Tax Digest

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

January 2013

FEDERAL

The American Taxpayer Relief Act of 2012

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During the waning hours of 2012 and early into Jan. 1, 2013, Congress and the White House worked to avert the so-called fiscal cliff that was due to strike on the first of the New Year. The result of these efforts is the American Taxpayer Relief Act of 2012 (the Act). This new tax law does several things relating to the fiscal cliff, including a deferral of sequestration, the set of mandatory, across-the-board spending cuts that were to take effect Jan. 1. As a result of the Act, these spending cuts have been deferred until March, when once again Congress and the White House will have to address them. The Act includes several components that will immediately impact tax planning and compliance, including:

- Individual tax rates, exemptions and payroll taxes adjusted
- Estate and gift tax laws made permanent
- Numerous expiring tax provisions extended
- IRA provisions extended
- Most health care reimbursement cuts delayed
- Treatment of carried interest unchanged

Temporary tangible asset regulations effective date officially delayed

Natalie Tucker, director, Washington National Tax
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On Dec. 14, 2012, the IRS and Treasury Department (the government) released technical amendments to TD 9564, officially amending the effective date of the temporary regulations regarding the deduction and capitalization of expenditures related to tangible property until taxable years beginning on or after Jan. 1, 2014, and providing rules for optional early application of the temporary regulations, generally for taxable years beginning on or after Jan. 1, 2012. Taxpayers choosing to early adopt provisions of the temporary regulations may continue to rely on the automatic consent provisions provided in Rev. Procs. 2012-19 and 2012-20. The continued availability of the automatic method change procedures provides taxpayers with an opportunity to determine which aspects of the temporary regulations to adopt, depending on their circumstances and tax planning goals (e.g., planning to mitigate the scheduled 2013 increase in individual tax rates or seeking to utilize or increase a net operating loss). Furthermore, the information provided by Notice 2012-73 regarding which areas in the regulations will likely favorably change (i.e., the de minimis rule, disposition rules and routine maintenance safe harbor) should assist taxpayers in making decisions as to which of the current 19 automatic method changes to go ahead and implement. The ability to early adopt sections of the temporary regulations and selectively file automatic method change requests for taxable years beginning after Dec. 31, 2011, provides a great opportunity for taxpayers to optimally plan for compliance with the final regulations by their 2014 tax years.

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Tax Digest

Employers required to issue health benefit exchange notices by March 1, 2013

Bill O'Malley, director, Washington National Tax

The Affordable Care Act (Act) provides that each state will have a health benefit exchange. The exchanges are to begin providing health insurance to individuals and small businesses beginning Jan. 1, 2014. Under the Act, employers must notify their employees about the existence of the health benefit exchanges no later than March 1, 2013. These notices must describe the services provided by the exchange and the potential advantages and disadvantages for an employee who elects to purchase health insurance through the exchange, as well as information regarding how to contact the exchange and an individual's appeal rights. It is anticipated that the U.S. Department of Labor will issue a model notice format. As the content of the notice will vary by state, this will be a potential administrative challenge for those employers with employees in more than one state.

Deferred compensation plan corrections made in 2012

Steve Levin, director, Washington National Tax

Did your company self-correct a nonqualified deferred compensation plan failure during 2012 under IRS relief procedures? To secure the relief from potential penalties, employers with such corrections must, in most cases, provide a written compliance statement to all affected participants no later than Jan. 31, 2013. The compliance statement must contain summary information describing the failure, identifying the failure as eligible for relief under the IRS guidance, summarizing the actions taken to correct the failure, and indicating the amount involved and the date of the correction. In addition, the employer and each affected participant are generally required to attach the compliance statement to their timely filed 2012 federal income tax returns. Failure to provide the compliance statement to the affected participants or to attach the compliance statement to the income tax returns, as required, could nullify the intended relief from penalties.

IRS begins issuing notices relating to merchant card and third-party network transactions reported on Form 1099-K

Patti Burquest, principal, Washington National Tax

Businesses and merchants that accept payments using credit and payment cards or receive payments from third-party networks (such as PayPal) receive Form 1099-K, which reports the amount of transactions processed by the card issuer or third-party network. By requiring the third parties to provide business, merchants and the IRS with information on the amount of transactions (using the cards or networks) during the calendar year, the IRS aims to minimize tax avoidance associated with businesses and merchants failing to report gross receipts. In late November, the IRS began issuing notices to businesses and merchants about potential discrepancies in the reporting of gross receipts, which the IRS based on comparisons of credit or payment card receipts to total gross receipts reported on tax returns. The notices focus on possible unreported gross receipts from cash or checks, and sample notices are now posted on the IRS website. These notices range from a simple notification of the gross receipts reported by third parties on Forms 1099-K (to allow businesses to cross-check the information against their returns), to a request for specific information on reported sales. Businesses and merchants that receive these notices should review the information carefully and treat their responses as part of a potential IRS audit. In order to forestall further IRS inquiries, notice recipients should seek advice from their tax advisors on the completeness of their responses prior to submission.

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Tax Digest

Now may be the time for reverse accounting methods planning

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During periods of stable tax rates, many tax planning opportunities exist to defer a taxpayer's income into future years or to accelerate deductions to earlier years. With tax rate increases scheduled to take effect this year, the reverse opportunity is available. Taxpayers anticipating tax rate increases or with expiring net operating losses should consider options to accelerate income into earlier years and defer deductions into later years. With effective planning, a taxpayer can experience permanent cash tax savings from such strategies. Taxpayers potentially facing an increase in the highest marginal ordinary income tax rate from 35 to 39.5 percent, an increase in the dividends tax rate from 15 to 39.6 percent, and an increase in the long-term capital gains rate from 15 to 20 percent, as well as the new 3.8 percent Medicare tax on net investment income of high earners that took effect Jan. 1, 2013, may want to consider ways to mitigate such tax increases (e.g., through an evaluation of normal business transaction opportunities and associated changes in underlying facts, annual elections that may be made each year, and accounting method changes to affirmatively change methods). Taxpayers most likely to benefit from reverse accounting methods planning are generally closely held businesses owned by individuals (e.g., S corporations, partnerships and disregarded entities). Taxpayers should contact their tax advisors to discuss their specific circumstances and whether they could benefit from such planning.

New IRS guidance on 3.8 percent investment income tax

Jacob Wilkinson, manager, Washington National Tax
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On Nov. 30, 2012, the IRS issued proposed regulations related to the new 3.8 percent tax on net investment income of high earners, which became effective Jan. 1, 2013. It is noteworthy that the proposed regulations do nothing to suggest any limitation on the ability of certain S corporation owners, as well as certain partners in limited partnerships, limited liability companies and similar entities, to receive income that is not subject to either the 3.8 percent net investment income tax or the parallel 3.8 percent levy imposed under the self-employment tax (or FICA) rules for high-income earners. With these new (or enhanced) taxes now fully applicable, we recommend you consult your tax advisor to plan for mitigation of the impact of the new tax, which could include restructuring to benefit from the advantages just described. As to issues explicitly addressed by the regulations, the guidance aligns with the assumptions and expectations of most tax professionals but contains a few notably taxpayer-unfriendly positions and burdensome reporting requirements. One major conclusion is that compliance with this new regime will not be a simple matter.

Cost of living increases for certain estate and gift tax provisions

Charles Schultz, director, Washington National Tax

Many contentious issues regarding estate and gift tax policy were left to Congress to negotiate this year, but cost of living increases for certain estate and gift tax provisions are settled. Effective Jan. 1, 2013, the annual gift tax exclusion has increased from $13,000 to $14,000. Married couples may give up to $28,000 per beneficiary, per year

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free of gift tax. The annual exclusion for gifts to noncitizen spouses has been increased from $139,000 in 2012 to $143,000 in 2013. Certain estates with substantial closely-held business interests (35 percent of the adjusted gross estate) can qualify for a section 6166 election that defers the estate tax liability over five years and provides a 10-year installment payment period following this five-year period. The accumulated business value that is subject to the 2 percent loan rate has risen from $1.390 million in 2012 to $1.430 million in 2013. Qualifying estates with large farm interests can elect a special use valuation for their farm interest that is smaller than the best use formula typically used by the IRS. The farm value that can be subject to this special use valuation has risen from $1.040 million in 2012 to $1.070 million in 2013.

Threshold requiring corporations to tell IRS of their uncertain U.S. income tax positions drops to $50M total assets for 2012 tax returns

Bob Adams, partner, Washington National Tax

The IRS created a tax form in 2010 that identifies uncertain or questionable positions taken on corporate income tax returns for which reserves for U.S. income tax have been reported on certified financial statements. The information on Schedule UTP (Uncertain Tax Positions) is used by the IRS to judge the risk of noncompliance in income tax returns and raises the chance of an IRS audit. For 2010 and 2011 income tax returns, only corporations that reported $100 million or more in total assets on the tax return balance sheet were required to file Schedule UTP. For 2012 and 2013 returns, that threshold has decreased to $50 million. Now is an opportune time for corporation income tax return filers that report $50 million or more of total assets, and that have or are included in certified financial statements that will report reserves for 2012 U.S. income tax, to discuss this matter with their tax advisor and independent auditor.

INTERNATIONAL

Losses on sale of foreign branch may not be deductible under dual consolidated loss rules

Ramon Camacho, principal, Washington National Tax

Under the federal dual consolidated loss rules, operating losses attributable to a foreign branch operation of a U.S. corporation may not be deductible against the consolidated income of the U.S. corporation if the loss is also deductible in the foreign country against income of a related party. Such a loss may be deducted for U.S. purposes if the corporation certifies that the loss will only be deducted in the U.S. (this is the so-called "domestic use election"). However, a taxpayer cannot make the domestic use election for a loss incurred upon the sale of the assets of the foreign operation. As a result, such a loss may be permanently disallowed for U.S. tax purposes, which could produce a significant negative impact to financial statement income because the tax assets associated with a permanently disallowed loss must be written off. Under certain facts, however, it may be possible to deduct the loss for federal tax purposes. In particular, the loss may be deducted to the extent of any positive accumulated income of prior years that is attributable to the foreign operation and that has not been reduced by prior losses. Beyond this amount, any remaining loss is likely to remain permanently disallowed. Taxpayers considering the disposition of a foreign business should carefully due diligence the tax consequences of the sale to determine whether a potential loss on the sale will be deductible under these often overlooked rules.

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Sale of stock could produce unexpected foreign exchange gain or loss

Ramon Camacho, principal, Washington National Tax

Shareholders of controlled foreign corporations (CFCs) are generally required to take into current income their ratable portion of the CFCs Subpart F income, which generally consists of passive income and income from certain related party transactions. Under an often overlooked rule, a U.S. shareholder that sells all or a portion of their CFC stock is treated as if the shareholder has received a constructive distribution immediately prior to disposing of the shares. As a result, the shareholder may be required to recognize ordinary foreign exchange gain or loss upon a sale or disposition of shares in a CFC even though the shares are held as a capital asset. The amount of foreign exchange gain or loss generally equals the amount by which the U.S. dollar value of the prior inclusion has changed due to movements in exchange rates between the date the inclusion was previously taken into account and the date the stock is sold. In addition, in some cases, gain on the sale of CFC stock may be treated as dividend income, and foreign taxes paid by the CFC may be available to shelter this deemed dividend. However, shareholders may not claim a foreign tax credit for foreign exchange gains recognized by operation of the constructive distribution that is recognized with respect to previously taxed Subpart F income. Thus, taxpayers who sell CFC stock may have to recognize ordinary income associated with the CFC's business with no ability to claim as a credit any foreign taxes with respect to such income. Taxpayers should carefully diligence a contemplated sale of CFC stock to identify any planning strategies that may help manage or reduce otherwise unexpected ordinary income.

STATE & LOCAL

Ohio enacts financial institutions tax

Michael Baker, director, Cleveland, Ohio

On Dec. 20, 2012, Ohio Governor John Kasich signed HB 510, a bill that repeals the dealers in intangibles tax and franchise tax on financial institution net worth as of the end of 2013, and enacts a new tax on financial institutions (FIT) for all tax years starting on or after Jan. 1, 2014. The FIT is imposed at graduated rates on the Ohio equity capital of bank organizations, bank holding companies, small dollar lenders, and other financial institutions. Insurance companies, credit unions, captive finance companies, and other dealers in intangibles that were subject to dealers in intangibles tax and franchise tax are exempt from FIT, but will be subject to commercial activity tax (CAT) for all tax years starting on or after Jan. 1, 2014. This shift from franchise tax to CAT for entities that no longer qualify as financial institutions may result in substantial tax benefits, because the CAT base does not include interest.

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