February 2013

Tax Digest

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

FEDERAL

Planning for the ATRA impact on trust income taxes

Charles Schultz, partner, Washington National Tax

With the advent of the American Taxpayer Relief Act of 2012 (ATRA), individual taxpayers now have an Obamacare tax of 3.8 percent, a top tax bracket of 39.6 percent, and a top capital gains tax rate of 20 percent. Though earmarked for high-income earners, these tax increases also have a particular impact on trusts that may warrant special planning. While the individual tax thresholds are $400,000/$450,000 for ATRA and $200,000/$250,000 for Obamacare, the trust income tax threshold is only $11,950. Nongrantor trusts pay tax on capital gains and accumulated income that stays in the trust, while the beneficiaries pay tax on income distributions received from the trust. For many trusts, planning may be as simple as distributing trust income to beneficiaries in lower tax brackets. Unfortunately, this can create a conflict between paying out trust income today to current beneficiaries versus preserving trust assets for future generations. The IRS allows a 65-day grace period (through March 6, 2013) to take distributable net income out of a trust and treat it as distributed in 2012. Given the new high rates, it may make sense to accelerate income distributions to the extent undistributed income remains in the trust. Finally, distributing capital assets to beneficiaries who can sell at a 15 percent capital gains rate may be better than having the trust sell assets at a 23.8 percent rate (20 percent capital gains tax and 3.8 percent Obamacare tax). Since a primary reason for keeping assets in trust may have ended, some families might dissolve existing trusts and distribute trust assets to the intended beneficiaries, which could provide sizable income tax savings.

Affordable Care Act and the employer shared responsibility tax

Bill O'Malley, director, Washington National Tax

At the end of 2012, the IRS issued proposed regulations on the employer shared responsibility provisions of the Affordable Care Act. (the Act) These proposed rules address the so-called "play or pay" provisions of the Act that go into effect in 2014. Under those rules, large employers (those with 50 or more full-time equivalent employees) that do not offer affordable health coverage providing a minimum level of coverage to their full-time employees may be subject to an employer shared responsibility payment (tax). This tax will apply if at least one of the employer's full-time employees receives a premium tax credit for purchasing individual coverage on one of the new Affordable Insurance Exchanges. With the issuance of these proposed regulations, an employer that may be subject to the tax based on its current facts and circumstances now has much of the guidance necessary to begin planning as to whether it should pay the tax or expand the health insurance offered to its employees.

Update on IRS pilot program for truncated taxpayer identification numbers

Jacob Wilkinson, manager, Washington National Tax

The IRS recently released proposed regulations allowing pilot participants to truncate the taxpayer identification numbers of individuals receiving certain payee statements

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by masking the first five digits with an asterisk or letter "x." This program is a continuation of efforts by the IRS to combat identity theft, which has become a growing problem and a top priority. For purposes of the pilot program, a payee statement includes only certain forms in the 1099, 1098 and 5498 series (i.e., does not encompass other widely distributed forms such as Form W-2). Currently voluntary, the program can be used by filers providing both electronic and paper payee statements. However, truncated identification numbers can be used only for individuals who are payees, and payor-filers are not allowed to truncate their own identification numbers on the payee statements or to truncate the payee identification numbers on statements provided to the IRS. With the exception of software limitations and initial setup time, little downside results from truncating taxpayer identification numbers. Given the increased risk posed by tax identity theft, all filers of payee statements should seriously consider following the truncated identification number rules. The proposed regulations were published on Jan. 7, 2013, public comments on the proposed regulations must be received by Feb. 21, 2013, and a public hearing is scheduled for March 12, 2013.

IRS likely to issue additional guidance on the application of the consolidated tax return "next-day rule"

Nick Gruidl, partner, Washington National Tax

Speaking at the D.C. Bar Association Taxation Section's Corporate Tax Committee luncheon, Larry Axelrod, special counsel to the IRS Office of Associate Chief Counsel, addressed a number of consolidated tax return issues. One of those issues was the possibility of the IRS releasing additional guidance on the application of the "next-day rule." In response to previous requests by taxpayers and advisors for such published guidance, the IRS has informally suggested that taxpayers not ask for clarification, as the taxpayers may not like the IRS position. For taxpayers enjoying the flexibility provided by the lack of published guidance, the expected guidance may not be welcomed with open arms.

Fiscal cliff deal extends and reinstates beneficial key cost recovery provisions

Natalie Tucker, director, Washington National Tax

The American Taxpayer Relief Act of 2012, signed on Jan. 2, 2013, contains several great cost recovery opportunities for businesses in the real estate and construction industry, including:

- Extension of 15-year straight-line cost recovery for qualified leasehold improvements, qualified restaurant buildings and improvements, and qualified retail improvements through 2013
- Extension of increased expensing limitations ($500,000 maximum amount and $2 million phase-out threshold) and treatment of certain real property as section 179 property for taxable years beginning in 2012 and 2013
- Extension of 50 percent bonus depreciation for 2013 (2014 in the case of certain long-lived and transportation property), as well as the decoupling of bonus depreciation claimed from the allocation of long-term contract costs under the percentage-of-completion method for assets placed in service during 2013 with a MACRS recovery period of seven years or less
- Extension of the election to accelerate the alternative minimum tax credit in lieu of bonus depreciation for 2013
- Extension of the section 45L credit for energy-efficient new homes through 2013

Do not overlook the small business stock exclusion

Tom Lenz, partner, Chicago, Ill.
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When enacted in 1993, the small business stock exclusion allowed noncorporate taxpayers to exclude 50 percent of

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the capital gains on their investments in qualified small business stock (QSBS) held more than five years, and the exclusion subsequently increased to 75 percent for QSBS acquired after Feb. 17, 2009. In 2010, the Tax Relief Act of 2010 (the 2010 Act) further increased the exclusion to 100 percent for QSBS acquired after Sept. 27, 2010, and before Dec. 31, 2011. Though set to revert to 50 percent in 2012, the 100 percent exclusion was retroactively extended by the American Taxpayer Relief Act of 2012 (the 2012 Act) to include QSBS acquired from Sept. 27, 2010, through Dec. 31, 2013. In addition to the 100 percent regular tax exclusion, the 2010 Act and the 2012 Act provide for a full exclusion from alternative minimum tax (AMT) for QSBS acquired between Sept. 27, 2010, and Dec. 31, 2013. QSBS acquired outside of these dates will be subject to a 7 percent AMT preference. In order to qualify for the exclusion, the stock must be held for more than five years and must be QSBS. QSBS generally means any domestic C corporation stock acquired at original issue if the corporation has aggregate gross assets not exceeding $50 million and meets an active business requirement (excluding certain service and other businesses). Under a generous limitation, the amount of excluded gain cannot exceed the greater of $10 million or 10 times the taxpayer's adjusted tax basis in the stock. In the case of pass-through entities, this limitation is applied at the partner or shareholder level. For 2013, the QSBS exclusion should be kept in mind when determining the type of entity to use for any new or acquired businesses. For prior acquisitions, taxpayers should identify QSBS to ensure any potential benefits are realized upon ultimate disposition.

INTERNATIONAL

IRS releases final FATCA regulations

Ramon Camacho, principal, Washington National Tax

On Jan. 17, 2013, the IRS released final regulations under the Foreign Account Tax Compliance Act (FATCA) enacted in 2010. While the regulations impose broad requirements on foreign financial institutions (FFIs) to conduct due diligence on new and existing accounts and set forth extensive rules governing withholding and information reporting, the regulations also provide significant relief to taxpayers. The regulations generally extend the FATCA grandfathering date to Jan. 1, 2014. Moreover, the regulations except a variety of entities from FATCA, including certain investment entities, credit card issuers and others. In addition, the regulations allow a single sponsor to perform consolidated reporting for a group of taxpayers if certain conditions are met. The regulations also require certain FFIs to appoint a responsible officer to ensure compliance with FATCA and certify to the IRS that the FFI complies with relevant provisions of FATCA. Even though withholding is generally scheduled to begin on Jan. 1, 2014, taxpayers that wish to avoid FATCA withholding may access the IRS FATCA portal by Oct. 25, 2013, and register as a participating or registered deemed compliant FFI to avoid withholding at source. The FATCA portal is expected to be available no later than July 15, 2013. Because FATCA may affect virtually all taxpayers that make or receive U.S. source payments, all taxpayers should assess the potential costs and other burdens of compliance with these rules.

Consider resolving double tax issues through the U.S. Competent Authority

Ramon Camacho, principal, Washington National Tax

Over the last few years, foreign tax authorities have aggressively pursued revenue by making adjustments to the income of taxpayers with operations in their jurisdictions. In most of these cases, a foreign tax authority will adjust the income recognized by a taxpayer from a transaction with a related party in another jurisdiction. Such an adjustment may result in double taxation because the foreign government may effectively assert jurisdiction over income that has already been reporting in another country. Taxpayers may attempt self-help to relieve any resulting double taxation by filing an amended return

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in the jurisdiction that has already taxed the income. However, that country (like the United States) may not allow the filing of a refund claim based on a reallocation of income in a related party transaction or, worse yet, the statute of limitations on filing a refund claim may have expired by the time a foreign government makes an income adjustment. In these cases, United States taxpayers may petition the U.S. Competent Authority for relief if there is an income tax treaty in place between the U.S. and the foreign government. Broadly speaking, U.S. income tax treaties grant the U.S. Competent Authority, currently the IRS Deputy Commissioner (International) for the Large Business and International Division, the authority to negotiate resolutions with foreign governments in cases involving double taxation. Under this broad authority, the U.S. Competent Authority may grant a refund of taxes paid to the IRS where income is properly allocated to the tax jurisdiction of a foreign government. Alternatively, the U.S. Competent Authority may persuade the foreign tax authority to reduce or eliminate a proposed income adjustment. In addition, many U.S. income tax treaties allow taxpayers to petition the U.S. Competent Authority long after the normal three-year period in which to claim a refund. In sum, U.S. taxpayers who have received, or expect to receive, an adjustment by a foreign tax authority should consider filing a petition with the U.S. Competent Authority to minimize any potential double taxation that may result from the adjustment.

STATE AND LOCAL

California Court of Appeal holds OEM royalties sourced as license of intangible property

Michael Nunez, director, Los Angeles, Calif.

On Dec. 18, 2012, the California 1st District Court of Appeal (Court of Appeal) issued its decision in Microsoft Corp. v. Franchise Tax Board, No. A131964 (Cal. Ct. App., Dec. 18, 2012), holding that, for corporation income tax sales factor purposes, original equipment manufacturer (OEM) royalties are sourced using California's all-or-nothing costs of performance methodology. For its tax years ended June 30, 1995, and June 30, 1996, Microsoft entered into contracts with OEMs under which the OEMs paid a royalty to Microsoft for the right to replicate and install Microsoft software on computer systems sold by the OEMs directly or indirectly to end users. At issue was whether the California Franchise Tax Board (FTB) properly treated OEM royalties for sales factor purposes as receipts from the license of tangible personal property sourced to the location of the OEMs. Microsoft contended the OEM royalties should have been treated as receipts from the license of an intangible right sourced to the state where Microsoft incurred the greater proportion of the costs of performance associated with the fulfillment of the agreement. If a taxpayer engaging in similar OEM contracts utilized the FTB's market approach to sourcing OEM royalties in filing their returns and the taxpayer's costs of performance associated with the OEM royalties were incurred outside of California, the taxpayer may have an opportunity to seek refunds.

Massachusetts Appeals Court holds cash sweeps treated as equity rather than debt

Girard Brisbois, principal, Boston, Mass.

On Jan. 11, 2013, the Massachusetts Appeals Court issued its decision in Kimberly-Clark Corp. v. Commissioner of Revenue, holding that a parent company could not deduct interest expense incurred as a result of cash sweeps from its subsidiaries because the group's cash management system did not create bona fide debt. Pursuant to the cash management system in question, cash was swept up to Kimberly-Clark from its subsidiaries on a daily basis and placed in a single pool from which the expenses of the group were paid. Kimberly-Clark recorded the net amount as a payable to its subsidiaries and deducted interest related to that payable on its Massachusetts returns. The Massachusetts Appeals Court held the net

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amount represented a return of capital rather than debt because promissory notes created in relation to the net amount lacked any collateral or default provisions, the interest rates were set at the applicable federal rate rather than negotiated separately in relation to each subsidiary, and no evidence was provided to show the notes had been, or ever would be, repaid. Because states have become more aggressive on the tax treatment of cash management systems, companies should consider the risk that a state could argue that such arrangements are not bona fide debt. Such a determination could result in the disallowance of claimed interest expense for state income tax purposes and an increase in capital, which would be subject to tax in those states that impose tax on capital or net worth.

Mississippi Supreme Court grants petition for review in alternative apportionment case

Mike Williams, partner, Dallas, Texas

On Jan. 10, 2013, the Mississippi Supreme Court decided to consider the parameters of the state's alternative apportionment powers, and granted the state's petition for review in Equifax, Inc. and Equifax Credit Info. Services, Inc. v. Dep't of Revenue (DOR). The Mississippi Supreme Court will evaluate the Mississippi Court of Appeals' holding that, when the DOR imposes an alternative apportionment method on a taxpayer, the DOR has the burden of proving the standard apportionment formula does not fairly represent the activities of a taxpayer within Mississippi and that the DOR's alternative apportionment formula is reasonable. The Mississippi Court of Appeals' ruling reversed the Hinds County Chancery Court's holding that the DOR's application of an alternative method should be granted a rebuttable presumption of correctness, with the taxpayer bearing the burden of proving that the alternative method is unreasonable and does not fairly represent the activities of the taxpayer.

In its reversal of this decision, the Mississippi Court of Appeals left the issue of the level of proof required for the Chancery Court to determine on remand. The Mississippi Supreme Court is likely to address all of these issues, with potentially wide-ranging impact given the state's recent expansion of its use of alternative apportionment, particularly in regard to sales of services.

Tennessee becomes latest state to apply due process clause as effective bar to state taxation

Craig Ridenour, partner, Raleigh, N.C.

On Jan. 8, 2013, the Tennessee Department of Revenue issued Rev. Rul. 12-27, holding that an intangible management company did not have Tennessee nexus under the due process clause of the United States Constitution and, therefore, could not be subject to Tennessee franchise and excise taxes. The company in question licensed its patents to a related-party manufacturer that produced the patented goods outside of Tennessee and then sold those goods to customers in Tennessee. Although the ruling did not directly reference the recent trend in federal and state jurisprudence strengthening the due process clause as a bar to state taxation, the facts considered in this ruling were substantially similar to those in Griffith v. ConAgra Brands, Inc., and the language of the decision mirrors the due process analysis applied by the United States Supreme Court in J. McIntyre Machinery LTD v. Nicastro. Taxpayers that perform services or license intangibles under similar circumstances should consider reviewing their nexus positions in light of this ongoing development.

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