Tax Insights

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

August 2016

BUSINESS GROWTH

5 myths that keep companies from filing for WOTC

Don't let misconceptions keep you from realizing this powerful tax benefit

Mark Blawas, Director

WOTC is a point-of-hire tax credit that can help employers offset the cost of new employees, yet many employers fail to take advantage of the credit because of a variety of misconceptions. With WOTC now extended through 2019 as part of legislation signed on Dec. 18, 2015, it's time for employers to take a new look at WOTC—and at the myths that have kept too many of them from filing.

Myth 1: WOTC isn't worth it because it will take forever to receive any benefit

For a number of years, this was true. WOTC had to be renewed on an annual basis. Congress often delayed action on WOTC and other credits until at or even after year-end, and then would implement them retroactively. At that point, businesses had to scramble to pull together information for the entire year, and the states, which process WOTC applications, would be flooded with a year's worth of forms all at once. Delays were inevitable and often very lengthy. Now, however, with the WOTC extended for five years, businesses can file in real time, which will speed up processing at the state level significantly.

Myth 2: We don't hire people who qualify

WOTC started life as the Welfare to Work program, and many employers still mistakenly believe that it is limited to welfare recipients. That's not the case. WOTC applies to numerous classes of hires, including:

- Unemployed veterans (including disabled veterans)
- Temporary Assistance for Needy Families (TANF) recipients
- Supplemental Nutrition Assistance Program (SNAP) recipients
- Designated Community residents (living in Empowerment Zones or Rural Renewal Counties)
- Vocational rehabilitation referred individuals
- Ex-felons
- Supplemental Security Income (SSI) recipients
- Summer youth employees (living in Empowerment Zones)
- Long-term unemployed

When you consider that more than 45 million Americans currently receive food stamps, you begin to understand that more employees qualify for WOTC than you might have thought. Without investigating your workforce, it's impossible to know how many qualifying employees you may have.

Myth 3: It's illegal to even ask employees if they qualify—or, if not illegal, at least intrusive

This is a legitimate but not insurmountable concern. Yes, asking applicants if they fall into some of the WOTC categories during the hiring process would violate employment law, but this is not an insurmountable issue. Many companies work with outside vendors to screen and process WOTC applications. Most vendors use phone or online tools that allow employees to self-identify their classification. The vendor then processes and submits Forms 8850 and 9061 for the employer.

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Myth 4: We're a flow-through entity—WOTC won't work for us

WOTC is available to most entities, not just C corporations. Partnerships, S corporations and other flow-through entities are eligible. These general business credits can be applied against the alternative minimum tax and flow to K1s.

Myth 5: We are required to use paper screening to screen all employees

Historically, in order to gather the required WOTC information and submit it to each state's labor department, an employee was required to sign *Form 8850*, Pre-Screening Notice and Certification Request for the Work Opportunity Credit. This process added more of a burden to the hiring manager's workload and many companies determined that the cost versus benefit was not worth implementing WOTC. However, in 2012 the IRS issued procedures accepting electronic signatures. As a result, companies are now able to screen employees via phone and Web-based processes with each method taking less than five minutes to complete. The employee electronically signs the required forms necessary to submit and virtually nothing further is required from the employee or employer except confirmation of start date and wage.

The amount of the credit you can receive for any given employee depends on WOTC category, compensation and other factors, but can range as high as $9,600 for some disabled veterans. In our experience, an average of $2,000 per credit is useful as a rule of thumb in most cases. Whatever the amount, though, don't let the above myths keep you from investigating WOTC eligibility.

SUCCESSION PLANNING

Succession planning resource center

Planning for and managing through business ownership succession can mean weighing dozens of competing, and sometimes conflicting, options. Your decisions should be guided by facts and objectivity. Understanding your goals and readiness is key, including when you'd prefer to exit the business and who you'd like to see running it in your place. We've gathered insights to help you navigate this important stage of business ownership.

Read more.

LIVE & ON DEMAND WEBCASTS

Managing a global business: Tax structuring, compliance and planning

Jerry Martin, Partner
Mitchell Siegel, Partner
Matt Sontag, Manager
Richard Cooper, Senior Manager
Amy Valentine, Senior Manager

LIVE WEBCAST | August 23, 2016

As a business owner or financial executive, what should you know about tax implications associated with global expansion? For U.S. companies with operations overseas, a host of tax-related issues arise, as you oversee your growing global business.

During this 60-minute webcast, RSM professionals will discuss specific tax considerations organizations face when entering new markets, including:

- Structuring considerations from a direct and indirect tax perspective
- How the evolution of base erosion and profit shifting is changing tax structures globally
- Key transfer pricing issues
- Cross-border mergers and acquisitions
- Managing global tax reporting

We are dedicated to helping our clients address the complexities of expanding internationally. Listen to our on-demand recording, Have you considered what it takes to expand globally? for guidance.

Tax Insights

Ownership succession planning: 3 approaches

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RECORDED WEBCAST | July 19, 2016

Business owners should always anticipate the unexpected when it comes to succession planning. Careful planning makes strategic decision-making much easier and helps you avoid any pitfalls, whether you are looking to transition today or in years to come.

As the owner of a closely held business, how do you decide how and when to transition your business and, just as importantly, who will help you through this process?

During this 60-minute webcast, RSM professionals explored various options to consider when preparing for the business succession, including family transition, a management buyout and/or employee stock ownership plan, or a sale to a financial or strategic buyer. Topics include:

- Pros and cons of the three most common selling strategies
- Tax and advisory considerations for each option
- Building your support team

Download webcast slides

TRENDING IN TAX

The future of carried interest?

Don Susswein, Principal

What are the candidates saying about carried interest?

The two presumptive major party presidential candidates both support changing the current tax treatment of carried interest. But what does that mean?

Hillary Clinton supports "ending the 'carried interest' loophole" as well as enacting a "Buffett Rule" to ensure that "no millionaire pays a lower effective tax rate than their secretary." In addition, Bernie Sanders—who could influence the party platform even if he is not the candidate—pledged to "end the carried interest loophole that allows billionaire hedge fund managers to pay a lower tax rate than nurses and truck drivers." In addition, he pledged to render the benefits of carried interest almost worthless, by eliminating capital gains rates for couples with income over $250,000.

Donald Trump would end the current treatment for "speculative partnerships that do not grow businesses or create jobs and are not risking their own capital." However, taking personal compensation in the form of a profits interest in the annual operating earnings of a growing concern could become more attractive, even without a capital gains break, since he would only tax operating business income at 15 percent.

There is evidently as much uncertainty about *how* the law might change as there is about *whether* or *when* it will change. What are some of the options?

Recap: What is carried interest?

A carried interest or profits interest arises when the manager of a partnership—or other employee or service provider to the partnership—is compensated for his managerial services with a percentage interest in the partnership's future income or gains. That may include capital gains if the partnership is engaged in buying and selling assets taxed at capital gains rates—or if the partnership is a business that sells all of its assets, including goodwill or other business assets generally taxed at capital gains rates.

When the taxpayer receiving the carried interest or profits interest is the founder or full-time manager or employee of an operating business, everyone seems to accept that capital gains treatment for his "piece of the action" is appropriate. It is the American dream, so to speak.

The leading presidential candidates seem to believe it should be different if the partnership is not itself a conventional operating business, but is a fund that invests in commodities, securities, real estate or equity interests in other businesses. As a technical matter, it can be argued that the manager should be treated no differently than the manager or employee of a conventional business, and should be able to be compensated with a piece of the action that is taxed at capital gains rates. But many believe that the manager's activities look too much like managing money or managing real property, not managing a business, and should not be able to enjoy the same treatment that is provided for a partner who is a full-time manager or employee of an operating business.

Any proposal to change the treatment of carried interest must first define the term.

At one extreme, new rules could apply across the board to any partnership interest received or held on account of the holder's provision of services to the partnership—including, say, the founder of a tech company who receives a substantial interest solely in exchange for his services in creating the company, without having to put up any substantial amount of cash or financial capital. Technically, some would argue that is a carried interest.

Others might say the new rules should only apply to partnerships that are investment or hedge funds that buy and sell commodities and securities on the financial markets for capital gains, or to private equity funds that buy and restructure other businesses, hoping to resell them at a capital gain, or to partnerships that buy, build or hold real estate with a view towards realizing a capital gain.

Thus, the first question for the politicians is what is the scope or definition of the partnership profits interest that will be subject to any rules.

What is the problem, what is the remedy?

Once it is defined, how should it be taxed? When a profits interest is granted, it typically has no readily ascertainable value. For that reason, the IRS and some courts have allowed it to be assigned a value of zero when it is granted. Thus, the grant itself does not give rise to any tax, and if capital gains are later generated, a portion of them are passed through and taxed to the holder as capital gains.

Congress or the IRS could change this rule, and insist that the value of the interest be determined when it is issued, and taxed as ordinary compensation income at that time, as if it was a cash bonus that the recipient received, paid tax on and then used to purchase an investment in his employer. That would be very difficult to apply, since the IRS, taxpayers and the courts would be tied up in disputes over the valuation.

Congress could keep the zero valuation at issuance, but insist that all or a portion of any later capital gains be recast as ordinary income. It could be 100 percent, 50 percent, 25 percent or a number determined based on a formula, perhaps linked to how much the underlying assets have actually appreciated. For example, if the assets appreciated at 5 percent per year, perhaps they would be taxed entirely as ordinary income, but if the assets appreciated at 15 percent per year, then two-thirds of the gain, the amount in excess of a 5 percent return, might retain its capital gain treatment. Thus, a relatively certain return would be treated as ordinary income, but a riskier, more speculative return would be taxed at capital gains rates. That could make sense to reinforce the policy underlying capital gains rates in the first place—promoting entrepreneurial risk.

Other approaches?

If Congress completely eliminated capital gains breaks—as was done in the landmark 1986 Tax Reform Act when the top rate for all income was set at 28 percent—there would be no real need to change the rules for carried interest. The same is true if Congress eliminated capital gains breaks for anyone with income over $250,000, as Bernie Sanders has proposed. In that event, very few managers would get any benefits from carried interest.

If Hillary Clinton's proposal advanced to impose a minimum tax rate of 30 percent on income over $1 million, that would also substantially cut back on the benefits of carried interest. If the capital gains rate was 20 percent and the ordinary income rate was 40 percent, and a millionaire manager whose income was entirely carried interest was subject to a minimum rate of 30 percent, it would be the equivalent of taxing half of the capital gains as ordinary income. That would seem to meet the objectives of Clinton and Sanders to ensure that hedge fund managers pay higher tax rates than moderate income taxpayers. That may already be the case, as average or effective tax rates, but it would also be the case for marginal tax rates under such a proposal.

Finally, at least in the case of many operating businesses, if Donald Trump's proposal is enacted to tax all business income at 15 percent, it may become attractive to hold onto certain successful businesses as "cash cows" where the income is taxable at 15 percent, rather than selling the business for a lump sum, just to ensure that the profits—attributable to the business becoming more profitable than it was when it was purchased—are taxed as capital gains. That would also make carried interest—and capital gains generally—of lesser importance to some taxpayers.

Final thoughts

Finally, just because the current presidential candidates agree—and assuming that one of them becomes president—there is no guarantee that anything will get done. With a divided government, we may be in for another four years of gridlock. One thing is almost certain—carried interest is not likely to be fixed as a stand-alone measure. If the Congress and the president cannot agree on a comprehensive reform, an item like this is unlikely to be pulled out and dealt with separately. It may be too valuable as a bargaining chip. Remember that it was widely expected that there would be a change to the rules governing carried interest in 2012 when the Congress and the president were forced to reach a consensus deal on the tax rates that would replace the expiring Bush-era tax cuts. To the surprise of many, nothing was done about carried interest, and that could happen again.

Minnesota Supreme Court upholds partial MTC repeal

Enactment of MTC did not create a contractual obligation with taxpayer

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The Multistate Tax Compact (MTC) was drafted as a model law intended to promote uniformity of direct taxation of businesses operating in more than one state. Enacted in 1967, many states joined the MTC and formally adopted the Compact's apportionment provisions. Under these provisions, a taxpayer could elect to utilize the MTC's equally weighted three-factor apportionment formula in lieu of any state-specific formula; however, historically, this election was not used because there was little to no difference between the MTC and state-specific apportionment provisions. Over time, states adopted apportionment rules that were significantly out of sync with MTC Articles III and IV (such as increasing the weight of the sales factor and moving to market-based sourcing for sales of services), doing so by either enacting mandatory state-specific apportionment rules alongside of those provided by the MTC or by repealing and replacing just the MTC apportionment provisions. Both of these approaches, however, arguably violated the terms of the MTC, which required full repeal and withdrawal from the MTC for a state to eliminate the Compact's apportionment election, and taxpayers elected to utilize the Compact's apportionment provisions in lieu of those provided by the state, resulting in a number of legal challenges regarding the binding nature of the MTC and whether the apportionment election was valid in the absence of a state's full repeal of, and withdrawal from, the Compact.

The Minnesota Supreme Court recently addressed this issue in *Kimberly-Clark Corp. v. Commissioner* of Revenue, holding that state's enactment of the MTC did not create a binding contractual obligation that prohibited the legislature from later repealing the apportionment formula provided in the MTC.

Kimberly-Clark mixes tax policy, Constitutional questions, and statutory interpretation to determine the state's power to enact and repeal tax statutes. Minnesota adopted the MTC in 1983, permitting taxpayers to use the state's statutory apportionment methodology, or to elect a three-factor, equally weighted formula using sales, payroll and property as provided under Articles III and IV of the MTC. Minnesota subsequently repealed Articles III and IV in 1987, requiring all taxpayers to use the more heavily weighted sales factor provided for in the state's statutory apportionment methodology. Minnesota later repealed the Compact in its entirety in 2013.

In 2013, Kimberly-Clark amended its corporate franchise (income) tax returns for tax years 2007 through 2009, asserting the right to use the three-factor apportionment methodology provided in the MTC because the state had not provided a full withdrawal, or repeal, from the MTC in the years at issue. The Tax Court, concluding that the state's 1987 repeal of the apportionment formula was constitutional, focused on whether the MTC created a binding contract or served as an advisory model law. The Tax Court observed that Articles III and IV provide for the apportionment election, but no where else in the MTC was a separate and distinct promise that the state could not alter or otherwise repeal the election.

On appeal to the Minnesota Supreme Court, the court focused on whether the MTC created a contractual obligation that prohibited the legislature from later repealing Articles III and IV. According to Kimberly-Clark, by enacting the apportionment formula in 1983, the state created a binding obligation that could not be terminated without a full and complete withdrawal from the Compact (which did not occur until 2013) and thereby violated the Contract Clauses of the United States and Minnesota Constitutions. The court concluded that even if there was a contractual obligation to the taxpayer prohibiting a partial repeal of the MTC, the legislative power of taxation could not be surrendered, suspended or contracted away. The court noted that the enactment of a statute does not create a contract right, but merely declares a policy to be pursued until the legislature decides otherwise through amendment or repeal.

The court also addressed the "unmistakability doctrine," a rule of contract construction that provides the sovereign powers of a state cannot be contracted away except in "unmistakable" terms. Kimberly-Clark argued that by enacting the apportionment option in Article III, the state unmistakably promised to be bound by the MTC's terms until withdrawal from the MTC or the member states collectively agree to amend the MTC.

The court found that while the MTC allowed a state to withdraw by repealing the statute, there was no "all or nothing" repeal requirement as argued by Kimberly-Clark. The court refused to read into the statute that silence or ambiguous terms construed a waiver of sovereign authority, thus, there was no provision representing a clear and unmistakable promise by the state to refrain from amending or repealing Articles III and IV.

In affirming the Minnesota Tax Court, the Minnesota Supreme Court did not address the arguments concerning the Contracts Clause of the U.S. and Minnesota Constitutions.

Other pending compact repeal litigation

California

On May 29, 2016, the taxpayers in *The Gillette Company, et al. v. Franchise Tax Board* case filed a petition for *writ of certiorari* with the U.S. Supreme Court to review the decision of the California Supreme Court that taxpayers were not entitled to elect to utilize the Compact's three-factor apportionment election in calculating franchise tax. Recently, both the Council on State Taxation and the Tax Foundation have filed amicus curie briefs urging the U.S. Supreme Court to grant *certiorari* to hear the issues presented in *Gillette*. For more information on the *Gillette* decision, please read our alert, *California, Gillette and the Multistate Tax Compact*.

Michigan

On June 24, 2016, the Michigan Supreme Court declined to review the Michigan Court of Appeals' decision in *Gillette Commercial Operations v. Department of Treasury*, which rejected claims by over 50 taxpayers challenging the constitutionality of the state's retroactive repeal of the Compact. In that decision, the Michigan Court of Appeals held that the MTC was an advisory agreement, not a binding compact or contract, and thus, removal from the agreement was not prohibited. For more information on the Michigan *Gillette* decision, please read our alert, *Michigan Supreme Court declines retroactive MTC repeal challenge*.

Oregon

On Sept. 9, 2015, the Oregon Tax Court issued its decision in *Health Net, Inc. v. Oregon Department of Revenue*, finding that the taxpayer could not elect to utilize the Compact's three-factor apportionment election when determining its Oregon corporate excise tax. On Oct. 26, 2015, Health Net appealed the Tax Court's decision to the Oregon Supreme Court where the case is currently pending.

Texas

On July 28, 2015, the Texas Court of Appeals issued its decision in *Graphic Packaging Corp. v. Hegar* determining that the Compact's three-factor election did not apply to the Texas Franchise Tax because that tax was not a tax imposed on net income. On Dec. 14, 2015, Graphic Packaging petitioned the Texas Supreme Court for review of the Texas Court of Appeals' decision where it is currently pending.

Takeaways

Taxpayers impacted by the availability of the Compact election should follow the litigation in the above states as it progresses through the courts. With no state's highest court finding the Compact election available after a repeal, all eyes will be on whether the U.S. Supreme Court grants review of *Gillette*. What's clear is that ultimate resolution of the issue is still pending.

What's the deal with sales and use tax on remote purchases?

Five primary approaches, one big discussion for remote sellers

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Download white paper

The internet has transformed the consumer products space over the past 10 years and accelerated the trend toward remote purchasing. According to the U.S. Department of Commerce, e-commerce sales accounted for over $92 billion of adjusted sales in the first quarter of 2016, an increase of $12 billion from the first quarter of 2015. And, in fact, e-commerce sales calculated on an adjusted basis have increased every quarter since the beginning of 2009. There is no slowing the engine of internet-based sales as consumers are increasingly making a larger portion of their yearly household expenditures online, including purchases that were never expected to become part of the e-commerce realm like grocery shopping and medical services (e.g., physician examinations through internet video). Businesses are adapting, and the once very expensive brick and mortar retail storefronts are becoming a necessity of the past.

This ongoing transformation in the retail space has sparked rigorous debate around the administration and collection of sales tax on remote purchases between retail-backed policy groups to state and local legislative bodies and the United States Congress.

- Are remote sellers required to collect and remit sales tax on purchases made by buyers in other states?
- What is the responsibility of the government to create a level playing field for remote sellers?
- Who is responsible for the accuracy of use tax compliance?
- Will remote sales tax collection effectively turn all remote sellers into multistate entities?
- Will the cost of administration eliminate small businesses from selling over state lines?

In this white paper, our state and local tax professionals discuss the statutory, regulatory, and administrative strategies states are using to capture remote sales tax collection as a funding source to boost state coffers.

Tax planning for high net worth individuals immigrating to United States

Rolando Garcia, Manager

For generations, the Statue of Liberty has welcomed immigrants with this most famous of quotes: "Give me your tired, your poor, your huddled masses yearning to breathe free" (Emma Lazarus, *The New Colossus*). However, Lady Liberty does not warn of the huge tax costs associated with immigrating to the United States. Foreign high net worth individuals immigrating to the United States should seek advice to minimize exposure to the U.S. income, gift and estate tax system. This item articulates some considerations for those taxpayers.

How residency and domicile are established

A person is not subject to U.S. income tax unless he or she is a U.S. citizen or resident (section 7701(a)(30)) and is not subject to gift or estate tax unless he or she is a U.S. citizen or domiciliary (Regs section 20.0-1(b)(1)). Residency for federal income tax purposes is different from domiciliary status for federal gift and estate tax purposes, and this distinction can often result in a person's having residency for income tax but not for estate or gift tax purposes (or vice versa). This distinction can make pre-immigration planning challenging but can create opportunities as well.

Income tax: The United States taxes the worldwide income of its citizens and residents (section 7701(a)(30)). Thus, U.S. citizens and residents, even when living abroad, are subject to the full brunt of the U.S. tax system. U.S. federal income tax rates can be as high as 43.4 percent on U.S. residents. For income tax purposes, noncitizen individuals are U.S. residents if they meet either the green card test or the substantial-presence test, as described below.

Green card test: Individuals who hold a permanent resident card (a green card) are taxable residents of the United States for income tax purposes, and as a result, their worldwide income is subject to U.S. income tax (section 7701(b)(1)(A)). Possession of a green card is the only relevant fact under this test (although there are special rules for the first and last year of lawful residence).

Substantial-presence test: In addition, individuals qualify as U.S. tax residents if they are present in the United States for 183 days or more in any given calendar year (section 7701(b)(3)(A)). If the individual is not present in the United States for 183 days or more in any given year, but is present for at least 31 days, and the individual's days present in that year and the two preceding years, based on a weighted formula, equals 183 days or more, then the individual also qualifies as a resident for that year (id.). An individual is subject to U.S. income tax on the first day of the year in which the individual meets the 183-day test. As a general rule, an individual who does not spend more than 121 days in the United States in any given year will not meet the substantial-presence test.

Some key exceptions present planning opportunities:

1. An individual present in the United States for fewer than 183 days in a given year may be able to avoid U.S. resident status by establishing a tax home in a foreign country and a closer connection to that foreign country than to the United States (section 7701(b)(3)(B)).
2. A person holding a full-time student, teacher or trainee visa, or who is an employee of an international organization, will not qualify as a U.S. resident, regardless of the number of days spent in the United States (sections 7701(b)(5)(A) and (B)).
3. Treaties with some countries include "tie-breaker" provisions to determine residency status for a person who could otherwise be treated as a resident of both of the treaty countries.

Domiciliary status for gift and estate tax: Unlike the mostly clear and objective variables used to determine residency status for income tax purposes, determination of a person's domicile for gift and estate tax purposes is based on a facts-and-circumstances analysis, which is subjective. Even the presumption that a green card holder has a U.S. domicile is rebuttable. Domiciliary status is acquired when one lives in the United States, even for a brief period, with no definite present intention of moving from the United States (Regs section 20.0-1(b)(1)). One can see that avoiding residency for U.S. income tax purposes does not rule out becoming a U.S. domiciliary for U.S. gift and estate tax purposes.

A person who is a U.S. domiciliary for estate and gift tax purposes is subject to gift tax at rates as high as 40 percent on that person's worldwide gratuitous lifetime transfers of property. In addition, U.S. domicile status could result in the person's worldwide assets' being exposed to federal estate tax upon death at rates as high as 40 percent. However, a non-U.S. domiciliary's estate and gift tax exposure extends only to gifts, bequests and estate holdings of U.S. situs property (section 2106).

Pre-immigration options: Given the worldwide reach of the U.S. income and transfer-tax systems, timing an immigrant's status as either a resident or domiciliary is essential. With a systematic and disciplined approach, a high net worth individual's exposure to these taxes can be minimized.

Minimizing income taxation

Step up basis: Under the U.S. check-the-box regime, a business entity may elect to be treated either as a corporation, a partnership taxed to its owners directly, or for an entity with a single owner, as a disregarded entity (see Regs sections 301.7701-1 *et seq.*). A foreign corporation whose owners elect partnership or disregarded-entity status will be treated as making a liquidating distribution of its underlying assets to its owners on the effective date of the election. As a result, the basis of assets held by the foreign corporation is stepped up (or down) in the hands of the entity's owners to its fair market value (FMV) on the date of the election.

Under current rules, this liquidating distribution is not taxable since gain realized on non-U.S. assets is not subject to U.S. income tax when realized by a nonresident (see section 871; U.S. tax generally not imposed on capital gains of nonresident aliens). However, for U.S. tax purposes, any step-up in the basis of the assets can reduce future realization of capital gain after the foreigner becomes a U.S. income tax resident.

Sell appreciated assets: Some countries, such as Mexico, allow for an inflation adjustment to the basis of assets, while the United States does not. The result is that gain in the United States could be significantly more than in the taxpayer's current home country. As a result, taxpayers coming from those jurisdictions should consider selling those assets before immigrating. This could result in little tax in the taxpayer's home country while allowing the taxpayer to purchase new assets and enter the United States with an FMV basis in the new assets.

Dispose of foreign corporations with passive income: A U.S. shareholder owning more than 10 percent (taking into account attribution and constructive ownership principles) of a foreign corporation may need to include in taxable income his or her pro rata share of the foreign corporation's "Subpart F" income, even if the shareholder receives no actual distributions (section 951(a)). Even if Subpart F does not apply, a U.S. shareholder who recognizes gain from the sale of shares in a foreign corporation that has passive income as the majority of its income (or where the majority of its assets produce passive income) may be subject to an extremely punitive tax regime under which any such gain may be taxed at ordinary rates (the passive foreign investment company rules, section 1291(a) *et seq.*). To avoid these regimes, a pre-immigrant taxpayer should consider disposing of those investments before entering the United States.

Plan with trusts: Before becoming a U.S. resident, a taxpayer can make irrevocable gifts to non-U.S. persons in trust where (1) the trust document indicates that it is not permitted to have U.S. beneficiaries, and (2) the trust is not otherwise considered a U.S. grantor trust. By doing so, the taxpayer may avoid U.S. income taxes on future income earned by the gifted assets and may also avoid later U.S. gift and estate taxes on the transfer of those assets, simply because the now-U.S. resident no longer owns the income-producing assets for U.S. tax purposes.

As a precautionary note, nonresidents who create foreign grantor trusts that have (or may have) a U.S. beneficiary are subject to U.S. income tax on that foreign trust's income if the nonresidents themselves become U.S. taxpayers within five years of transferring property to the trust (Regs section 1.679-5(a)). Thus, a nonresident alien who intends to immigrate to the United States should create and fund the foreign trusts at least five years before becoming a U.S. person, in order to avoid being taxed on trust income.

Alternatively, a taxpayer can, before immigrating to the United States, transfer a portion of his or her assets to an irrevocable discretionary trust of which the taxpayer and other family members are permissible discretionary beneficiaries. While this will become a grantor trust for U.S. income tax purposes, subjecting its income to U.S. income tax in the hands of the grantor after the grantor becomes a U.S. resident (sections 671–677), the assets should not be subject to U.S. estate tax on the taxpayer's death (section 679). Moreover, life insurance can be used to cut off the accumulation of any undistributed net trust income (thereby minimizing the income tax liability to the grantor) by using trust assets to purchase a life insurance policy.

Invest in an annuity or a life insurance policy: Before immigrating, a taxpayer can purchase an annuity or a life insurance policy. A life insurance policy that is not a modified endowment contract can provide funds under its terms (e.g., loans) to the taxpayer, even when the taxpayer becomes a U.S. tax resident, without payment of U.S. income tax, because a loan from the taxpayer's insurance policy is generally not taxable (section 72(e)(5)(A)).

Minimizing exposure to gift and estate taxation

Foreign irrevocable trust: Even if the five-year waiting period discussed above cannot be met, contributing foreign property to a trust before immigrating to the United States still has significant transfer tax advantages. As stated above, the nonresident's non-U.S. assets that are in the trust will not be subject to any U.S. estate tax.

Gifts to U.S. persons: Assuming a desire to so do, it is advisable to make gifts to U.S. persons before becoming a U.S. domiciliary because nonresidents are subject to U.S. gift tax only on gratuitous lifetime transfers of U.S. situs property (including U.S. real estate and tangible property located in the United States, such as cars, art, jewelry and furnishings) (section 2101(a)). However, a U.S. person who receives a gift from a foreign person may need to report the gift to the IRS, and penalties may result from failure to do so (section 6039F).

Gifts between spouses: If spouses become U.S. residents but not U.S. citizens, any gifts between them in excess of $148,000 per year (2016 amount) will be subject to gift tax. Thus, any gifts between spouses should be made before entering the United States with non-U.S. situs assets (section 2523(i)).

Anomalous treatment of U.S. shares: Shares of a U.S. corporation are intangible property and therefore, are not considered taxable as U.S. situs property for gift tax purposes, similar to debt instruments issued by U.S. issuers and Treasury securities. However, shares of a U.S. corporation are considered U.S. situs property for estate tax purposes (sections 2104(a), 2501(a)(3) and 2511(b)). Thus, nonresidents who own U.S. shares and intend to immigrate to the United States should consider making gifts of their U.S. shares. Those gifts may achieve two tax-saving goals. The gifts will be exempt from U.S. gift tax and will also reduce the U.S. estate for estate tax purposes.

Conclusion

Through advanced and disciplined planning before becoming a U.S. resident, a taxpayer can significantly reduce exposure to U.S. income, gift and estate taxes. At a minimum, individuals considering a move to the United States should seek advice long before establishing U.S. resident or domiciliary status.

BEPS will mean higher costs and uncertainty for middle-market companies

Survey finds that middle market expects significant impact from BEPS

Download survey report

The Base Erosion and Profit Shifting (BEPS) project will have direct and significant consequences for middle-market companies. It will increase compliance costs and global effective tax rates, and is creating considerable strategic uncertainty. Many companies will need to make changes to their corporate structures, and these changes may be significant. These are among the findings of a recent survey commissioned by RSM and conducted by *Euromoney Institutional Investor* in early 2016. More than 750 executives in leadership roles at multinational enterprises gave us their insights on the perceived risks associated with, and sentiments about, the BEPS project.

The BEPS Project will have a significant impact on the middle market

The BEPS project was launched in 2013 by the Organisation for Economic Cooperation and Development (OECD) and the leading rich and developing nations known as the G-20. It aims to provide governments with ways to close perceived gaps in existing international tax rules that can be used by multinational enterprises to make profits disappear for tax purposes, or to shift profits to low-tax jurisdictions where these enterprises have little or no real activity, allowing them to pay low or no corporate taxes. When the BEPS Project was initiated, many assumed that it would have a limited impact on middle-market companies. This is clearly not the case. Middle-market companies (revenues ranging from $50 million to $1 billion) and large companies (revenues of more than $1 billion) report very similar expectations concerning anticipated:

- Increases in compliance costs
- Increases in effective global tax rates
- Uncertainty regarding business strategy
- Changes to corporate tax structures
- Activities necessary to align with new transfer pricing and permanent establishment rules

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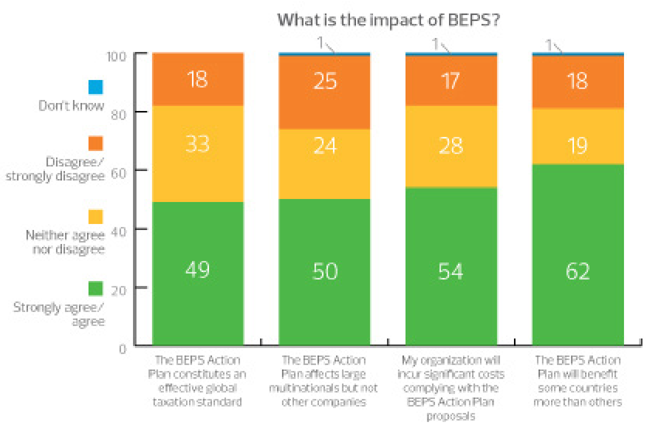
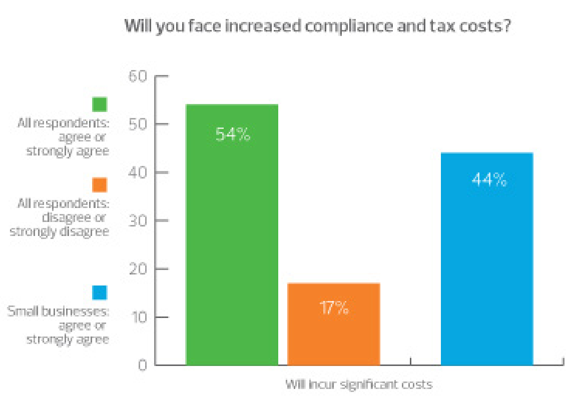
By comparison, respondents from small companies (less than $50 million in revenue) were less likely to anticipate increases in compliance costs and tax rates, reported lower uncertainty, and were less likely to anticipate changes to their corporate structures.



Compliance costs and global effective tax rates will increase

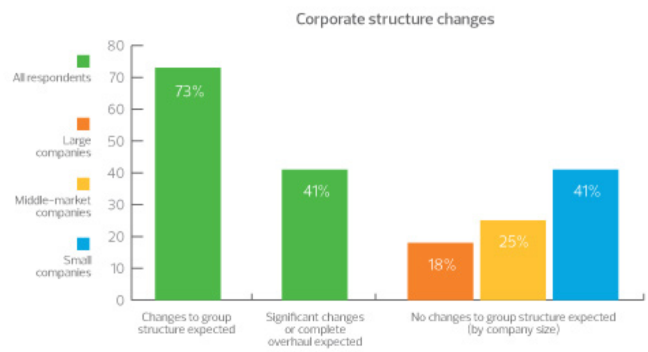
The vast majority of respondents, 68 percent, expect their compliance costs to increase by at least 10 percent, with 34 percent expecting those costs to increase by 25 percent or more. Most also anticipate an increase in their worldwide effective tax rate, with 72 percent expecting some increase and 31 percent expecting an increase of more than 10 percent.



The BEPS Project is creating strategic uncertainty and will likely mean changes to corporate structure

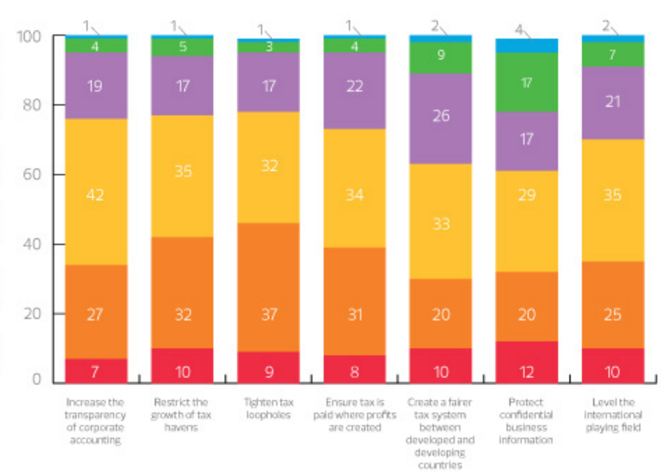
More than 70 percent of respondents report that BEPS is causing uncertainty regarding their business strategies.

Companies also anticipate having to change their group structures, with 73 percent expecting to make some change and 41 percent planning to institute a significant change to or even a complete overhaul of their structures.



Most agree change is necessary but see BEPS as a work in progress rather than the ultimate answer

The majority of respondents, 69 percent, believe it is necessary to implement some form of global taxation standards. However, 61 percent felt the BEPS Action Plan only moderately satisfies, slightly satisfies or does not at all satisfy the primary objective of ensuring tax is paid where profits are created, and only a third (35 percent) felt it would largely or completely satisfy the objective of leveling the international playing field. However, overall, while conscious of the flaws in the BEPS process, our survey respondents seem well-disposed to, or at least open minded about, the benefits it could deliver.



For more information, download the complete report here.

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ON THE BLOG

Research tax credit limitations for partners and S corporation shareholders

Tom Windram, Partner

When determining the extent to which a shareholder in an S corporation or a partner in a partnership may benefit from the tax credit for qualified research activities performed by the pass-through entity, it is important to understand the special rule that applies to the pass-through of the research tax credit.

This rule limits the credit to the portion of tax that would apply to the individual owner's taxable income that is derived from that person's interest in the business entity that performed the research and generated the tax credit.

> For example, assume Shareholder 1 has a 20 percent interest in S Corporation A and is taxed at the top marginal tax rate of 39.6 percent on income from the S corporation. The S Corporation A computes a research tax credit of $100,000 and passes through a credit of $20,000 on Shareholder 1's Form K-1. S Corporation A also passes through $40,000 of taxable income to Shareholder A.
>
> The research tax credit limitation for Shareholder A is then computed as $40,000 of taxable income multiplied by the marginal tax rate of 39.6 percent to compute a limitation of $15,840. Any credit in excess of the limitation cannot be used in the current year but may be carried back one year or carried forward for 20 years until it is fully utilized.

In the example above, the $20,000 total credit minus the $15,840 utilized credit would result in a $4,160 credit carryback or carryforward. Owners of S corporations and partnerships should ensure the taxable income limitation and any resulting carryforwards and carrybacks are taken into account when preparing their federal tax returns.

IRS addresses deferred revenue treatment in taxable stock acquisition

Christian Wood, Principal

In situations where the target is deferring revenue, a taxable stock acquisition may create an inconsistency between the total amount of revenue recognized under generally accepted accounting principles (GAAP) and the amount of revenue recognized for income tax purposes.

In general, for income tax purposes, a corporation may be eligible to defer the recognition of an advance payment for one year, provided the corporation is deferring the revenue in its audited financial statements. If the stock of the corporation is acquired pursuant to a taxable stock acquisition, GAAP will generally require the deferred revenue liability to be written down to the fair value of the future performance obligation. The write-down of deferred revenue for GAAP is not controlling for tax purposes, and the full amount of the advance payment must be recognized.

> For example, assume that in 2015, a corporation receives $120 as an advance payment. On its audited financial statements, the corporation will recognize $40 of revenues in 2015, $60 in 2016, and $20 for 2017. During 2015, the corporation is acquired, creating a short taxable year. As of that date, the corporation had recognized only $20 of the revenue in its audited financial statements.
>
> For GAAP purposes, if the fair value of the future performance obligation was determined to be $10, the opening balance sheet at the date of the acquisition would only reflect $10 of deferred revenue. The remaining $90 will never be recognized for GAAP. For income tax purposes, the full amount of the remaining deferred revenue ($100) is recognized in full during the short taxable year created upon acquisition.

Recently released guidance confirms the IRS' view that a taxpayer is not able to escape the recognition of revenue through a transaction or change in fair market value for GAAP purposes, and buyers should be aware of the potential tax consequences when deferred revenue is acquired in such a situation.

Choi, Kim & Park, LLP

CERTIFIED PUBLIC ACCOUNTANTS & CONSULTANTS

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