Tax Digest

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

December 2014

FEDERAL

Revenue from software licensing and related services treated separately for DPAD purposes

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The domestic production activities deduction (DPAD) allows software developed by a taxpayer to be treated as qualified production property and licensing revenue from such software to be treated as domestic production gross receipts (DPGR). In the current software as a service and cloud computing environment, it is often difficult to distinguish between the licensing of software (DPGR) and the sale of services (non-DPGR). The IRS National Office recently addressed this issue in a technical advice memorandum. Under the facts evaluated in the memorandum, a taxpayer (T) develops and licenses custom software to a contracting party (C). C uses the software to manipulate its own data. An end user (U) enters into a subscriber agreement with both T and C whereby C uses the licensed software and C's data to compute certain results that are provided to U. The IRS treated this transaction as occurring in two steps: (1) T produces software and licenses it to C, and then (2) C uses the software to provide services to U. It is important to note in this case that C uses its own data to perform the service and the license does not indicate that T is providing any services to U. Accordingly, the revenue from the software license may be treated as DPGR. Companies wishing to claim the DPAD for software should consider contracting separately for the licensing of software and the provision of any services.

Possible ordinary income treatment on distributions from partnerships

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Federal tax rules prevent the use of a partnership to convert potential ordinary income into capital gain. If a partnership sold inventory or collected its unrealized receivables, it would generate ordinary income. If, on the other hand, a partner sold its partnership interest, but for section 751, the partner would have capital gain, even if the value of the partner's interest included the value of these so-called "hot assets." Similar rules apply to a distribution from a partnership to a partner. On Nov. 3, the IRS issued proposed regulations offering guidance on how a partner measures its interest in these hot assets on a distribution from a partnership. These new proposed regulations adopt a "hypothetical sale approach" versus the "gross value" approach under the current regulations. In determining the partner's share, the former focuses on the partner's share of the ordinary income element inherent in each asset, whereas the latter focuses on the partner's share of the asset's value. For now, the most important thing to be aware of is the fact that taxpayers have a choice of continuing to apply the old rules–until the new rules are made mandatory through the issuance of final regulations–or electing to apply the new rules for distributions occurring on or after Nov. 3, 2014.

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IRS clarifies application of one-per-year limit on IRA rollovers

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Through 2014, the one-rollover-per-year limit applies on an IRA-by-IRA basis. This allows taxpayers to roll multiple IRAs over, tax-free, during the calendar year. Effective in 2015, tax-free rollovers will be limited to only *one rollover per individual per year*. In a recent announcement, the IRS clarified that the new rule will apply to IRA distributions occurring on or after Jan. 1, 2015. Any 2014 year-end distribution will be grandfathered under the 2014 rules, even if the 60-day rollover period extends into 2015. This gives IRA owners a chance to use the old rollover rules with distributions made prior to year-end while providing taxpayers a fresh start in 2015 when applying this new one-per-year rollover limit on IRAs.

IRS announces 2015 contribution limits for 401(k) and other retirement plans

Bill O'Malley, Director, Washington National Tax

The IRS has announced the 2015 contribution limits for 401(k) and other retirement plans. For 2015, individual participants can contribute up to $18,000 (up from $17,500) to their 401(k), 403(b) or 457(b) plan. Plus, participants in 401(k), 403(b) and governmental 457(b) plans who will be age 50 by Dec. 31, 2015, can contribute an additional $6,000 for a total maximum contribution of $24,000 for 2015. The 2015 limits for IRAs remain unchanged from 2014. Individuals with sufficient earned income can contribute up to $5,500 to an IRA, with an additional $1,000 catch-up contribution available for those 50 or older.

Department of Labor reiterates that employers cannot reimburse employees for premiums paid for individual health policies

Bill O'Malley, Director, Washington National Tax

The U.S. Department of Labor recently posted updated frequently asked questions (FAQs) that reiterate the government's position that medical reimbursement plans that reimburse employees for health insurance premiums paid for policies the employees purchase in the individual marketplace violate the Affordable Care Act's market reform provisions. Earlier this year, the IRS issued a similar set of FAQs reminding employers that making these reimbursements potentially subjects the employer to a $100-per-day/per-participant penalty. For more information, see our article, *Affordable Care Act impact on certain health care plans*.

Affordable Care Act update: IRS puts up a roadblock on the "skinny plan" strategy

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As a reminder, an employer can avoid penalties under the Affordable Care Act (ACA) if it offers substantially all of its employees (and their dependents) the opportunity to participate in a plan that provides minimum essential coverage, is affordable and provides minimum value. Many employers were looking to the so-called *skinny plans* as a way of meeting the ACA employer shared responsibility provisions. These plans meet the ACA requirement to provide certain specified preventive services. However, they do not provide substantial coverage for in-patient hospitalization services or for physician services (or for both). These skinny plans do meet the technical definition of minimum value. In spite of this, in a recent notice the IRS announced it intends to issue proposed regulations that will provide that plans that do not offer hospitalization and/or physician service benefits do not constitute minimum value coverage. For plans that were in existence before Nov. 4, 2014 (the date of the notice), there is a brief transition period before the regulations will apply once finalized.

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Final regulations address location of E&P in asset reorganizations

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Final regulations provide that the acquiring corporation in certain tax-free reorganizations will inherit the transferor's earnings and profits (E&P) and that only in the case of a section 355 spin-off will there be an allocation of the E&P. The definition of acquiring corporation has been narrowed to mean "the corporation that…directly acquires the assets transferred by the transferor corporation, even if that corporation ultimately retains none of the assets so transferred." Said differently, the acquiring corporation will retain the E&P (and tax attributes) despite any subsequent transfers of those assets to a subsidiary. This represents a change from the historic rule that provided that the E&P and tax attributes would transfer to a controlled subsidiary when all of the assets acquired pursuant to the plan of reorganization were transferred to that controlled subsidiary. The regulations focused on eliminating uncertainty surrounding the meaning of "all," but at the expense of reduced electivity for the taxpayer. However, with proper planning, different transaction structures can allow taxpayers to retain enough electivity to locate E&P at the entity of their choosing. The final regulations apply to transactions occurring on or after Nov. 10, 2014.

IRS memorandum discusses accelerating deductions for recurring liabilities

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The IRS recently released a memorandum ruling that an accrual-method, professional moving company taxpayer could not use the recurring item exception to accelerate its liability to pay for damaged goods. The recurring item exception provides a method for accelerating certain recurring liabilities into the year prior to the year of payment. The controversy arose over how the liability to pay for damaged goods should be classified when applying the economic performance rules. The IRS held that the liability fell into a category of "other liabilities," which are explicitly excluded from the requirements of the recurring item exception. While unfavorable for the taxpayer at issue, the memorandum does serve as a reminder for accrual-method taxpayers currently accelerating deductions into the year prior to payment to evaluate such treatment to ensure it is consistent with either the recurring item exception or another provision of federal tax law. Because controversy can arise when determining which liabilities meet the requirements of the exception, accrual-method taxpayers should consult with their tax advisors in determining whether any liabilities may be accelerated under the recurring item exception.

Portion of proceeds received by employee-shareholder in M&A deal treated as compensation

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In a recent case, the Tax Court held that consideration paid to an executive shareholder in excess of target stock value represented compensation and not capital gain. While a shareholder is generally free to negotiate a separate price for his or her shares that may be in excess of what other shareholders receive, the shareholder's status as an employee may bring additional IRS scrutiny. In this instance, the shareholder originally disputed the amount he was to receive for his shares and negotiated an agreement to receive more than his ratable share of the target's value. The agreement included entering into an employment and intellectual property assignment agreement with the acquirer, and a portion of the proceeds were reported by the target as compensation (although not claimed as compensation by the shareholder). Based on these facts, the Tax Court held that the additional consideration received by the shareholder in excess of his ratable share represented compensation. Employee-shareholders should closely scrutinize all transaction agreements and consult with their tax advisors in any merger and acquisition transaction, but particularly where consideration received is not ratable to their percentage of ownership and where employment agreements and other contingent stipulations exist.

IRS plans to limit the filing of informal claims for refund during an LB&I examination

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In the coming months, the IRS plans to issue new, revamped quality examination process procedures, which provide guidelines for conducting Large Business and International Division (LB&I) examinations. LB&I Commissioner Heather Maloy expects the new procedures to limit the time period during the examination process within which taxpayers can file informal claims. The approach currently being discussed with stakeholders would require all informal claims to be filed within 30 days from the opening conference. If a company under examination discovers an error in the IRS's favor on the return under examination, it can request correction of the error during the examination by submitting a written informal claim to the examination team and request a credit against any tax adjustments arising during the audit. The informal claim process allows the IRS and the taxpayer to discuss and resolve the claim during the examination without the processing of an amended tax return (which may trigger the filing of amended state tax returns). However, the IRS believes the informal process encourages taxpayers to hold on to the claim until late in the audit in order to use it to negate or offset tax adjustments developed by the IRS. This delay creates challenges for the IRS as it is finalizing its audit adjustments. Stakeholder reactions to the 30-day limit are mixed. Often, return errors are discovered during the examination as the taxpayer is responding to information requests, and thus, the 30-day period may have expired long ago. The preparation of a formal amended return can be time-consuming and costly for taxpayers and can delay refunds for many months, or even years. Some say the IRS is being short-sighted because additional examination resources will be required to process and examine the amended returns (Forms 1120X) or formal claims (Forms 843). If the limitation is ultimately imposed, companies should evaluate informal claim potential before the audit begins and be prepared to file informal claims quickly once the audit commences.

INTERNATIONAL

Mandatory electronic filing of accounting records in Mexico

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Starting Jan. 1, 2015, all Mexican businesses must electronically file accounting records every month with the Mexican tax authority. Under Mexico's 2014 tax reforms, all enterprises must maintain accounting records on a monthly basis that conform with Mexico's accounting standards and satisfy various other requirements. At a minimum, taxpayers must electronically file a chart of accounts, a trial balance and journal entries for all transactions. The electronic file must meet certain XML formatting requirements. Failure to timely file correct records will expose the taxpayer to substantial penalties and could lead to an audit. Taxpayers have a three-day grace period to submit records and correct errors after a filing deadline passes. The Mexican legal community expects many taxpayers to challenge the new filing requirements on the theory that the requirements violate certain provisions of the Mexican constitution. However, because Mexican courts are not bound by prior court decisions on similar issues, each taxpayer wishing to challenge the filing requirement must file its own lawsuit, even if other taxpayers are successful in court. U.S. companies that have a Mexican subsidiary or permanent establishment in Mexico should work with their Mexican tax advisors and IT departments to ensure they are ready to meet the upcoming Jan. 25, 2015, filing deadline. In addition, taxpayers should assess, based on their specific facts, whether to challenge the new electronic filing requirement in court.

New foreign expense apportionment rules may result in additional value-added tax in Mexico

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Mexico's federal tax authority recently announced new rules allowing taxpayers to apportion certain expenses (such as management fees) from non-Mexican related parties and deduct these expenses in determining Mexican taxable income. All U.S. companies with related entities operating in Mexico should understand the requirements of this provision, as there are both benefits and pitfalls for the unwary. Historically, Mexico's tax authorities allowed deductions for related-party management or technical expenses under a "time and materials" approach, which required taxpayers to track time and determine an hourly rate. This method proved difficult to administer and offered little audit protection because no official detailed guidance existed. While providing clarity, the new rules also impose several strict requirements a Mexican taxpayer must meet to deduct apportioned expenses. For example, apportioned expenses must directly relate to the Mexican taxpayer's activities. In addition, the expenses must be apportioned from an entity organized in a country with an information exchange treaty with Mexico, and the expenses must be commensurate with the benefit provided to the Mexican taxpayer. Finally, the taxpayer must satisfy strict documentation and invoice requirements, and the expense must satisfy the arm's-length standard contained in Mexican transfer pricing rules. Failure to meet any of the above requirements may result in a disallowance of the apportioned expense, which would not only increase the Mexican taxpayer's income tax liability but could also result in a 16 percent value-added tax on the disallowed amounts. U.S. companies with Mexican subsidiaries should examine this recent guidance and assess whether opportunities exist to increase the amounts their subsidiaries deduct for management, technical or other related-party expenses.

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