February 2015

Tax Digest

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

FEDERAL

Audit protection may not be available for taxpayers implementing the tangible property regulations while under IRS exam

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The new tangible property regulations apply to tax years beginning on or after Jan. 1, 2014. To comply with these new rules, a taxpayer using a calendar year must adopt the regulations no later than on its 2014 tax return. Taxpayers implement the regulations through the filing of one or more Forms 3115, *Request for Change in Accounting Method*. Generally, once a taxpayer files a Form 3115 to request a change, the taxpayer has "audit protection" for that item for prior tax years. However, prior to the recent issuance of updated accounting method change procedures, taxpayers under IRS examination generally were not permitted to file a Form 3115 unless certain conditions applied. When the IRS originally released the rules for implementing the tangible property regulations, it permitted taxpayers under IRS examination to file Form 3115 (and receive corresponding audit protection) as long as the Form 3115 was filed for a tax year beginning before 2015. Recently, the IRS released two revenue procedures that provide updated rules for taxpayers filing any Form 3115. While the new rules make it easier for taxpayers under IRS examination to file a Form 3115, they eliminate prior-year audit protection for those taxpayers. While there are exceptions, they are limited. Taxpayers required to implement the regulations should consult with their tax advisors to determine the impact of the new rules.

5-year built-in gain recognition period extended for 2014

Geoffrey Bayo, Manager, Raleigh, North Carolina

Signed into law in December 2014, the Tax Increase Prevention Act of 2014 included important provisions impacting S corporations. The act retroactively extended through 2014 the temporary five-year recognition period for built-in gains. Generally 10 years, the built-in gains recognition period has been temporarily shortened in each of the past several years. The most recent extension means that a calendar-year S corporation with an S election effective date that precedes Jan. 1, 2009, will generally not be subject to the built-in gains tax in 2014. Companies should be aware, however, that absent future legislative changes, the built-in gains recognition period reverts to 10 years in 2015. An additional welcome change in the legislation is a provision that extended through 2014 the rule that permits S corporation shareholders to reduce their stock basis by the basis, rather than the fair market value, of appreciated property donated to a charitable organization. Absent this change, shareholders would have been required to reduce the basis by the full fair market value of the property.

Favorable AMT adjustment for unamortized R&E expenditures related to abandoned projects

Tom Windram, Partner, Washington National Tax

Noncorporate taxpayers are required to capitalize otherwise currently deductible research and experimentation (R&E) expenditures and amortize them

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over 10 years when computing alternative minimum taxable income (AMTI). However, this adjustment is not required for R&E expenditures associated with an activity in which the taxpayer materially participates. In addition, an often overlooked rule provides that if a taxpayer incurs a loss on the disposition of property for which the R&E expenditures have not been fully amortized, the amount of loss deductible in computing AMTI is the lesser of (1) the amount of loss allowable for the expenditures had they remained capitalized, or (2) the amount of expenditures remaining to be amortized for alternative minimum tax purposes. This rule enables the unamortized balance of R&E expenditures to be deducted against AMTI when the related research project is abandoned.

Bottom guarantees of debt eliminated in proposed regulations

Larry Hirsh, Partner, Cleveland, Ohio

A common technique utilized by partners to provide partnership basis is a "bottom guarantee" of mortgage debt. This is a guarantee of the least risky portion of the debt. For example, a partner would be liable on a $2 million bottom guarantee of a $10 million mortgage only if the property's net sale proceeds were less than $2 million. Although involving minimal risk, this guarantee provides the partner with an allocation of debt to increase basis. Among the changes in proposed section 752 regulations issued earlier this year is the elimination of the ability to use this type of arrangement. This change would apply to liabilities incurred or assumed on or after the date the final regulations are published. While it is far from certain that all portions of these proposed regulations will be adopted, partners should be aware of this possible change. Until that time, the bottom guarantee remains a viable planning technique to increase a partner's basis.

New sick leave requirements

Bill O'Malley, Director, Washington National Tax

In his 2015 State of the Union address, the president called for the adoption of a national sick leave policy. In this regard, employers should remember that while Congress has yet to take this issue up on a national level, several states and cities have already adopted mandatory sick leave policies. For example, California's Healthy Workplaces, Healthy Families Act of 2014 goes into effect on July 1, 2015. Similarly, Massachusetts voters approved by ballot initiative the adoption of an earned sick time law that also goes into effect on July 1, 2015. In adopting these new laws, California and Massachusetts join Connecticut and several cities (e.g., Washington, D.C. and New York City) in imposing mandatory sick leave requirements. Each law is unique to the state or municipality of adoption, meaning any employer with multistate operations needs to review whether its sick leave policy conforms to the requirements of each jurisdiction in which it does business.

Opportunity for refund of federal estimated taxes

Patti Burquest, Principal, Washington National Tax
Bob Adams, Partner, Washington National Tax

Did your company overpay its federal estimated tax for 2014? The Internal Revenue Code allows corporations to obtain a quick refund of overpaid estimated tax amounts by filing Form 4466 prior to the original due date of the return for the year the estimated amounts were paid. For calendar-year corporations, the form can be filed as early as January, but no later than March 15, 2015. The requested refund must be at least $500 and at least 10 percent of the expected 2014 tax liability. Refunds are generally paid within 45 days from the date the IRS receives Form 4466, and electronic refunds can be requested for refunds in excess of $1 million. The

IRS generally honors requests to credit the refunded amount to other tax years or other taxes that the taxpayer may owe. For example, if the company plans to file an amended return for 2012 showing an additional tax liability, it can request the IRS to credit all or a portion of the refund amount to 2012 by instructing the IRS to do so in a statement attached to the Form 4466. Even though Form 4466 allows corporations to estimate the amount of tax that will be shown on Form 1120 and obtain a refund or credit of the excess amounts paid in, the IRS can impose a penalty if the corporation underestimates its tax liability on the form and owes tax when it files its return.

Supreme Court to rule on same-sex marriage—April argument and late June decision likely

Charles Schultz, Partner, Washington National Tax
Audrey Young, Director, Washington National Tax

On Jan. 16, 2015, the U.S. Supreme Court announced it would hear appeals in four new cases on same-sex marriage. The two questions to be answered by the Court are whether state bans on same-sex marriage are constitutional and whether states can lawfully refuse to recognize same-sex marriages performed in other states. These issues were not addressed in the *Windsor* case, decided in 2013, which struck down a portion of the Defense Of Marriage Act. Following *Windsor*, the IRS adopted a rule of celebration and now recognizes all lawful marriages regardless of the spouses' domicile. At present, same-sex marriage is permitted in 36 states. Bans remain in effect in the other 14 states, and all have been challenged. The focus of the appeals and the oral argument will be the Sixth Circuit decision last November that upheld bans on marriage or marriage recognition in Kentucky, Michigan, Ohio and Tennessee. For purposes of the 2014 tax filing season, married same-sex couples should follow the law of their resident state with respect to state tax filing requirements.

INTERNATIONAL

US management company creates US tax obligations for foreign fund

Jamison Sites, Supervisor, Washington National Tax
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In a recent memorandum, IRS Chief Counsel determined that certain lending and underwriting activities conducted by a U.S. fund manager on behalf of a foreign investment fund (Fund) constituted a U.S. trade or business (USTB) for the Fund. In particular, the IRS concluded that such activities did not qualify for an exception to USTB status for trading in stock or securities. This conclusion could affect funds that rely on the exception to avoid U.S. tax obligations and could create a tax filing obligation for non-U.S. partners of a foreign fund. Foreign persons are generally engaged in a U.S. trade or business if they regularly and actively trade in stocks and securities in the United States. However, two safe harbors exist where the taxpayer trades in the United States through an independent agent or through an agent for the taxpayer's own account. The memorandum concludes that the Fund was engaged in a USTB as a result of its stock underwriting and lending activities. However, the IRS determined that such activities did not constitute trading because the Fund earned interest income from holding loans and also earned fees from its underwriting activities. The IRS reasoned that because the Fund did not earn income from changes in the market values of its debt or equity securities, it was, therefore, not engaged in trading activity. Taxpayers that rely on the trading exceptions to USTB status should evaluate their positions in light of the memorandum because non-U.S. partners in a foreign fund engaged in a U.S. trade or business will have a U.S. filing obligation absent an exception to trade or business status.

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New requirements for non-EU businesses to collect VAT

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Non-EU businesses that provide telecommunication, broadcasting or electronic services (digital services) to EU residents must generally collect value-added tax (VAT) on the provision of these services and must file and possibly register in each jurisdiction in which services are provided. Under a new EU law that took effect on Jan. 1, 2015, the consumption of digital services is now subject to VAT in the country where the consumer belongs, rather than based on the historic "place of supply" rule. In order to ease the registration/compliance burden, the EU has created a portal for registration and remittance of collected VAT called the Mini One-Stop Shop (MOSS). The MOSS Web portal enables businesses responsible for VAT to register in a single EU member state. Taxpayers may use MOSS to remit VAT to other member states without the need to register in each customer's member state. While EU businesses must register under MOSS in their state of residence, non-EU businesses may choose to register in any member state. Prior users of the VAT on the e-Services system must separately register under the new MOSS system. Taxpayers should ensure that they transition properly to the new MOSS system and take this opportunity to correct any past noncompliance with respect to VAT collection obligations.

STATE AND LOCAL

Minnesota updates federal tax conformity

Craig Lawless, Director, Minneapolis, Minnesota

On Jan. 25, 2015, Minnesota Governor Mark Dayton signed H.F. 6, updating the state's tie-in date for conformity to the Internal Revenue Code for corporate franchise and personal income tax purposes from March 26, 2014, to Dec. 31, 2014. Pursuant to the bill, the state will treat federal changes effective between March 26, 2014, and Dec. 31, 2014, as if they were effective for state purposes at the time those changes were made effective for federal purposes, potentially resulting in retroactive changes to business and individual tax liabilities for 2014. Minnesota law continues to decouple from the federal bonus depreciation provisions and the increased section 179 expensing allowance for the 2014 tax year. Minnesota taxpayers should review their 2014 tax calculations to account for this change.

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