Tax Digest

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

September 2014

FEDERAL

Only certain parties authorized to sign partnership returns

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Obtaining the proper signature for the filing of Form 1065, *U.S. Return of Partnership Income*, is important to avoid an invalid return, a delay in the statute of limitations and potential late filing penalties. The majority of corporate tax filings can be signed by an authorized officer of the corporation. In contrast, Form 1065 is required to be signed by either a general partner or a member manager of a limited liability company (LLC). A member manager is any owner of an interest in an LLC with continuing authority to make management decisions. In the absence of any elected or designated member managers, each owner is treated as a member manager. An officer or employee of a partnership or LLC cannot be delegated the signing responsibility. In a recent Chief Counsel Advice memorandum, the IRS concluded that a partnership return was invalid because the name of one of the entity's owners, rather than the signature of an individual with authority to sign the return under these rules, was reflected on the taxpayer signature line. As a result, the statute of limitations for the partnership return never began. Although not addressed in the memorandum, a potentially costly penalty for late filing of a partnership return, $195 per month per member, could also have been imposed.

Corporate spin-offs followed by REIT conversions are becoming increasingly popular

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Corporations are finding ways to increase tax efficiency and shareholder value by utilizing tax-free spin-offs of real property into real estate investment trusts (REITs). The benefit of a REIT is that its income effectively escapes the corporate-level tax and is generally taxed only at the shareholder level. Both CBS Corporation and Penn National Gaming, Inc. recently undertook structured REIT spin-offs, illustrating the versatile nature of these transactions. However, some members of Congress are seeking to stop what they see as an erosion of the corporate base by utilizing REITs for other than their intended purpose. For corporations that are real property intensive (e.g., own rather than rent significant amounts of real property), a REIT spin-off may be an opportunity worth exploring. Because nontraditional REIT transactions may face increased scrutiny in the future, now is a good time to address the opportunity.

IRS releases final tangible property disposition regulations

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On Aug. 14, 2014, the IRS released final regulations relating to the disposition of tangible property. The regulations generally adopt all the provisions from the September 2013 proposed regulations, including those

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associated with the federal income tax treatment of dispositions of tangible property and assets included in one or more general asset accounts. The final regulations also include changes in the manner of determining the unadjusted basis of disposed assets in general asset accounts and partial dispositions of assets. These rules allow taxpayers to use a reasonable method to determine basis when disposing of a portion of tangible property if few or no records are available. While effective for tax years beginning on or after Jan. 1, 2014, the regulations may be applied to tax years beginning on or after Jan. 1, 2012. Taxpayers should consult with their tax advisors to determine the steps required to comply with the new regulations.

Final regulations clarify impact of shareholder loans to an S corporation

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On July 22, 2014, the IRS issued final regulations that could affect S corporation shareholders claiming tax basis for loans made to an S corporation. These regulations clarify that in order to create basis, the debt must be bona fide and owed directly to the shareholder. This rule is more favorable than the standard previously used by some courts that relied on the "actual economic outlay" test. Under that test, shareholders would only get additional basis when the debt issuance caused a significant change to the shareholder's economic wealth, with the individual being made "poorer in a material sense." An example in the regulations helps illustrate the difference between these tests. In the example, an individual is the sole shareholder of multiple S corporations. The shareholder borrows $200,000 from the first S corporation and loans that money to a second S corporation. Under the final regulations, this transaction creates $200,000 of additional basis for the shareholder in the second S corporation because there is a bona fide debt between the parties. However, under the actual economic outlay test, this transaction might not have created basis as the shareholder was effectively in the same economic position before and after the transaction. As such, these new final regulations provide additional flexibility to taxpayers when basis limitations become problematic. Shareholders with basis issues should review the new rules to determine whether they provide opportunities to generate additional basis.

New information reporting requirements under the Affordable Care Act

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The Affordable Care Act imposes significant information reporting responsibilities on employers starting with the 2015 calendar year. Employers with at least 50 full-time employees (including full-time equivalents) will be required to file new Forms 1095-C and 1094-C with the IRS to report information about their health plans and workforce. A Form 1095-C, *Employer-Provided Health Insurance Offer and Coverage*, must be completed for each employee indicating whether the employee was full-time and offered health coverage. A copy of Form 1095-C must be provided to the employee by Jan. 31, 2016. Form 1094-C, *Transmittal of Employer-Provided Health Insurance Offer and Coverage Information Returns*, the employer will report its employee counts plus information about its health plan. The employer must also disclose the identity of other companies that are in a controlled or affiliated service group with the employer. The 2015 Forms 1095-C and 1094-C must be filed with the IRS by Feb. 28, 2016 (March 31 if filed electronically). Employers will be subject to penalties of up to $200 per return for failing to timely file the returns or provide information to employees. Employers should take action now to ensure their systems will be able to collect the needed data.

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Related issuances surrounding corporate organization treated as single issuance for section 382 testing

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Section 382 limits a corporation's ability to use net operating losses after a 50 percent or greater change in ownership over a three-year period (shorter in certain circumstances). To determine whether an ownership change has occurred, cumulative ownership shifts are calculated on testing dates. As a result, identifying testing dates and understanding when that testing begins are an important part of the analysis. Consistent with prior rulings, a recently issued IRS legal memorandum held that stock issuances taking place on more than one date as part of a taxpayer's organization and prior to it commencing operations represent a single stock issuance for purposes of section 382 testing. Such treatment prevents the date of a subsequent issuance associated with the initial organization from being treated as a separate testing date under section 382. Companies often undergo multiple issuances of stock as a part of an initial capital raise, which may include the issuance of common and preferred stock. Although spanning a period of time, these stock issuances generally occur prior to the commencement of operations and are often pursuant to an integrated plan. In these situations, the multiple issuances should not create multiple testing dates under section 382, thereby reducing the cumulative ownership shift. As a result, identifying this set of facts can drastically change the results of a section 382 analysis. This memorandum serves to remind taxpayers that the facts surrounding a company's organization could potentially provide a more favorable section 382 outcome than previously thought.

IRS to improve medical device excise tax collection efforts

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The Treasury Inspector General for Tax Administration (TIGTA) recently issued a report detailing the IRS's difficulty in collecting the medical device excise tax (MDET) from taxpayers. The report highlights that, in many situations, the IRS cannot accurately determine the party liable for paying the tax, primarily due to the IRS's reliance on a Food and Drug Administration (FDA) database to identify taxpayers potentially subject to the MDET. Unfortunately for the IRS, the FDA database does not contain the data necessary to make proper determinations of taxability, especially due to the numerous MDET exemptions and safe harbors that exist. Furthermore, the TIGTA report shows that the IRS vastly overestimated the number of impacted taxpayers and the amount of revenue it could collect from the MDET. Actual collections for the first six months after the effective date of the MDET were just over $900 million from 5,000 taxpayers, as compared to the IRS estimate of nearly $1.2 billion in MDET collections from nearly 9,000 taxpayers. Compounding these issues, the report also showed discrepancies between as-filed excise tax returns and IRS-recalculated liabilities totaling over $117 million. Since the TIGTA highlighted these issues, the IRS is expected to revamp and step up MDET collection efforts. In anticipation of this, medical device manufacturers should contact their tax advisors to discuss MDET filing requirements, determinations of taxability, and applicable exemptions in order to ensure compliance.

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GAO testimony highlights IRS's struggle to examine large partnerships

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In July 2014, the U.S. Government Accountability Office (GAO) presented testimony to the U.S. Senate's Permanent Subcommittee on Investigations that highlighted the IRS's administrative difficulties with examining large partnership tax returns. Though the GAO did not issue any recommendations during the testimony, a report will be released later in the year that assesses the IRS's challenges in this area. The GAO's testimony resulted from a comprehensive review of IRS documentation, interviews with IRS officials and six focus groups within the IRS's large partnership examination division. Over the past decade, the number of newly formed partnerships has risen 45 percent, while the number of newly formed corporations has decreased almost 14 percent. Despite the dramatic growth in the number of partnerships, IRS audit rates for large partnerships have generally been at less than 1 percent since 2007, while during the same time, audit rates for comparably sized corporations ranged from 21 to 27 percent. Furthermore, partnerships have experienced significantly higher rates of "no-change" audits than corporations, and corporate audit adjustments are typically higher than partnership audit adjustments. One of the most significant discussion points in the GAO's testimony involved the difficulty the IRS encounters when administering the TEFRA audit procedures applicable to partnerships with 11 or more partners (or any number of partners if any partner is a pass-through entity such as a partnership, S corporation, limited liability company or certain trusts.) The administrative burdens placed on the IRS when managing large partnership audits could support a call for a Congressional solution that would change the way partnerships are taxed.

Donald Sterling and incapacity planning–some lessons learned

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Many have been following the developments associated with Donald Sterling, his wife, Shelly Sterling, and the litigation surrounding the sale of the Los Angeles Clippers. Mrs. Sterling removed Mr. Sterling as co-trustee of the family trust that owned the Clippers and sold the Clippers for $2 billion. A court has provided a preliminary ruling in favor of Mrs. Sterling that Mr. Sterling was incapacitated and that she had the authority to remove Mr. Sterling as trustee and sell the trust's interest in the Clippers. Lesson one is that proper estate planning includes not only death planning, but incapacity planning as well. A well-drafted estate plan will have provisions, either through the use of a trust or through the use of a financial durable power of attorney, to account for the management of the estate in the event of physical or mental incapacity. Because incapacity can be a gradual process, it is important to determine when the actions of the taxpayer truly demonstrate incapacity. This leads to lesson two: An estate plan should place this decision with a trusted and qualified doctor. Many plans have ambiguous language regarding this issue. If the decision maker on incapacity can be specifically identified or the criteria to determine the qualifications of this decision maker are precisely laid out, it may prevent the courts from unilaterally making this determination of incapacity. Lesson three deals with special assets. That is, a taxpayer may have one person pay personal bills and manage personal assets and another, better qualified person, manage sophisticated business interests. Thus, taxpayers should consider appointing more than one power holder to ensure the proper management of all assets. The final lesson relates to the turn-off switch. Specifically, plans should provide for a trigger to allow a taxpayer to regain control should the taxpayer regain capacity. While many documents are drafted under the assumption that incapacity is a permanent event, documents should be nimble enough to account for instances where the taxpayer regains capacity.

INTERNATIONAL

Are inversions unpatriotic?

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For several months, tax inversions have dominated media headlines, with the press uniformly asserting that corporations invert solely to avoid paying U.S. corporate tax. Typically, an inversion involves a transaction in which a U.S. corporation combines with a foreign corporation and, as part of the transaction, moves its headquarters to a foreign country with a significantly lower corporate tax rate. The ongoing debate centers on whether these transactions are unpatriotic (because the inversion is done solely to lower U.S. taxes) or whether inversions represent a legitimate way for U.S. corporations to become more competitive by reducing operating expenses. While any corporation considering an inversion must consider a myriad of issues, the question of being unpatriotic should not be among them. In perhaps the most famous tax case in U.S. history, *Gregory v. Helvering*, both the Second Circuit Court of Appeals and the U.S. Supreme Court recognized that taxpayers have every right to minimize their taxes by any means allowed by law and do not have *even a patriotic duty* to pay more tax than legally owed. Thus, even true patriots are permitted to legally reduce their taxes, whether by an inversion or any other legal means.

New passive foreign investment company (PFIC) filing requirements for indirectly owned PFICs apply for 2013

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In December 2013, the U.S. Treasury Department issued temporary regulations requiring taxpayers to report their ownership in certain passive foreign investment companies (PFICs). A PFIC is a foreign corporation if (1) 75 percent or more if its gross income consists of passive income, or (2) 50 percent or more of its assets are passive assets. Taxpayers who dispose of shares in, or receive distributions from, a PFIC may be subject to special tax and interest charges on receipt of a distribution or on a sale of PFIC shares. While prior law required taxpayers to report their PFIC interest on IRS Form 8621 when they receive income from, or dispose of, a PFIC, or make certain elections, the temporary regulations now generally require U.S. persons who own a PFIC indirectly through a foreign entity (e.g., a foreign partnership or certain foreign corporations) to report ownership in the PFIC even if no "event" (i.e., a distribution or disposition) occurs with respect to the PFIC. Thus, for the 2013 year, such taxpayers may have a filing obligation where they had none before and the additional compliance burden may be significant because taxpayers must file a separate Form 8621 for each PFIC. Failure to file Form 8621 may toll the running of the statute of limitations for the entire return, absent reasonable cause. As upcoming filing deadlines approach, taxpayers should allow additional time to prepare and file any additional Forms 8621.

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STATE & LOCAL

California FTB rules LLC members have nexus

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On July 22, 2014, the California Franchise Tax Board (FTB) issued a legal ruling, finding that the business activities of a multiple-member limited liability company (LLC) classified as a partnership for tax purposes can be attributed to its members in determining whether those members have nexus with the state. As a result, out-of-state entities that own a membership interest in an LLC doing business in California will be subject to California tax in their separate capacities. However, rules that operate to expand nexus tend to cut both ways, and it is arguable that this rule could provide significant benefit to California-based taxpayers via establishing the right to apportion and eliminating the application of the state's throwback rule. Whether this ruling will stand as written is uncertain, as related issues are currently being litigated in the California courts. Accordingly, impacted LLC members should closely consider the application of this rule and the status of pending cases as part of the compliance process.

California FTB rules receipts from bankruptcy sales must be included in the sales factor

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On June 3, 2014, the California Franchise Tax Board issued a chief counsel ruling, concluding that a taxpayer's sales of assets undertaken as part of its plan of reorganization under Chapter 11 of the Bankruptcy Code could not be excluded from the sales factor as occasional sales within the meaning of Cal. Code Regs. 18 sections 25137(c)(1)(A) and (2). Pursuant to that regulation, a sale qualifies as an occasional sale if the transaction is infrequent and occurs outside of the taxpayer's normal course of business. As part of its bankruptcy plan, the taxpayer at issue made numerous asset sales during 2012 and 2013, and the number and frequency of the sales over that two-year period were sufficient to make those sales an ordinary part of the taxpayer's business activity. This ruling may present a significant benefit for taxpayers that engage in numerous bankruptcy asset sales that would be sourced outside of California, as those sales would arguably be included in the denominator of the taxpayer's California sales factor and excluded from the numerator.

Texas comptroller considers repealing trailing nexus rule

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The Texas Comptroller of Public Accounts has distributed a draft regulation calling for comment on a proposal to repeal the state's trailing nexus rule. Several states, including Texas, use trailing nexus to require out-of-state sellers that formerly were "engaged in business" in the state to, for a set period of time, continue to collect and remit sales and use taxes to the state on taxable sales made to in-state customers *after* the seller's nexus-causing activities have ended. Texas applies a 12-month trailing nexus requirement under TAC Rule 3.286(b)(2). The draft regulation would delete the trailing nexus provisions from Rule 3.286 because, per the comptroller's statement in the preamble to the draft regulation, trailing nexus "is contrary to the physical presence test articulated in *Quill v. North Dakota*, 504 U.S. 298 (1992)." Sellers significantly impacted by trailing nexus rules in Texas and other states should consider claiming refunds of tax paid subsequent to the termination of nexus-causing activities.

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