Tax Digest

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

April 2016

EVENTS

More tax events and webcasts

FEDERAL

IRS will begin to contact employers that fail to deposit payroll taxes

Nick Passini, Manager, Washington National Tax

It is not uncommon for employers to experience issues in remitting amounts due for payroll taxes. Often, these issues go unnoticed by the employer and the IRS for long periods of time. As a result, corrective actions may occur well after payroll tax returns are due or filed and may result in additional tax and penalties. In an effort to reduce these issues, the IRS has launched an initiative to monitor deposit patterns, identify employers whose payments appear to be declining, late or unpaid, and proactively contact those employers. These employers will receive letters and automated phone calls from the IRS to remind them of their payroll tax responsibilities. In the event the IRS contacts your company on a payroll tax matter and indicates some action on your part is required, you should immediately contact your tax advisor to discuss the appropriate response.

IRS to address conversion ratio adjustments for convertible debt

Stefan Gottschalk, Senior Director, Washington National Tax

Convertible debt instruments (convertibles) are widely used in corporate finance. The value of a corporation's convertibles can decrease significantly if a corporation engages in mergers or change of control transactions or pays higher-than-expected dividends. To protect holders of convertibles against these decreases in value, many convertibles provide for conversion ratio adjustments. While deemed taxable distributions to holders of convertibles (or preferred stock) can arise when changes are made to the holders' rights, conversion ratio adjustments that protect against potential dilution of value are not supposed to trigger these taxable events. A regulation that generally protects anti-dilution adjustments from taxable treatment, however, excludes adjustments based on corporate distributions from its protection. Thus, it is uncertain whether distribution-based adjustments may trigger taxable distribution treatment. An industry group has advocated permitting these adjustments without current taxation, and the IRS is working on guidance expected to address whether events that trigger the conversion rate adjustments should be treated as taxable distributions to the convertible holders. In the absence of clearer guidance addressing the tax treatment of conversion ratio adjustments, taxpayers should carefully consider the impact of these adjustments and seek tax advice when structuring or marketing convertibles and when an adjustment is triggered.

Family limited partnership failure–lessons learned

Rebecca Warren, Manager, Washington National Tax

The U.S. Tax Court has restated the ground rules for what is required to use a family limited partnership to transfer wealth from an estate. In a recent case, an individual created a partnership. She also formed an LLC to serve as

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the general partner. She contributed marketable securities to the partnership, both 'on behalf of' the LLC, which took a 0.1 percent general partner (GP) interest, and in exchange for a 99.9 percent limited partner (LP) interest for herself. She then transferred the GP interest to her children in exchange for cash equal to the gross value of that interest and transferred a 10 percent LP interest to an irrevocable trust that she had created contemporaneously. The partnership agreement provided that income in excess of operating costs would be distributed to the partners, though there was only one small distribution made before the individual died. The estate reported only the decedent's remaining 89.9 percent LP interest on the decedent's estate tax return. The IRS argued for inclusion of all partnership assets in her estate on the basis that the transfers in question were not bona fide sales. The court agreed, finding no significant nontax purpose for the formation of the partnership, no respect for the partnership's business or operational structure, and no other indicators of anything other than an estate tax motivated transaction. Indeed, at the end of the day, as the IRS asserted, the decedent was on the same side of the transaction in the sense that she effectively controlled the assets both before and after the transaction. The case is a reminder that intrafamily transfers need to be founded upon sound business reasons and respected accordingly.

Re-evaluate benefits to increase employee engagement

Anne Bushman, Senior Manager, Washington National Tax
Bill O'Malley, Senior Director, Washington National Tax

There is an abundance of information documenting the benefits a company receives from having engaged employees. These benefits may include lower turnover cost, higher employee productivity, and fewer employee sick days. Employers seeking to engage their employees should understand their workforce composition and look beyond salaries and wages at the entire benefits package or overall employee work experience. According to Pew Research, millennials (individuals born between 1981 and1997) became the largest segment of the U.S. workforce during 2015, and their proportion will only grow as the baby boomers move into retirement. Much has been written about millennials wanting recognition for their contributions and to form positive connections at work; they are technologically savvy and ready to make a meaningful impact on the world. Employers should re-evaluate how their employee benefits align with employee desires. There are many no- and low-cost benefits employers can provide to create a total package that will engage employees. For example, mentoring programs can provide connections and help plan career paths, and cafeteria benefit plans can offer, in a way, a pick-your-own compensation package. If designed properly, many employee benefits receive tax advantages. With thoughtful planning and careful consideration of the tax rules, employee benefits can result in a win-win scenario for employers and employees.

A reminder on the tax treatment of advance payments

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In a recently released memorandum, the IRS concluded that a taxpayer could defer for up to two years the recognition of certain advance payment income received from the sale of unredeemed gift cards for goods or services. While this conclusion hinged on the facts and circumstances related to the specific taxpayer, it serves as a timely reminder of the tax treatment of advance payments received by companies. Advance payments are amounts received in advance of the provision of goods, services or several other items. Generally, a taxpayer that receives an advance payment must include the advance payment in taxable income when received. Though the tax rules in some instances allow a taxpayer to defer the recognition of income to a different period, the taxpayer must meet certain criteria and have adopted this deferral method for tax purposes. The proper tax treatment of advance payments can be overlooked during the preparation of book income to taxable income reconciliation schedules, as taxpayers may have differing balance sheet terminology or be unaware of the tax consequences of these payments. A company receiving payment in advance of the provision of goods or services should consult with its tax advisors to determine the proper tax treatment and assess whether a more optimal method of accounting would allow the company to defer the recognition of this income.

INTERNATIONAL TAX

IRS appeals Tax Court's *Altera* decision

Jamison Sites, Manager, Washington National Tax

The Department of Justice, on behalf of the IRS Commissioner, recently appealed the U.S. Tax Court's July 27, 2015, ruling in *Altera Corp. v. Commissioner*. The Tax Court's ruling in *Altera* was a major defeat for the Treasury and the IRS because the court invalidated the final cost-sharing regulations and called into question the procedure the Treasury and IRS use to issue regulations. While practitioners have long expected that an appeal would be filed, some have questioned the move considering the Tax Court ruled unanimously in favor of the taxpayer. Whether the IRS is appealing the ruling as a whole or just a specific holding will not be clear until the government files its brief. The government's brief must be filed by May 13, and *Altera* will then have until June 13 to file its reply. In the meantime, there will be continued speculation on whether the *Altera* decision will cast lasting doubt upon existing regulations and impact the regulations process. Taxpayers that have previously relied on *Altera* for a tax filing position should consult with their tax advisors to assess the strength of their facts in light of this recent development.

Specified foreign asset reporting expands to entities

Jamison Sites, Manager, Washington National Tax

The Treasury and IRS recently issued final regulations that will affect the reporting requirements of many domestic entities with specified foreign assets. With the issuance of these regulations, specified domestic entities must start filing Form 8938, *Statement of Specified Foreign Financial Assets*, with their annual tax return. In particular, any domestic entity that is formed or availed of principally to avoid the reporting requirement that normally applies to individuals must file Form 8939 under the final regulations. A domestic entity satisfies this test if either (1) at least 50 percent of the entity's gross income or assets is passive, or (2) at least 10 percent of the entity's gross income or assets is passive, and the entity is formed or availed of by an individual with a principal purpose of avoiding the Form 8938 filing requirement. Special rules apply to determine whether income is passive for this purpose. Entities with taxable years beginning after Dec. 31, 2015, will have to start filing Form 8938 with their 2016 tax return. Because a failure to file Form 8938 may result in a penalty of $10,000, taxpayers with foreign assets, even if already reported on another form or disclosure statement, should talk with their tax advisors to determine whether they are subject to these expanded filing requirements.

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STATE AND LOCAL TAX

States continue to step up scrutiny of intercompany transactions

Brian Kirkell, Principal, Washington National Tax

States have historically challenged the state income tax benefits generated by intercompany transactions using a variety of approaches, including the application of intercompany addback rules and forced combination. Recently, states have been stepping up the use of these tools to combat what they perceive as tax-motivated base shifting and have been working to add a new set of more sophisticated tools to the toolbox. For example, in 2015, the Multistate Tax Commission (MTC) launched its Arm's-Length Adjustment Service (ALAS) program to assist states in performing state-specific transfer pricing studies. Although the ALAS program has been slow to take off, the MTC has doubled-down on the program by naming Marshall Stranburg, Florida Department of Revenue executive director, to be its deputy executive director, and broader state support is expected in 2016. Further, states have been working to expand intercompany addback rules to apply to more transactions and to narrow applicable exclusions. For example, Louisiana recently enacted legislation that, effective Jan. 1, 2016, created an addback requirement for intercompany intangible, interest and management expenses. Lastly, in relation to intercompany transactions between U.S. and foreign entities, states have been looking to expand their reach by enacting legislation to require combination of foreign tax haven entities. More than 10 states proposed tax haven legislation in 2015, and this issue is expected to make its way onto the legislative calendar of state legislatures across the country in 2016. Businesses engaging in intercompany transactions should review their activities in light of the states' increased focus on this matter.

Texas court rules COGS deduction applies to seismic data provider

Mike Williams, Partner, Dallas, Texas

On March 9, 2016, the Texas Court of Appeals for the Third District issued a decision affirming the trial court's decision that a business that acquires and processes seismic data for use by the oil and gas industry in developing wells was entitled to claim the costs of goods sold (COGS) deduction in calculating its franchise tax because the data provided was integral to the construction and improvement of its customers' wells. The court's decision was based on its finding that the taxpayer provided labor and materials to clients that used that labor in the construction of real property within the meaning of Texas Tax Code section 171.1012(i), which provides that "[a] taxable entity furnishing labor or materials to a project for the construction, improvement, remodeling, repair, or industrial maintenance of real property is considered to be an owner of that labor or materials and may include the costs, as allowed by this section, in the computation of cost of goods sold." This decision is another in a recent series of cases expanding the applicability of the COGS deduction beyond the comptroller's narrow approach and offers continued support for an expansive interpretation of the term 'labor' in Texas Tax Code section 171.1012(i). Taxpayers that have not previously used, or were denied the use of, the COGS deduction should review their business activities in relation to the application of the COGS deduction, and determine whether to file refund claims.

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