Tax Insights

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

October 2016

BUSINESS GROWTH

Employment tax and employee benefits: 5 issues for growing companies

A growing workforce means growing tax and employee benefit challenges

A growing business usually means a growing head count. Accurately understanding and effectively managing the tax challenges of a growing payroll is central to success. Focusing on the following five tax and employee benefit issues will allow business leaders to properly staff for business growth without creating unnecessary headaches.

1. Make sure you know whether you are adding employees or utilizing contractors

Many growing businesses rely on independent contractors instead of hiring employees under the assumption that this approach allows for greater flexibility and is a "win-win" for the business and the worker. Contractors can bring the skills you need while minimizing your payroll tax and employee benefit expenses. Calling someone an independent contractor does not make them one, however. You need to consider a series of questions relating to the control you exercise over these workers to determine whether they actually qualify for contractor classification. Federal and state tax authorities are being increasingly aggressive in targeting workers who are inappropriately classified as contractors, and the costs if workers are reclassified as employees can be significant.

While adding employees does bring additional cost, it may also make your company eligible for tax credits or other business incentives. From hiring to training incentives, there may be opportunities to offset some of the hard costs of employment through federal or state programs. Understanding your options can help you determine your most effective hiring strategy and develop tax efficiency related to workforce growth.

2. Use incentive compensation to drive growth

When employers think of incentive compensation programs, they often think only of their managers and executives. But an increasing number of employers are discovering the benefits of broad-based incentive programs that encourage all employees to drive growth. The key? Understanding exactly which employee behaviors you want to encourage, determining how you can measure them and then designing a plan that rewards workers for results—while still satisfying all related tax obligations. Think outside the box for your key players, too. For many growing companies, especially closely held businesses that don't want to dilute control through more typical equity incentive plans like stock options, non-qualified deferred compensation plans can offer attractive ways to allow key personnel to share in the success of the company.

3. Get creative with your employee benefits

Finding the right people to drive your growing business is hard. Turnover makes it harder. Having the right compensation and benefits programs may help you attract and retain talent. Many employers are finding that today's millennial generation may favor different benefits, causing a need to reevaluate the overall compensation package or employment experience for workers. Cafeteria plans, which give employees more flexibility in creating a customized benefits mix, may be one option. While traditional benefits, such as health and retirement programs still matter, be creative. For example, repaying student loans is a concern for many younger workers, so some employers are adding student debt repayment to their compensation packages. Some often-overlooked options, such as mentorship programs, can be offered at little or no cost but still affect the employees' work experience. Many employee benefits follow specific tax rules so once you decide on options to provide, pay attention to the rules in order to receive the most beneficial tax treatment.

4. **Understand payroll, even if you outsource it**

Growing companies are usually focused on innovation—matching the right products and services with the right opportunities. By comparison, managing payroll seems pretty mundane. But if you think simply hiring a payroll service means that your payroll tax obligations are going to be handled effectively, think again. Payroll servicers structure their agreements to insulate themselves from as much potential liability as possible, and their services are always limited by the information you provide to them. You must still understand the rules and keep appropriate records. As the employer, you are the withholding agent, not your payroll vendor. If something goes wrong, it will likely cost you, not them. It may not be exciting, but investing the resources to ensure that your payroll tax obligations are being met is vital.

5. **Don't forget employment issues when you go across borders**

Growing your business often means pursuing international opportunities, but as your employment footprint crosses borders, your employment-related tax challenges grow exponentially. Many employers that expand abroad fail to fully understand their obligations and total employment costs until it is too late. Social taxes, the possible ramifications of tax equalization agreements, how employees can affect permanent establishment status and a host of other issues must be understood and addressed to control your tax exposure and that of your employees. One example: an employee's salary may not be the only thing exposed to tax when that employee moves to another jurisdiction; many other sources of wealth that the employee has may be, too—and you might end up footing the bill if you have a tax equalization agreement that isn't appropriately drafted. Another example involves living allowances and other items which are subject to social taxes in some jurisdictions—failing to understand the rules could result in significant additional expense for you and for your employee.

As you plan to build your business and expand your workforce, these are some of the critical areas where employment growth and tax considerations intersect. Read our additional insights for more about how tax plays a role in your growth strategy.

You may also be interested in

- 3 tests, few answers: The not-so-simple world of worker classification
- Many middle market companies overlook hiring and training incentives
- Do I owe US tax on my foreign pension plan?
- 5 myths that keep companies from filing for WOTC
- Should you consider an employee stock ownership plan (ESOP)?

BUSINESS SUCCESSION

Are you ready for your business' succession?

Important succession planning goals and owner readiness considerations

Your business has been a major force in your life. It's a place where you may have dedicated years of hard work, taken risks, overcome challenges and celebrated hard-fought successes. And now, it's time to think about the sale or succession of your beloved company. Are you ready?

Owner readiness is the cornerstone for successful business succession, but many closely held, entrepreneurial business owners may struggle with this important initial step. Owners often are busy dealing with the rigors of operations and the daily grind of the business. There's frequently no time to think about successors or buyers. Further still, some owners fear the emotional stress and interruption a business transition may bring and choose to put off discussions and planning. This avoidance could amplify planning complexities and position you for greater risks. The truth is, someday, your business will transition, whether through sale or succession, and the sooner you can think through your personal post-succession goals, the better it will be for you, your family and the future of the business.

Define your future

The emotional factors connected with the sale or succession of a business can be a huge transition roadblock if not dealt with. Can you see yourself doing something else other than leading your business? Is your family prepared for this change? Will you have enough money to live the life you want after you exit the business?

All these concerns can be difficult to face, but it's important to weigh these issues, address the related anxieties you might have and think about your ideal outcomes. Further still, you may not even have the luxury of time to wrangle with conflicting emotions in terms of selling your business. Unforeseen circumstances like illness or sudden market shifts can quickly turn thoughtful succession planning into a rushed process. Either now or under duress, you, as a business owner, must do some soul-searching in connection with two core considerations. Answering the following can give you the stability and clarity you need during this emotional process:

- What is your role with the business post-succession?
- What do you need to maintain your lifestyle post-succession?

Perhaps your goal is to retire from the business and travel. Or, you have a chosen successor in mind, but you'd like to remain in a consultative role with the business for a year or two to help with the transition. Ultimately, your responses to these two core questions will inform your transition path, whether it will entail selling your business to a third party, transitioning ownership to employees or passing the business on to family.

Know your goals

Other questions to consider as you establish your succession planning goals include:

- How reliant is the business on you to remain successful?
- Who will manage the business after you exit?
- Have you developed a plan mapping out your financial independence post-succession?
- Have you prepared your family and addressed their emotional concerns?
- How will you communicate your exit to employees, stakeholders and customers?

You likely get the point that deep reflection is in order in terms of successful transition planning. Carefully considering your options and wishes cannot be emphasized enough. To help with this, look for advisors who understand your goals and the dynamics of your family and business and will work with you in a holistic way to meet your needs. It's a complex process, but there are professionals who can provide objectivity and the help you need to prepare you for the next phases in your life.

Business succession may be daunting, but addressing the raw and real emotions connected to this major change in your life, along with weighing critical questions about your wishes and goals, will provide you the foundation and assurance for a successful transition.

You may also be interested in

- Comprehensive planning for family businesses
- Succession and estate planning provide clear vision of family's future
- Using sell-side due diligence to maximize deal value
- Consider the tax treatment of stock redemptions in family businesses
- Valuation issues in dissenting shareholder cases

Tax Insights

EVENTS AND WEBCASTS

2017 fixed asset management primer

Daniel Hurtado, Senior Manager, Tangible Property Services
Chris Atwell, Director

RECORDED WEBCAST | October 13, 2016

View this webinar, presented by experts from Bloomberg BNA and RSM, to hear about the ways that you can take advantage of recent regulations and other guidance while also tightening your fixed asset management processes so that you can deliver value and execute your strategy.

This presentation will help you assess and improve fixed asset strategy and implement best practices that can maximize efficiency, accuracy and benefits.

Our panel will discuss:

- Recent tax updates
- Proven methods to mitigate risks
- Best practices for successful fixed asset management
- Effective tools for creating efficiencies and ensuring accuracy

Download webcast slides

2016 Fall tax summit series

IN-PERSON EVENT

Tax policy continues to be a key issue surrounding the 2016 presidential election and is an important consideration for growing companies. Business leaders need a clear understanding of the potential impact of tax reform, as well as insights on opportunities and challenges that can affect their growth goals. Join us and a group of your peers as we explore important tax issues to consider while mapping your company's growth trajectory.

Details on each summit will be posted as they become available. Please check back for information on the event taking place nearest you.

Alabama
Dec. 8 – Birmingham

California
Dec. 15 – Los Angeles

Connecticut
Nov. 16 – Stamford

Florida
Dec. 6 – South Florida
Dec. 9 – Orlando
Dec. 15 – Tampa

Iowa
Nov. 17 – Davenport
Nov. 18 – Cedar Rapids

Georgia
Dec. 7 – Atlanta

Maryland
Dec. 8 – Baltimore

Massachusetts
Nov. 15 – Boston

Minnesota
Nov. 15 – Duluth

Missouri
Dec. 6 – St. Louis

New Jersey
Dec. 13 – TBD

North Carolina
Nov. 14 – Iselin

Oklahoma
Feb. 9 – Oklahoma City

Pennsylvania
Nov. 17 – Philadelphia

Texas
Nov. 3 – Houston
Dec. 7 – Dallas

RSM sponsorships

Join RSM at these upcoming events where we are speaking and sponsoring

IN-PERSON EVENT

November 2016

SYNERGY 2016, Nov. 6-9, 2016, in Grapevine, Texas

RSM is a Silver Sponsor at SYNERGY 2016, Thomson Reuters users' four-day conference for tax and accounting professionals. Learn what's happening with the latest tax technology and connect with our corporate tax office professionals for new ways to grow your tax department. Stop by our sponsor table for tax insights, attendee gifts and a chance to win an Amazon Echo.

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March 2017

UPPO Annual Conference, March 19-22, 2017, in Austin, Texas

Join us at the premier event for professionals responsible for unclaimed property. RSM will be a sponsor of the 2017 UPPO Annual Conference. The instructor lineup includes RSM's (speaker TBD). Learn more about managing your unclaimed property risk by participating in this session or stop by our booth to get timely information and insights to achieve and sustain compliance with unclaimed property laws and regulations.

April 2017

2017 National Center for Employee Ownership Conference, April 4-6, 2017, in Denver, Colorado

As a sponsor of the 2017 Employee Ownership Conference, RSM will be on-site to answer any questions regarding ESOPs, including administrative challenges, accounting, legislative and regulatory updates, taxation, plan design and more.

Registration will open in mid-November.

International tax controversy: New developments and opportunities

Patti Burquest, Principal
David Click, Director
Ramon Camacho, Principal

RECORDED WEBCAST | October 05, 2016

The IRS is changing the way it audits international tax issues, making it even more critical that taxpayers have a strong game plan to manage an ongoing or potential IRS audit.

Our tax professionals will discuss new IRS developments that affect international tax controversy matters in this webcast. We will also address opportunities to pursue and pitfalls to avoid. Topics include:

- Cost-sharing arrangements and transfer pricing regulations after *Altera v. Commissioner* and eligibility for filing a protective claim
- The competent authority process as a method to mitigate double taxation
- New acknowledgment of facts information document request (IDR) process for cases heading to appeals or litigation
- Other IRS developments

Download webcast slides

TRENDING TAX

Proposed 2704 regulations have significant life insurance implications

Charlie Ratner, Senior Director

Download white paper

The long-awaited proposed regulations under section 2704 are out. If they become final, these regulations will have a profound impact on planning for transfers of interests in business entities.

The focus of the commentary on the proposed regulations has naturally been on the significant implications on wealth transfer planning and the associated valuation issues. And, to be sure, there will be renewed focus on transfers that do not involve the business entity itself, e.g. transfers of fractional interests in an underlying asset such as real estate.

Meanwhile, however, the implications of these regulations on the use of life insurance for estate liquidity are also quite profound, both for those whose irrevocable life insurance trusts (ILITs) own policies today and for those who are considering buying policies via ILITs. Read our white paper to learn about a few associated observations on what planners should be talking about in the coming weeks and months.

Frequently asked questions on country-by-country reporting

Crystal Golob Lindholm, Senior Manager
Enrique Rayon, Senior Manager

Tax Insights

Download FAQs

The IRS has issued final regulations requiring annual country-by-country reporting (CbCR) by some U.S. taxpayers that are the ultimate parent of a multinational enterprise (MNE) group. These regulations are based on model legislation from the Organisation for Economic Co-operation and Development (OECD) and are part of the project addressing base erosion and profit shifting (BEPS). We've outlined some of the frequently asked questions around CbCR* and how it can be managed by internationally active companies in this document.

1. When is CbCR effective?

The U.S. regulations require CbCR for fiscal years that begin on or after June 30, 2016. Therefore, a calendar year MNE must begin reporting in the United States for 2017. However, other countries that have passed CbCR legislation require reporting for 2016. The preamble to the final U.S. regulations states that Treasury intends to allow voluntary filing for reporting periods that begin on or after Jan. 1, 2016, but before the applicability date of the regulations. Forthcoming guidance will provide procedures for the voluntary filing.

2. When is the report due?

The OECD recommendations call for a due date not later than one year following the close of the MNE's fiscal year. This due date has been adopted by most countries with CbCR legislation. The U.S. regulations require the CbC report to be filed with the U.S. MNE's income tax return for the year, thus filing is required no later than eight and a half months after year-end. This will be Sept. 15, 2018, for calendar year taxpayers while fiscal year taxpayers will be subject to earlier filings.

3. How is it filed?

The OECD has developed a model template to aid countries in collecting the required information. The IRS developed a form that is based on the OECD model template, Country-by-Country Report, Form 8975.

4. Are there penalties associated with late filing or failure to file?

The OECD did not include penalty recommendations in its report. The U.S. regulations do not include any new penalties for failure to file a CbC report, though general reporting-related penalties may apply. Other countries will impose penalties based on specific or general penalty provisions. Penalties may be civil and criminal, depending on a country's law.

5. Will this information be shared with other countries?

Yes. The CbC report is filed with the ultimate parent entity and shared between jurisdictions through automatic exchange of information, pursuant to government-to-government mechanisms such as the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, bilateral tax treaties or Tax Information Exchange Agreements (TIEAs). As of June 30, 2016, 44 countries have signed the Multilateral Competent Authority Agreement for the automatic exchange of CbC reports. In March 2016, an agreement was reached enabling automatic exchange of CbC reports between EU member states.

6. Will this information be made available to the public?

The OECD is supportive of confidentiality and has proposed confidentiality protections. The United States remains committed to confidentiality, stating that all automatic information sharing by the United States would be suspended should confidentiality be breached.

The European Commission has indicated that it is considering whether public reporting of some of the information contained within the reports should be mandatory.

7. What measures are in place to maintain the confidentiality of this information once it is provided and shared among jurisdictions?

The OECD's proposed confidentiality protections include a framework for government exchanges of information contained within the CbC reports. The framework recommends enforceable legal protections similar to information exchange provisions within tax treaties, tax information exchange agreements, the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, or the Global Forum on Transparency and Exchange of Information for Tax Purposes.

8. How will tax authorities use this information?

The information provided in the CbC reports is intended to give governments a better understanding of whether companies may be engaged in practices designed to artificially shift substantial amounts of profits to low-tax jurisdictions where there is little or no substance to support such profits. It is intended as a high-level transfer pricing risk assessment tool, but is not meant to replace a detailed transfer pricing analysis or provide conclusive evidence that a company's transfer pricing policies are appropriate or inappropriate.

9. What are the risks to MNEs associated with CbCR?

Both the OECD guidelines and the U.S. regulations leave a number of aspects of the report to the reporting MNE's discretion, such as the source of the data and the basis on which to report employees. Further, some of the definitions are ambiguous and some of the requirements are inconsistent, particularly with respect to permanent establishments. These issues make it likely that countries will interpret the reporting requirements and the information contained within the report differently. If an assessment is made solely based on this information, the taxpayer may be faced with double taxation or engaged in a lengthy and costly competent authority process.

10. Which entity or entities within the group must file?

Under the U.S. regulations, a U.S. business entity that is the ultimate parent entity of a U.S. MNE group with revenues of $850 million or more of consolidated group revenue, for the preceding annual accounting period, will be required to file the U.S. CbC report. Other countries that have adopted CbCR legislation generally follow the OECD's recommendations requiring reporting when group revenues exceed €750 million.

11. What is a constituent entity?

A constituent entity is a separate business unit of the MNE group that is included in the consolidated group for financial reporting purposes. This includes a permanent establishment if a separate income statement is prepared for regulatory, financial, internal management or tax purposes. Under the U.S. regulations, a constituent entity includes a disregarded entity but does not include foreign corporations or partnerships of the U.S. MNE for which informational reporting is not required due to lack of control or any permanent establishment of such foreign corporation or foreign partnership.

12. What local notifications must be made by each constituent entity regarding CbCR and when are these due?

Each constituent entity must notify its jurisdiction of tax residence if it will file as the ultimate parent or surrogate parent, and if not, which entity of the MNE will file as the ultimate or surrogate parent. If there is more than one entity in a jurisdiction, notice must be given as to which entity is the filing entity in that jurisdiction. Notice must be received in each constituent entity's jurisdiction by the end of the year for which the report is being filed.

13. Is reporting required if the ultimate parent country does not require CbCR?

Yes, if a MNE has operations in a country or countries that have implemented CbCR and exceeds the applicable revenue thresholds.

14. How is a surrogate parent entity defined and what requirements must be met?

Designating a surrogate parent allows MNEs to avoid multiple local filings when the ultimate parent country doesn't require CbCR. The surrogate parent must be a tax resident in a country that requires CbCR and exchanges information.

15. What factors should we consider when selecting a surrogate parent entity?

It is important to understand the reporting MNE's global footprint and which countries will require CbCR, which allow surrogate parent filing and the specific local country requirements for surrogate parent filing. Consideration should be given to which tier in the organization may be the surrogate parent, the reputation of the foreign jurisdiction and whether there are appropriate information exchange procedures in place.

16. Does every country's CbCR legislation allow for surrogate filing?

No, not every country allows surrogate parent filing. Local legislation should be reviewed to determine if surrogate filing is acceptable or if local filing must be done.

17. If surrogate filing is not allowed and a constituent entity must file a local report, do the local rules for CbCR govern?

Yes, local rules regarding timing, currency, reporting standards, content and definitions for CbCR must be adopted.

18. How is the transition managed when reporting in the ultimate parent country is eventually required?

Careful consideration will need to be given to the transition from surrogate filing to ultimate parent company filing given there could be country-specific differences between the two filing requirements. Planning for the ultimate parent company filing should be considered during any transitional period data gathering and filing in order to enhance efficiency.

19. Is there a mechanism to deal with the gap year caused by the fact that the OECD has recommended start dates of fiscal years beginning on or after Jan. 1, 2016, and some countries have met this recommendation, but the U.S. regulations require CbCR for fiscal years that begin on or after June 30, 2016?

Yes. The United States is planning to allow for a voluntary filing mechanism to accommodate voluntary filing for ultimate parent entities resident in the United States, to file early. By voluntarily doing ultimate parent surrogate filing, this deactivates the need for local parent surrogate filing in another jurisdiction.

20. What period does the CbC report cover? How are constituent entities within the group with different year-ends reported?

a. The CbC report covers the fiscal period of the reporting MNE. The OECD guidelines state that constituent entities should be reported based on (i) the fiscal period that ends on the same day as the reporting MNE or that ends within the 12-month period preceding such date or (ii) based on the fiscal year-end of the reporting MNE. For example, assume a reporting MNE with a Sept. 30 year-end and a constituent entity with a Dec. 31 year-end. The 2017 CbC report is based on the reporting MNE's year-end of Sept. 30, 2017. Constituent entity information must be included for its year-end of Dec. 31, 2016, or based on the reporting MNE's year-end of Sept. 30, 2017.

b. The U.S. regulations require information to be furnished for the 12-month period with respect to which the ultimate parent entity prepares its applicable financial statements ending with or within the ultimate parent entity's taxable year for which the CbC report is filed. However, if the ultimate parent entity does not prepare applicable financial statements, the reporting period is the 12-month period that ends on the last day of the ultimate parent entity's taxable year.

21. How are branches or permanent establishments reported?

Branches and permanent establishments should be reported under the tax jurisdiction where they are located with a note indicating the associated legal entity.

22. How are hybrid entities treated?

The U.S. regulations disregard the U.S. tax classification generated by U.S. check-the-box regulations in a reverse hybrid situation, requiring reporting by the partners of a reverse hybrid in the partner's tax jurisdiction. Based on the definition in the U.S. regulations of tax jurisdiction of residence, traditional hybrid entities are reported in the jurisdiction in which they are organized and subject to income tax.

23. What sources may be used to obtain information?

Data may be obtained from consolidated reporting packages, statutory financial statements, regulatory financial statements or internal management accounts.

24. What accounting principles must be used (local GAAP, IFRS)?

Companies have flexibility in determining the source of the information as well as reporting standards used as long as it remains consistent from year to year.

25. Does the information need to reconcile with consolidated financial statements or statutory reporting? Do you recommend reconciliation with consolidated financial statements or statutory reporting as a best practice?

Reconciliations are generally not required under current guidance; however, reconciliations are recommended to ensure accuracy of information reported as well as to provide a trail for future audits. A best practice would be to reconcile audited financial statements, statutory reporting and local tax returns to the CbC report.

26. Does the information need to come from the same source every year and across jurisdictions (e.g., statutory financials, consolidation packages, internal management accounts)?

Yes, the reporting MNE has discretion as to the source of the data, but the OECD guidelines require consistency from year to year and across jurisdictions. The U.S. regulations do not contain a consistency requirement.

27. Do I need a transfer pricing analysis in order to complete CbCR? Do I need to update my current transfer pricing documentation?

A transfer pricing analysis is not required in order to complete the CbC report. However, some countries may independently require a master file and local file to be prepared. Any MNE that has significant or high-risk intercompany cross-border transactions should consider completing or updating transfer pricing documentation.

28. What currency must be used (functional, local)?

Amounts should be reported in the functional currency of the reporting MNE. The U.S. regulations state that U.S. reporting must occur in U.S. dollars and an exchange rate that is not in accordance with U.S. GAAP must be disclosed.

29. Is the reporting required on an entity basis or a tax jurisdiction basis?

Reporting is required based on a tax jurisdiction basis.

30. What is included in revenues?

Both the OECD guidelines and the U.S. regulations include sales of inventory and properties, services, royalties, interest, premiums and other amounts derived from transactions with related or unrelated parties. This does not include dividends in certain situations.

31. Does income tax paid include withholding taxes?

Yes, both the OECD guidelines and U.S. regulations include withholding taxes paid by other entities with respect to payment to each entity.

32. Does income tax accrued include deferred taxes and provisions for uncertain tax liabilities?

No, the OECD and U.S. regulations include only current amounts.

33. How is stated capital of permanent establishments reported?

Generally, under the OECD guidelines and U.S. regulations, the stated capital of a permanent establishment should be reported by the legal entity of which it is a permanent establishment.

34. How are the accumulated earnings of permanent establishments reported?

Generally, under the OECD guidance and U.S. regulations, the accumulated earnings of a permanent establishment should be reported by the legal entity of which it is a permanent establishment.

35. How is employee defined?

The OECD guidelines and U.S. regulations state that employees on a full-time equivalent basis should be reported. Independent contractors that participate in the operating activities of an entity may also be included. Reasonable rounding or estimates are permissible as long as it does not materially affect the number of employees reported across jurisdictions.

36. As of what date is the number of employees reported?

Under the OECD guidelines and U.S. regulations, the number of employees may be reported as of year-end, on an average yearly employment level basis, or any other reasonable basis. Reporting must be consistent across tax jurisdictions and from year to year.

37. Are tangible assets reported on a net or gross basis?

Tangible assets are reported based on the net book values under the OECD guidelines and U.S. regulations.

38. What is included in the definition of tangible assets?

The OECD guidance and U.S. regulations require reporting of all tangible assets other than cash and cash equivalents, intangible assets and financial assets.

39. How are tangible assets of permanent establishments reported?

Generally, under the OECD guidelines, the assets of a permanent establishment should be reported by reference to the tax jurisdiction where the permanent establishment is located.

40. What type of additional information is required in Table III?

This space allows companies to include any information that may assist in the understanding of information provided elsewhere in the CbC report. For example, a brief note indicating the data sources used should be included in Table III.

41. What best practices do you suggest for collection and aggregation of data?

When determining the source of information to be reported, consideration should be given to the timing of when the data sources are available relative to the due dates of the CbC report. MNEs should also give thought to practices adopted by their industry or competitors to avoid "unfair" comparisons. Existing data sources should be leveraged, if possible. For example, much of the information may be available from sources supporting Forms 5471, 8858 and 8865, the tax account roll forward, and human resources.

42. What action is required now and before the end of 2016?

U.S. MNEs that are subject to CbCR for 2016 must provide notifications in each tax jurisdiction in which a constituent entity is resident to inform the authorities of their filing positions. They should also review the CbCR template, notify their foreign subsidiaries of the information required, and identify potential issues with obtaining information in order to find solutions well ahead of the reporting deadline in 2017.

* Based on OECD model legislation and U.S. Treas. Reg. section1.6038-4

First steps to finding the right tax department resource balance

3 questions to ask before choosing a tax department outsourcing approach

Elizabeth Sponsel, Partner
Tom Ording, Senior Manager

The tax issues facing every company are unique, varied and complex, which means there is no one right way to address tax staffing. By extension then, tax co-sourcing is not an either/or decision between a large, in-house tax department and an outsourced solution. Rather, it should be a nuanced decision on how best to control your tax risks, use an outside resource to add value and manage your overall tax staffing expenses.

For tax directors and others looking at the potential for tax co-sourcing, this means considering the following key questions.

1. What is your full inventory of tax responsibilities?

Income-based taxes are always a top-of-mind concern, but they are just the tip of the iceberg. Indirect taxes, such as sales and use taxes and property taxes, and other related nontax responsibilities must be considered. For example, a restaurant chain with nearly six hundred locations used its corporate tax department to manage liquor license issues for each location. For this company, it made sense for this nontax responsibility to be handled within the tax function, as the tax group was already handling the specific food and beverage taxes that apply to liquor sales in each jurisdiction. They were familiar with each location's operations and it seemed to be an efficient solution ... but such a scenario could easily be overlooked when evaluating tax function resources.

When you look at the tax department responsibilities you may wish to co-source or outsource, it is important to recognize all related business needs so that you can design an approach that ensures every area can rely on a qualified individual or team.

Initial questions to consider may include:

- Besides U.S. federal and state income taxes–what other indirect taxes or industry-specific "pseudo" taxes are imposed on your company?
- Do you have international operations that create foreign jurisdictional compliance and statutory reporting, transfer pricing or withholding obligations? Do your international operations present occasional or frequent expatriate concerns?
- What are your other common business issues that have associated tax implications? Are these handled inside or outside the tax department?

By starting with a complete understanding of tax issues you have to address, you can lay the foundation for a more informed business case for staffing needs or changes in process or workflow assignments.

2. Are your tax capabilities aligned with your corporate needs and priorities?

Is your tax function addressing its responsibilities in a way that effectively aligns with your company's priorities? Yes, compliance is vital, but having returns and tax accounting done timely and accurately isn't the whole story for high-performing tax departments. Your team needs the skills and experience necessary to address your full range of issues, and this may demand a new definition of team.

Historically, has the tax department been considered a critical team member on significant business transactions or corporate initiatives? If not, this could be an indication that there are gaps or mismatches between the company's needs and internal capabilities–which can point to key co-sourcing opportunities.

Has the frequency of highly technical tax issues that require specific expertise changed from occasional to frequent? Honestly assess whether the skill sets in your tax function have kept pace with the evolution of the business and consider whether the time is right to grow the department by adding in-house specialists. If headcount is an issue, you may want to consider outsourcing routine compliance and redirect full-time employees to handle the tax technical challenges.

3. How effective are your current systems and processes?

Your tax function depends on timely and accurate access to data from your accounting and finance departments. In many companies, data and information flow between these functions seamlessly, while in other organizations, tax professionals are using spreadsheets and manual workarounds to gather the information they need to fulfill tax requirements.

Cost-effective co-sourcing arrangements rely on efficient methods of gathering, assembling and sharing data. So if you can readily share necessary data and if it is easy for your co-source vendor to understand how they fit into your overall operation, then chances of success are significantly improved. If, on the other hand, your current systems and processes make that difficult, it may make sense to work with your co-sourcing provider to address these challenges before establishing fixed-fee based arrangements predicated on existing tax operational systems.

What makes co-sourcing successful?

When considering tax co-sourcing, you need to balance the answers to each of the above three questions. Thoughtful assessment and understanding of your current state and future goals will allow you to evaluate the potential value of a solution against your tax opportunities and risks, as well as your business goals. Co-sourcing is an effective approach to balancing the technical demands placed on a corporate tax department with the efficiency demands placed on businesses overall. But doing it well requires advance planning.

In addition to answering the questions above, companies that co-source successfully share these key attributes:

- They are comfortable with the idea of co-sourcing, and they have buy-in from all critical stakeholders. This sounds simple, but it is vital. If you don't believe that co-sourcing can provide value, then you are unlikely to reap the full benefits of such an arrangement.
- They have well-defined and effective processes, systems and controls–and a plan to refresh these on a regular basis to keep tax operations in alignment with corporate strategies and goals.
- They know exactly what they want their co-source vendor to do. Clearly defined responsibilities and measureable goals mean that co-sourced personnel can focus on assigned tax responsibilities. Clarity also facilitates accountability, allowing you to better measure the co-sourcing effort's success by comparing ongoing results with baseline metrics.

Tax co-sourcing is not a simple, one-size-fits-all outsourcing arrangement, but when approached with open eyes and defined goals, it can often provide your tax department with:

- Additional resources to meet peak compliance demands, keeping your tax staff lean during slower periods
- The ability to conduct strategic tax planning in-house with the flexibility to execute those plans using scalable resources

A successful co-sourcing relationship is tailored specifically to your organization, and the right answer is driven by your circumstances. It can range from a completely in-house approach to working with one co-sourcing firm to enlist help from a variety of outside resources. Considering the questions above is a good way to start evaluating if and what type of co-sourcing relationship might work for you.

Retailers must be mindful of gift card tax pitfalls

John Nicolopoulos, Retail Practice Leader
Matt Talcoff, Partner
Christopher Shaker, Senior Manager

While it is widely accepted that a well-designed and executed gift card program can drive customer traffic, increase sales and build customer loyalty, retailers and restaurant operators must be mindful of the financial reporting and tax consequences of their gift card programs in order to manage them effectively. Understanding the various financial reporting and tax issues requires a closer look.

Listen to John Nicolopoulos, national retail practice leader, explain the importance of having a strategic and successful gift card program.

Financial reporting

In nearly all cases, the sale of a gift card results in a liability recorded at the point of sale representing the obligation to deliver goods or services to the customer on redemption of the gift card. However, the method by which the liability is relieved and revenue is recognized is where we see some diversity in practice.

Given the absence of guidance requiring uniform accounting treatment, some retailers elect a policy for unused gift cards for which amounts will not be escheatable to the state to allow the liability to remain on the balance sheet until such time that the gift card either has been redeemed for goods or services or expired. This approach, however, can lead to significant liabilities on the balance sheet for the obligation to deliver future goods or services that may never be fulfilled. For example, in an attempt to use the entire gift card, consumers often redeem their cards for goods and services that are close to the full value of the card, but leave behind small balances on the cards. This can result in a consistent pattern of small, unredeemed amounts outstanding on gift cards sold. With enough volume, this approach can lead to significant liabilities that would remain on the balance sheet of the retailer in perpetuity (if no expiration date) or until such amounts are escheated to the state, if required by state law.

In response to this, many retailers have adopted accounting policies to derecognize these liabilities earlier based on breakage. The concept of breakage for gift cards relates to estimating the portion of gifts cards that are expected to remain unused. Applying this concept would allow a retailer to derecognize the estimated breakage liabilities and record revenue in circumstances in which there is no obligation to remit amounts to the local jurisdiction either 1) when the likelihood of redemption of the gift card or portions thereof is considered remote or 2) over the period in which the remainder of the gift cards are expected to be used.

There are several key elements in such a policy that require data collection and analysis, diligence and judgment. The first is estimating the amount of gifts cards that are expected to remain unused and determining at what point in time the likelihood of redemption is remote, and the second is determining whether or not a legal obligation exists to remit amounts to local jurisdictions.

In order to estimate the amount of gifts cards that are expected to remain unused and determine when the likelihood of redemption is remote, sufficient historical data must be available to assist management in making an accurate determination. For that reason, there is normally a period of multiple years before a company has enough information to reliably make such a determination.

In a retail environment in which sales are made not just through brick and mortar stores, but through multiple channels, including internet sales, determining whether or not amounts need to be remitted to local authorities can be difficult. Retailers need to determine factors such as the state of origin of the individual purchasing the card, the address of the last known owner of the card and the unique escheat laws in many different states.

New guidance for retailers

In May of 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (ASU 2014-09), which provides specific guidance to all entities, including retailers, regarding breakage, which would apply to gift cards. Based on ASU 2014-09, revenue should be recognized when the card is presented for redemption and the goods or services are transferred to the customer. However, if there is a portion of a gift card sold that is not expected to be redeemed for goods or services (i.e., breakage), the ASU requires an entity to recognize revenue for the breakage they are entitled to proportionately as other gift card balances are redeemed. However, the ASU goes on to state that consideration received from a customer that must be remitted to a governmental entity (i.e., as a result of escheat laws) should not be recognized as revenue.

ASU 2014-09 will replace most existing revenue recognition guidance in generally accepted accounting principles when it becomes effective and permits the use of either a full retrospective or modified retrospective with cumulative effect transition method. ASU 2014-09 will be effective for annual reporting periods beginning after Dec. 15, 2017, for public reporting entities and for annual reporting periods beginning after Dec. 15, 2018, for nonpublic reporting entities.

ASU 2014-09 offers more specific guidance that must be applied with respect to breakage, but the burden of estimating the amount of gifts cards that are expected to remain unused and determining whether or not amounts are escheatable to a government entity will still fall on the retailer. While the standard is not yet effective, now is the time to consider the impact the new standard will have on accounting policies.

Tax considerations

The importance of tracking in order to defer taxable income

Under the right circumstances, retailers have a limited ability to defer the recognition of income for federal income tax purposes for the sale of gift cards (including issuing refunds on a gift card) from the year of sale into the subsequent tax year.

Under Rev. Proc. 2004-34, retailers can defer the recognition of income from the sale of gift cards that are not redeemed in the current tax year to the subsequent tax year if they have an Applicable Financial Statement (AFS), generally defined as an audited financial statement, to the extent the retailer's AFS also defers the revenue as discussed in the financial reporting section. However, under Rev. Proc. 2004-34, retailers must recognize taxable income in year two for any income that is deferred from the year of cash receipt even if the AFS defers beyond the subsequent tax year (i.e., a maximum of a one-year deferral for tax reporting). Alternatively, if the retailer does not have an AFS, they must recognize all cash received on the sale of the gift card in the year received to the extent such income is earned in that year (i.e., to the extent the gift cards are redeemed in that year) with the remaining amount deferred to the next tax year. This may or may not result in the same tax position as if there was an AFS depending on how revenue, including gift card breakage, is being recorded for financial accounting purposes.

The IRS has extended the use of this method to gift cards redeemable by members of a consolidated group or even unrelated third parties (whether the gift card program is operated by a gift card subsidiary, franchisor, franchisee or management company). To qualify for the treatment under Rev. Proc. 2004-34, retailers must carefully track gift card revenue and redemptions.

Sales tax

In general, sales tax can be a complicated area. Businesses have to deal with sales tax associated with gift cards as well as incentives such as coupons, loyalty programs and deal-of-the-day incentives. The rules can be state-specific related to all these different incentives which is why it is important to not just apply the sales tax rule for one type of incentive to another. With respect to gift cards, they are typically considered a cash equivalent, and therefore, no sales tax is charged at the time the gift card is purchased. Sales tax is applied to the transaction at the time a gift card is used to purchase taxable merchandise or services, with few exceptions.

Unclaimed property

Gift cards are generally subject to abandoned and unclaimed property rules. Abandoned and unclaimed property is not actually a tax, although many think it is. Thus, traditional nexus standards do not apply. It is, in fact, an unpaid contractual liability. Many companies don't believe they have unclaimed property. However, if a company sells gift cards which remain unredeemed, then that company likely has some sort of unclaimed property, but what does that mean?

All states have unclaimed property laws requiring companies with tangible or intangible personal property owed to a third party to escheat the property or its value to the respective state after a period of inactivity, known as the dormancy period. Unclaimed property laws vary by state and no two sets of laws are exactly alike. In the United States, there are 54 jurisdictions (50 states, the District of Columbia, Guam, Puerto Rico and the U.S. Virgin Islands) to consider if you are issuing gift cards.

Unclaimed property has become an increasing source of revenue for states; accordingly, jurisdictions have increased audit efforts, including through third-party contract audit firms. They often exercise their ability to estimate the liability for years where accounting records no longer exist, which can result in significantly increased assessments. For example, states like Delaware have historically extrapolated liability back over 30 years during audits. However, Delaware is reviewing its voluntary disclosure agreement policies and expects to introduce legislation to address some of the issues raised in a recent court case when the General Assembly reconvenes in 2017.

For most types of unclaimed property, the escheatment process can be fairly straightforward, but for gift cards, it is a bit more complex since gift cards can be purchased through one channel or location and redeemed through a different channel or location. Some states exempt gift cards from unclaimed property laws and others require only some or a portion of the unredeemed gift card to be escheated, so again, what does that mean?

Broadly speaking, unclaimed property is sourced to the state of the owner's last known address. If the last known address of the owner is unknown or if the state of the last known owner does not provide for escheatment of the property, then a holder's state of incorporation or organization may lay claim to the property. Said another way, if the purchaser is unknown, it is the issuer's state of incorporation that may make claim to the property.

Since many sellers of gift cards do not obtain owner name and address information, frequently such property is escheatable to the company's state of incorporation or organization. This is very important to understand and to understand thoroughly. The rules around last known owner can have a significant impact on whether the unclaimed property, or gift card breakage, must be remitted to a state, and if so, which state and at what value. At one extreme, an issuer company could keep the unclaimed property and record 100 percent as income, and at the other extreme, the issuer may be required to remit all or some of the unclaimed property to multiple jurisdictions, which can be a heavy burden to track and remit accurately. Accordingly, understanding the regulations, developing a program that considers those regulations, and maintaining complete and accurate records is critically important to managing this exposure.

Finally, it is important to note that litigation has been increasing with respect to various unclaimed property matters across the country, including gift cards. In 2014, Delaware unsealed a qui tam (e.g., whistleblower) civil action claiming that numerous Delaware incorporated entities failed to escheat the value of unredeemed gift cards by engaging in improper practices to escape their obligations to report unclaimed property to the state of Delaware. In November 2015, the judge in the case issued a memorandum opinion on the defendants' Motion to Dismiss. While the opinion is unfavorable for the defendants, the litigation is still ongoing.

Action steps

Given ongoing litigation and ever-changing unclaimed property laws, retail organizations should take specific action steps to mitigate potential exposure, including:

1. Review existing gift card programs and practices to confirm compliance with state escheat laws. To the extent programs are administered through gift card management companies, perform an examination of the related form and substance of the entities and the level of information they retain on gift card purchasers and holders.
2. To the extent potential liabilities are identified, consider entering into voluntary disclosure agreements. Benefits of a voluntary disclosure agreement generally may include a limited look-back period and abatement of interest and penalties.
3. To the extent that your business model permits, consider adapting your gift card program to the company's advantage, minimizing the administrative burden associated with a multistate gift card escheatment program.
4. Lastly, gift cards are only one type of unclaimed property. Retailers and restaurant operators are often targeted by states and their third-party auditors for full-blown unclaimed property audits, which typically encompass a complete general ledger review, including but not limited to, vendor checks, payroll checks, merchandise credits, etc. Understanding the regulations, assessing exposure and instituting proactive remediation can mitigate interest and penalty.

Conclusion

While trends in consumer spending play out at the cash register, they also make a real difference in the back-office through tax compliance and planning as well as financial reporting. Retailers need to be aware of how to treat gift card sales, redemptions and those that remain outstanding in the long term, and understand the complexities, especially when operating in multiple states or obtaining new customers who live across state lines. Errors applied to a single transaction may seem inconsequential, but when multiplied across many gift card transactions and multiple states the potential for miscalculation and cash flow surprises is significant. Best practices recommend at a minimum an annual review of gift card procedures, including assessing reporting, sales tax, unclaimed property and more.

Tax Insights

ON THE BLOG

Is your sales force creating nexus around the country?

Mo Bell-Jacobs, Manager

A recent Washington Department of Revenue Determination should serve as a reminder to businesses with traveling sales employees that the physical presence nexus standard for sales and use tax purposes is alive and well despite recent criticism and calls for reform.

The Determination involved an out-of-state manufacturer with customers in Washington, but no payroll, facilities or other property in the state. The manufacturer maintained an in-state independent representative and had an out-of-state employee visit Washington customers several times a year for one or two days each visit. The Determination concluded that both the independent representative and out-of-state employee, on their own merits through accepting sales and procuring licensing agreements, were establishing or maintaining a market in Washington for the manufacturer's business. Therefore, nexus was established for the manufacturer, creating a sales tax collection and filing obligation in Washington.

Businesses should remember that there is well-established U.S. Supreme Court case law finding that physical presence for sales and use tax purposes only need be demonstrably more than the slightest presence – a single sales trip may be sufficient. However, some states have provided minimum presence thresholds for out-of-state sales people, such as requiring two days of presence in the state before nexus is established. Other exemptions may exist for employees where the presence in a state is limited to a convention, conference or trade show, but those exemptions vary greatly among the states.

Many businesses engage in the following activities, often on an infrequent basis, which typically create nexus in a state under the physical presence nexus standard:

- Employees or representatives soliciting sales
- Employees providing warranty service or other assistance to customers
- In-state management of customer relationships or
- Making deliveries of property other than through the U.S. Postal Service or other common carrier, i.e., using your own trucks to complete a delivery

When considering your sales and use tax nexus profile, it is absolutely imperative to take stock of the travel of your sales force or independent representatives in order to understand your nexus exposure.

Foreign federal contractors must act quickly to avoid 2 percent excise tax and penalties

Jamison Sites, Manager

Newly issued final regulations offer certain foreign federal contractors a 90-day window to satisfy past tax and filing obligations with respect to the 2 percent federal excise tax (the procurement tax) on certain payments made to foreign persons under a federal procurement contract. Although the procurement tax was enacted in 2010 (and taxpayers should have been paying it since 2011), the IRS didn't propose regulations until April 22, 2015. On Aug. 18, 2016, the IRS issued final regulations that clarified a number of issues and that allows taxpayers who haven't complied with their obligations to pay the tax without penalty (interest will still apply).

Generally, the procurement tax applies to foreign persons that are party to contracts with the U.S. government for the purchase of goods or services, if the goods are produced or services are provided in a country that is not a party to an international procurement agreement with the United States. There are a number of exemptions from the procurement tax, however, we expect many taxpayers to claim exemption under a tax treaty that has a nondiscrimination article. Rev. Proc. 2015-35 provides a list of countries with which the United States has an income tax treaty that may provide the basis for an exemption claim. In order to claim any exemption from the procurement tax, a taxpayer must file Form W-14, *Certificate of Foreign Contracting Party Receiving Federal Procurement Payments*. The instructions to Form W-14 also contain a list of current U.S. income tax treaties that may exempt certain persons from the tax.

Federal agencies must withhold and deposit the procurement tax with the IRS on behalf of taxpayers.

However, taxpayers subject to the tax and for whom an agency failed to withhold can avoid penalties by satisfying their tax and filing obligations before Nov. 16, 2016, the effective date of the final regulations. Taxpayers should promptly assess whether they should take advantage of this penalty waiver contained in the final regulations.

For a further discussion on the section 5000C excise tax and the specific exemption, please see our tax alert: Final rules issued for tax on payments to foreign federal contractors.

Will your health plan trigger IRS penalties?

Jill Harris, Director

Due to the Affordable Care Act (ACA), large employers that fail to offer employee health insurance that meets ACA standards may be assessed a shared responsibility payment by the IRS. A company is a large employer if it averaged at least 50 full-time employees (including full-time equivalents) during the preceding calendar year.

In order to avoid this "pay or play" penalty, a large employer must offer employee health coverage that meets three ACA requirements:

- Minimum essential coverage
- Minimum value
- Affordability

To meet the minimum essential coverage requirement, an employer must offer health coverage to at least 95 percent of its full-time employees and their dependents. If a large employer fails to meet this requirement in 2016, it could be assessed a penalty of $2,160 for each full-time worker employed during 2016.

The minimum value standard requires the health plan to cover a certain percentage of all medical expenses incurred by employees. The affordability standard will be met if employees are paying less than 9.66 percent of their wages for self-only coverage. A health plan that does not meet the minimum value or affordability standards can trigger an employer penalty of $3,240 for each employee who declines the employer's coverage and enrolls in health insurance through the Health Insurance Marketplace (also known as the exchange).

Since 2015 was the first year employers needed to comply with these ACA standards, several transition rules applied that cannot be relied on for 2016 and future years. Therefore, employers should review their health plans to ensure they are in compliance with the 2016 rules.

To determine which employers owe the penalty, the IRS is requiring large employers to file Forms 1095-C and 1094-C to report workforce and health plan information for 2015 and future years. The deadline for filing the 2015 forms was June 30, 2016. Over the next few months, the IRS will be processing the 2015 forms and mailing penalty notices to employers that they believe owe a shared responsibility payment. Employers will have an opportunity to respond to the notices before a demand for payment is made. Consequently, you should review any penalty notices carefully and respond promptly regarding any disagreement with the IRS's assessment.

For more details about employer-shared responsibility payments, please review our article, Employers face new penalties on health plans under the Affordable Care Act.

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