Tax Digest

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

April 2013

FEDERAL

Protective claims for FICA refund for calendar year 2009 may be filed through April 15, 2013

Tim Ellenwood, Director, Vienna, Va.
Lorraine Bodden, Director, New York, N.Y.

Recent decisions around *Quality Stores, Inc. v. United States* and *CSX Corp. v. United States* leave open the opportunity for protective refund claims for employers that made severance payments to involuntarily terminated employees during 2009. The IRS is not currently paying any claims filed by employers in the Sixth Circuit, and is disallowing any claims filed by employers outside the Sixth Circuit. However, a protective claim filed by April 15, 2013, for 2009 severance payments, will effectively extend the statute of limitations, and preserve a company's rights to refunds based on the outcome of a presumed Supreme Court ruling to be made in 2013 or 2014.

OREO holding costs may be deducted under right circumstances

Bob McCahill, Director, Washington National Tax
Natalie Tucker, Director, Washington National Tax
Steve Pashley, Manager, Washington National Tax

For banks holding foreclosed real estate, the IRS has issued a very favorable Chief Counsel Memorandum, in which it reverses its previous position regarding the tax treatment of "other real estate owned" (OREO) property as inventory. Previously, IRS exam agents had been requiring banks to capitalize many of the holding costs associated with OREO property. Now, banks may be able to deduct these expenses as ordinary and necessary business expenses under section 162, depending on their facts and circumstances. However, a change in method of accounting requiring IRS consent may be required. Not only is this a better answer for banks from a current deductibility perspective, but the IRS reversal also means that banks will not be burdened with the administrative task of applying section 263A to OREO property. The change in IRS position, with respect to the deductibility of costs of holding OREO properties, is welcome relief for many banks. Depending on a particular bank's facts and circumstances, it should consult with its tax advisor to determine the favorable impact of the most recent guidance, and whether a change in method of accounting (i.e., filing of Form 3115) will be required.

Treatment of non-compensatory options and convertible instruments issued by partnerships

Mort Kessel, Partner, Chicago, Ill.

The IRS has published final regulations (T.D. 9612), effective Feb. 5, 2013, on the tax treatment of non-compensatory options and convertible instruments issued by a partnership. The final regulations apply to specified call options, warrants, convertible debt and convertible equity not issued in connection with the performance of services. These regulations adopt, with some revisions, proposed regulations (REG-103580-02) published in January 2003. The final regulations generally provide that the partnership and the option holder will not recognize gain or loss when the option is issued or when it is exercised. An exception to the no gain or loss rule upon issuance is the transfer of appreciated or depreciated property to the partnership in exchange for the non-compensatory option. In addition, some non-compensatory options will be treated as partnership interests even before they are exercised.

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Tax Digest

Tax Court confirms no step-up in S corporation stock basis arising upon QSub election

Mark Forde, Partner, Vienna, Va.

In *R. Ball v. Commissioner*, T.C.M. 2013-39, the Tax Court determined that unrecognized gain resulting from a Qualified Subchapter S Subsidiary (QSub) election did not create an item of income or tax-exempt income under section 1366(a) and, therefore, did not produce an increase in the shareholder's basis in the parent S corporation's stock. In *Ball*, the taxpayer argued that the gain realized upon the deemed liquidation of the QSub constituted income under section 331, but that section 332(a) then exempted the realized gain from income with nonrecognition. Analogizing the income realized by the subsidiary and the parent S corporation to tax-exempt income, the taxpayer contended that this income should then pass through to the S corporation shareholders, resulting in an increase to stock basis. Noting that any different conclusion would lead to "absurd results," the Tax Court affirmed the position of the IRS that a liquidation governed by section 332(b) resulting in unrecognized gain did not also create an item of income pursuant to section 61(a)(3).

Higher tax rates heighten benefits of charitable remainder trusts

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

Few planning strategies offer the income tax and deferral benefits of a charitable remainder trust (CRT), and as the new reality of higher ordinary income and capital gains tax rates takes hold, the benefits of establishing a CRT may increase for many taxpayers. A donor's transfer of assets to a CRT provides the donor with a current income tax deduction for the actuarially calculated remainder interest. The non-charitable beneficiaries of the CRT (often the donor and/or the donor's spouse) generally receive lifetime payouts from the income and capital gains generated by the CRT, which are taxed as received pursuant to the ordering rules in section 664. There is considerable latitude for setting the payout amount, though at least 10 percent of the CRT's value must be earmarked for the qualified charity or charities that will receive the remainder interest, and payment amounts can be structured with the new income tax thresholds in mind. Thus, a CRT is somewhat analogous to an installment sale, in that any gain on the transferred assets is taxable to the donor over time. Meanwhile, appreciation inside the CRT is deferred to the extent the growth inside the CRT exceeds the payout amounts, and the compounding is tax-free, since the CRT is a non-taxable entity. Finally, the CRT structure avoids application of the 3.8 percent Medicare surtax on any undistributed net investment income of the trust. While attractive to many taxpayers, establishing a CRT will be of particular benefit to those holding low-basis assets, because it affords the opportunity to defer recognition of gain.

Guidance released regarding the deductibility of minimum royalties included as a component of sales-based royalties

Kate Abdoo, Manager, Washington National Tax
Natalie Tucker, Director, Washington National Tax

A recent IRS Field Attorney Advice (FAA 20124401F) concluded that under section 263A, minimum royalties incurred by a taxpayer for the use of licensed patents in the production or sale of property are capitalizable to ending inventory, even when such royalties are subsumed by a sales-based royalty. This ruling was based on license agreement terms that provided that an annual minimum royalty was payable regardless of any sales-based royalties earned by the licensor. The IRS's reliance on license agreement terms indicates that taxpayers may have an opportunity to structure agreements to avoid having to capitalize a portion of an otherwise sales-based royalty to ending inventory under section 263A. Taxpayers that incur licensing costs subject to section 263A should consider structuring license agreements to provide that to the extent a sales-based royalty meets or exceeds a minimum royalty otherwise due, no minimum royalty will be due.

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Taxpayers should review existing license agreements and their methods of capitalizing sales-based and minimum royalties under section 263A to determine whether a change in accounting method to correct impermissible treatment or to take advantage of more favorable treatment is advisable.

INTERNATIONAL TAX

Proposed rule changes would allow third-party preparers to complete FBARs

Ramon Camacho, Principal, Washington National Tax

The Financial Crimes Enforcement Network (FinCEN) recently requested comments on proposed changes to Form TD F 90-22.1. This form, commonly referred to as the FBAR, is used to report information on foreign financial accounts in which a U.S. person has signature or other authority, and has a balance in excess of $10,000. The proposed changes would allow the FBAR to be completed and filed by third-party preparers, as is the case for other FinCEN forms. Currently, the FBAR does not provide a space for third-party preparers to sign, and filers who wish to electronically file the FBAR must personally register on the FinCEN e-filing system to submit the form electronically. If finalized, the proposal will be a welcome change, since all FBARs submitted after July 1, 2013, will be required to be electronically filed. If the proposal is finalized, the burden placed on individual filers to individually register with FinCEN should be significantly reduced.

Long-awaited Brazilian tax information exchange agreement may facilitate FATCA implementation

Ramon Camacho, Principal, Washington National Tax

On March 13, 2013, the Brazilian government approved an exchange of information agreement (agreement) with the United States that will likely create the framework necessary for taxpayers to comply with the Foreign Account Taxpayer Compliance Act (FATCA). Originally signed on March 20, 2007, the agreement had been stalled for several years, but is now in full force and effect. Under the agreement, the tax authorities of the requesting country may obtain information available to the tax authorities of the requested country under their internal domestic laws. Thus, U.S. tax officials may request and obtain information held by financial institutions or other persons in Brazil if the data are relevant to a tax proceeding conducted by the United States, and vice versa. Approval of the agreement after several years of inaction indicates a significant change in Brazilian policy on information disclosure, and increases the likelihood that Brazil will enter into an intergovernmental agreement to facilitate FATCA compliance. However, it remains unclear whether approval of the agreement implies that an income tax treaty between the United States and Brazil is imminent. The parties failed to conclude an income tax treaty several years ago over a disagreement relating to tax sparing, and any treaty likely will not be concluded until the parties resolve this issue.

STATE & LOCAL

Georgia manufacturers may qualify for a sales tax manufacturing exemption for energy starting in 2013

Chris Cunningham, Manager, New York, N.Y.

In March of 2012, Georgia passed HB 386, which introduced an exemption from Georgia sales tax and local taxes, except local taxes paid for educational purposes, for energy used in manufacturing. The exemption is phased-in at 25 percent per year for four years starting in calendar year 2013, and applies to transfers of artificial gas, gasoline, electricity, solid fuel, wood, waste, ice, steam, water and other materials necessary and integral for heat, light, power, refrigeration, climate control or processing. To claim the exemption, a manufacturer must

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file Form ST-5M with its energy suppliers and Form ST-5M Addendum with the Georgia Department of Revenue. Given the broad scope of the exemption and newness of the rules and forms, Georgia manufacturers may not be taking full advantage of this opportunity, and refunds and going forward benefits may be available. Further, from a national perspective, many states offer similar exemptions under a variety of rules, and a multistate review of energy exemptions may be lucrative. Manufacturing companies should consult with their tax advisors to determine if they qualify for this and other energy exemptions.

New Mexico legislature passes numerous corporate income tax changes

Brian Kirkell, Director, Washington National Tax

On March 16, 2013, the New Mexico legislature passed HB 641 (including Senate Floor Amendment 1), which Governor Martinez is expected to sign into law. The law makes substantial changes to the New Mexico corporate income tax, including:

- The top corporate income tax rate of 7.6 percent will be reduced to 5.9 percent over a period of five years.
- Retailers making retail sales of goods in a facility of more than 30,000 square feet under one roof in New Mexico will be required to file on a unitary combined basis beginning in 2014. Mandatory unitary combination will not apply to taxpayers that operate non-retail facilities employing at least 750 employees.
- Elective single sales factor apportionment will phase in over five years for manufacturers. A manufacturer will be bound by this election for at least three years, and making the election will block the application of the throwback rule for years covered by the election.
- The gross receipts tax deduction for sales of consumables to manufacturers will be modified to include repair parts and spares in the definition of deductible "consumables."
- The high-wage jobs credit will be extended.
- Rebates for film production spending will increase from 25 to 30 percent for a television series that shoots at least six episodes in a single season.

Corporate taxpayers should consult with their tax advisors to assess the impact of these changes.

North Carolina announces small business trust fund tax amnesty

Craig Ridenour, Partner, Raleigh, N.C.

On Feb. 28, 2013, the North Carolina Department of Revenue and Small Business Commissioners Office launched the Small Business Counseling Program (SBCP) to assist qualified businesses that have fallen behind on sales, withholding and other trust fund taxes to come into compliance and stay in compliance in future periods. To qualify, a business must have 200 or fewer employees and must not be facing criminal charges or be the subject of an ongoing criminal investigation by the DOR. Additionally, a responsible corporate officer, LLC member or manager or partner must attend free small business counseling sessions provided by the Small Business and Technology Development Center or the Small Business Center Network. A business that meets these requirements and files and pays all outstanding taxes may have its penalties and collection fees waived, subject to continued compliance. If your business has fallen behind in payments, consult with your tax advisor to see how this program can benefit you.

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For additional information or change of address, contact Hyong Sik Yoon or Kiho Choi at (213)480-9100 or e-mail them at hyongsikyoon@ckpcpas.com or kihochoi@ckpcpas.com.

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