax fraud

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In an ongoing effort to combat identity theft and tax fraud, the IRS is implementing new procedures to limit the number of refunds that are electronically deposited into a single bank account. Starting in January 2015, the IRS will only deposit up to three electronic refunds (1) into a single financial account, or (2) onto a prepaid debit card. If a fourth refund or deposit is requested, a notice stating that the financial account has exceeded its annual refund limit will be issued, and taxpayers can expect to receive a paper refund check in the mail within four weeks of the notice. Taxpayers who have not made multiple requests for direct deposit of a refund and unexpectedly receive such a notice should immediately consult the Taxpayer Guide to Identity Theft on the IRS website for further action steps. This new limitation is also designed to protect taxpayers from abuse by preparers who attempt to obtain payment for services via a direct deposit of a taxpayer's refund into the preparer's bank account. As always, taxpayers are encouraged to track expected federal tax refunds via the IRS' Where's My Refund? website.

New FASB revenue recognition standard may have tax implications

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The Financial Accounting Standards Board and the International Accounting Standards Board recently released a final, joint standard for revenue recognition. The standard will replace existing guidance on revenue recognition for generally accepted accounting principles and international financial reporting standards and is effective for annual reporting periods beginning after Dec. 15, 2016, for public companies and after Dec. 15, 2017, for nonpublic entities (see Revenue recognition: A whole new world). While federal income tax laws contain specific guidance for the timing of revenue recognition for income tax purposes, certain treatment may key off of financial statement reporting. To the extent a taxpayer follows its book treatment for income tax purposes, a change in financial statement treatment may necessitate a change in method of accounting for federal income tax purposes (i.e., the filing of one or more Forms 3115). Thus, while this new guidance is generally not effective until 2017, taxpayers should consult with their tax advisors to determine the impact the guidance may have on the treatment of certain revenue items for federal income tax purposes.

New streamlined program for FBAR filing

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On June 18, 2014, the IRS announced modifications to its "streamlined" program for certain U.S. taxpayers who have failed to properly file FinCEN Form 114, otherwise known as an FBAR. A U.S. person is required to file an FBAR if the person (1) had a financial interest in or signature authority over at least one financial account outside of the United States, and (2) the aggregate value of all foreign financial accounts exceeded $10,000 at any time during the calendar year. Representing the closest thing to a total amnesty for taxpayers who have failed to file these returns in the past, this program can result in a waiver of most or all of the penalties otherwise attributable to a failure to timely file this form. The determination as to the availability of this program with respect to a particular taxpayer will depend on whether past noncompliance was willful. For example, if the taxpayer has properly reported his or her income from both domestic and offshore activities, this will serve as a good case for nonwillfulness, and the taxpayer should qualify under this new program. If not, then the taxpayer might consider the Offshore Voluntary Disclosure Program, particularly if there is a desire to abate any possible criminal penalties. For those taxpayers who have offshore interests, it is strongly recommended that they consult with their tax advisors to determine whether this new program is an appropriate path to pursue.

Potential for legislative repeal of the Affordable Care Act: Is it really possible before 2017?

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Continued controversy around the implementation of the Affordable Care Act (ACA) has left many to question the likelihood of its repeal or significant modification before 2017. Given the current political environment, this question is one of politics, not policy or logic. Despite numerous attempts at repeal by the Republican-controlled House, these bills have never been presented for vote in the Democrat-controlled Senate. With no possibility of a change in control of either house until the November 2014 midterm elections, there is essentially no chance of significant change this year. When looking toward 2015 and 2016, there is the potential for a shift in power in both houses of Congress, but even if Republicans controlled both houses of Congress, one can expect that President Obama would veto any bill passed that would harm the ACA. It will also be some time before the affect of the contrary judicial decisions in *Halbig v. Burwell* (disallowing tax subsidies paid through federal exchanges) and *King v. Burwell* (allowing those same subsidies) work their way to the Supreme Court for final resolution. Thus, regardless of the outcome of the 2014 midterm elections, there is likely no possibility for repeal or modification of the ACA before 2017–when President Obama is no longer in office. As the controversy continues, business leaders should make sure they have plans in place to address the needs and demands which will be made on their business under the ACA.

Section 355 spin-off granted–employee compensation plans could keep interests in the separate business

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In a ruling issued earlier this year, the IRS granted approval for a tax-free separation where the corporate employees maintained incentive compensation plans with equity interests tied to both the distributing and distributed businesses. The overlap of the corporate interests, through the compensation plans, did not impede a tax-free separation of the businesses under section 355. Quite often, a taxpayer will desire a tax-free separation but will not want its employees' incentive compensation affected by the separation. This ruling shows that with a real and meaningful purpose for the separation, taxpayers have avenues to preserve their employees' incentive compensation packages without having to cancel them and start over.

Tax Digest

INTERNATIONAL

2014 Indian Federal Budget contains some surprises

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On July 10, 2014, the new Indian government presented a new 2014 budget to the Indian Parliament that contains a number of significant tax proposals of interest to taxpayers doing business in India. First, the administration surprised taxpayers by proposing to leave in place a 2012 law that would tax gain on *indirect* sales of subsidiaries by non-Indian parties that occur entirely offshore. The 2012 law attempted to reverse the ruling of the Indian Supreme Court in the *Vodaphone* case, where the Court held that India had no jurisdiction to tax gain arising from the sale of a Cayman company that indirectly owned an Indian subsidiary. The budget would also make significant changes to India's transfer pricing rules, including allowing taxpayers to use an arm's length range in supporting their transfer pricing. In addition, the budget would allow taxpayers to use data from comparable transactions spanning a number of years and to apply transfer pricing methodologies approved by the Indian government under an advance pricing agreement to prior tax years, which could allow taxpayers in current litigation to settle their cases outside of court. Finally, the budget also proposes to reform India's federal indirect tax system by consolidating the vast majority of indirect taxes into a single indirect tax on goods and services. Taxpayers with Indian operations should monitor these developments closely because these proposals could affect current (and past) Indian tax and compliance burdens significantly.

Corporate inversions may take middle market by surprise

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While many may think that recent proposals to restrict corporate inversions will affect only large, multinational companies, middle-market businesses should keep in mind that these proposals, like existing law governing inversions, may have a significant unexpected impact on them. Generally speaking, a U.S. business inverts by reorganizing itself as a foreign corporation. An inversion may eliminate the U.S. corporate tax on non-U.S. earnings and may allow a company to reduce the tax on U.S. earnings through the use of related-party financing and other intercompany transactions. Any business, from the largest multinationals to closely held private concerns, can potentially achieve these benefits. However, current law eliminates these advantages if (1) pre-inversion owners of the business own at least 80 percent of the foreign corporation; (2) the foreign corporation acquires substantially all of the assets of the pre-inversion business; and (3) the foreign corporation does not conduct substantial activity in its home country. Many companies with international operations unknowingly enter into accidental inversions. For example, a U.S. partnership that transfers its business to a non-U.S. corporation may trigger the anti-inversion rules. In addition, the transfer of a U.S. corporation to a foreign corporation may be an inversion even if the owners of the U.S. company are all foreign individuals. In these cases, U.S. law treats the foreign corporation as a U.S. corporation, requiring it to pay U.S. tax on its worldwide income and to file U.S. income tax returns even though the corporation is organized under foreign law. Proposed legislation in Congress would expand the situations covered by current-law inversion rules, potentially increasing the number of foreign corporations treated as having inverted, accidentally or otherwise. Taxpayers contemplating a cross-border corporate transaction should carefully consider existing law and the impact of pending legislation.

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