Tax Digest

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

February 2014

FEDERAL

Not all recapitalizations are created equal

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In a tax-deferred stock exchange, the value of the shares received must approximately equal the value of the shares exchanged. In tax-deferred transactions involving unrelated shareholders, the adverse positions of each party to the reorganization generally lead to an arm's length value-for-value exchange. However, that is not always the case. In a recently issued IRS field memorandum, a shareholder exchanged common stock with a zero fair market value for common and preferred stock with value (amount was undisclosed) in a purported section 368(a)(1)(E) recapitalization. While not defined in the tax statutes or regulations, a recapitalization generally involves only a "reshuffling" of the corporation's capital and not a change in the economic position of the shareholders. In this case, the taxpayer did not exchange stock of equal value and instead received excess value in the exchange. As a result, the IRS ruled the exchange did not qualify as a tax-deferred recapitalization, and the taxpayer recognized ordinary income with respect to the excess value of the stock received. The IRS holding serves as a good reminder that not all corporate equity restructurings will provide tax-deferred exchange treatment to the shareholders involved. If the equity being issued relates to anything other than the shares exchanged, immediate taxation is likely to occur.

IRS rules on application of medical device excise tax to foreign-assembled convenience kits

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The IRS issued a ruling on Dec. 23, 2013, that provides taxpayer guidance regarding the applicability of the medical device excise tax (MDET) to medical convenience kits. Even though the domestic taxpayer shipped the articles to a foreign entity for assembly into convenience kits, the fact that the foreign entity was participating in a special importation program in the foreign country meant that the kits were considered to be domestically produced by the taxpayer. As a result, the MDET was not imposed on the sale of the convenience kits. Instead, the ruling instructs taxpayers to look through the kit to the individual components making up the kit. To the extent an individual item in a kit is a taxable medical device, the MDET is imposed on that device. If a kit contains a combination of taxable and nontaxable items, the MDET should be calculated based on the portion of the selling price representing taxable items. For items without an established selling price, the MDET is allocated based on the actual cost to manufacture the device.

IRS releases first component of tangible property transition guidance

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On Jan. 24, 2014, the IRS released the first of two documents providing guidance on adopting the final (and proposed) tangible property regulations. Rev. Proc. 2014-16 provides automatic method change procedures to adopt the final tangible property regulations covering the federal income tax treatment of materials and

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supplies and costs to acquire, maintain and improve tangible property. It is expected that the second revenue procedure (covering the proposed disposition regulations) will be issued sometime in February. In addition to providing procedures to adopt the final tangible property regulations, Rev. Proc. 2014-16 provides automatic method change procedures for taxpayers wishing to adopt a reasonable UNICAP method for self-constructed assets and for taxpayers wishing to adopt an allowable method of accounting under section 263A for certain costs related to real property acquired through foreclosure, by deed in lieu of foreclosure, or in other similar transactions. Taxpayers should consult with their tax advisors to determine whether any of the method changes provided in Rev. Proc. 2014-16 are applicable to their operations.

Employer health plans affect cost of exchange coverage

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Open enrollment for the new health insurance exchange (also known as the marketplace) started on Oct. 1, 2013, and extends to March 31, 2014. Based on income and family size, individuals applying for health insurance through the exchange may be entitled to premium tax credits that reduce their cost of coverage. For example, a single person with income under $46,000 or a family of four with household income under $94,200 could qualify for the credits unless they are eligible to enroll in an employer-sponsored health plan that meets minimum value and affordability standards. Individuals applying for exchange coverage are asked whether their employers' health plans meet these standards, and the exchange may contact the employers to verify the answers. Therefore, it is important that employers understand how to determine if their health plans meet the minimum value and affordability requirements since their plans can have a direct impact on the cost of exchange coverage for employees. For more information about the minimum value and affordability standards, read our article, *The Affordable Care Act-What's next for employers?*

IRS agents now have more discretion when raising and resolving issues

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Starting in the 1980s, the IRS focused its examiners on significant issues through the issuance of coordinated issue papers (CIPs), which offered specific guidance and technical analysis supporting these issues. The practice began as part of the IRS' Industry Specialization Program and grew from industry-specific issues (e.g., an accrual of interest on nonperforming loans for banks) to cross-industry issues (e.g., research credit claims). The hallmark of the CIP was the requirement that agents raise the issue in an examination where it was found to exist unless the issue owner released the agent from the issue. Appeals officer discretion was also limited by settlement positions and guidelines developed for each issue. The goal of the CIP practice was to promote consistency in agents' development of issues and consistency of settlements by appeals. On Jan. 21, 2014, the Large Business and International (LB&I) division issued a directive providing that all current CIPs were de-coordinated, effective immediately. To the extent that any CIP included guidance or tools relevant to addressing an issue or transaction, such guidance or tools will be made available to examiners through the Industry Practice Groups and International Practice Networks serving LB&I. This announcement and the de-coordination of issues return significant discretion to revenue agents and their teams on raising and resolving issues.

TEFRA audit adjustments can affect a partner's carrybacks and carryforwards

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A partnership with 11 or more partners (or with a pass-through entity as a partner) is considered a TEFRA partnership (under the Tax Equity and Fiscal Responsibility Act of 1982) for IRS audit purposes. TEFRA status allows the IRS to audit at the partnership level, rather than at the individual partner level. Audit adjustments that are "partnership items" are agreed to by the partnership's Tax Matters Partner (TMP), and tax associated with the adjustment is directly billed to the underlying partners, without the IRS auditing the individual partners' tax returns and without the partners filing amended returns. In a recent IRS memorandum, the IRS advised that under a TEFRA audit, if the TMP signs a Form 872-P to extend the statute of limitations for assessment, the extended statute applies to partnership items that are adjusted by the examination, regardless of what year the partnership items were claimed on a partner's return. The IRS chief counsel advised that the extended TEFRA assessment period applies to the partnership item itself. Thus, tax associated with a disallowed loss or credit that is carried forward or back by the partner can be assessed under the TEFRA statute extension, even if the statute of limitations for assessment on that partner's return has otherwise expired.

IRS addresses additions to corporate "no-rule" policy

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At the American Bar Association Tax Section's Midyear Meeting, William Alexander, IRS associate chief counsel (Corporate), addressed cutbacks to the private letter ruling program while speaking at the Affiliated and Related Corporations session. Rev. Proc. 2014-3 added both *Granite Trust* transactions and the treatment of hook equity to the IRS' no-rule program. However, Mr. Alexander stated that neither of these additions to the no-rule policy is a commentary on substantive law, but rather a means of achieving cost savings in light of IRS resource constraints. Thus, although taxpayers can no longer seek rulings in these areas, these additions to the no-rule policy are not due to the IRS rethinking the validity of these positions. Finally, a third addition to the no-rule policy includes relief in connection with failure to file Form 1122 to join the filing of a consolidated return. However, taxpayers may still seek determination letters in this area, and the IRS is hoping to provide some type of automatic relief procedures in the future. While additions to the no-rule policy are unfortunate for taxpayers looking for certainty from the IRS, the statements from Mr. Alexander serve as welcome notice that the view of the IRS has not changed on the underlying issues.

Recent ruling addresses section 382 ownership issues and a taxpayer's duty to inquire

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In a recent private letter ruling, the IRS addressed a publicly traded taxpayer's reliance on SEC filings and its corresponding duty to inquire as to the existence of a coordinated acquisition in determining whether a group of entities included on a single schedule 13D or 13G represented a group required to be treated as a single 5-percent shareholder. The requirement to treat such a filer as a 5-percent shareholder increases the likelihood that the taxpayer will undergo an ownership change that would subject the corporation's net operating losses and other tax attributes to limitation. Based solely upon the language in the SEC filings and the taxpayer's representation that it was unaware of any coordinated acquisitions made by its shareholders, the IRS ruled that the taxpayer could exclude the filer, as no entity subject to the filing held 5 percent or more of the company. There was no apparent attempt by the taxpayer, nor did such an attempt appear to be required by the IRS, to directly inquire with the filer to determine whether a coordinated acquisition had occurred. This taxpayer-favorable ruling stands for the proposition that a taxpayer would not be required to separately attempt to verify the existence of a coordinated acquisition or the lack thereof. However, as with any private letter ruling, application beyond the taxpayer is not binding.

INTERNATIONAL

Final PFIC regulations provide new guidance on reporting standards

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On Dec. 30, 2013, the IRS and the Treasury Department released temporary and final regulations regarding passive foreign investment companies (PFIC) that in many cases will impose additional reporting requirements on taxpayers that own an interest in a PFIC. The regulations set forth rules on determining ownership of a PFIC (including indirect ownership), impose annual filing requirements and also amend the reporting rules that apply to owners of controlled foreign corporations (CFCs). Not only of interest to taxpayers that own a direct interest in a PFIC, these rules will be important to taxpayers that have asserted that they have no reportable interest in a PFIC because the indirect attribution rules do not apply to them absent final regulations. In addition, the rules provide relief to taxpayers that rely on the "constructive ownership" exception to avoid filing Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*, with regard to indirectly owned CFCs by allowing such taxpayers to take advantage of the exception without filing the statement required under prior rules. The PFIC rules are very complex, and while these new rules provide some clarity on certain technical issues, taxpayers should assess the impact these rules may have on their foreign compliance obligations.

The IRS is taking FBAR penalties seriously, and they stack up quickly

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Any U.S. person that has a financial interest in or signature authority over a foreign bank account that at any time during the tax year exceeds $10,000 in value is required to file a Report of Foreign Bank and Financial Accounts (FBAR) with the IRS. As Beanie Baby founder and billionaire Ty Warner recently found out, failing to report these foreign accounts to the IRS can result in steep civil and criminal penalties. In Warner's case, the civil penalties alone were in excess of $53 million. From 1996 into the mid-2000s, Warner held a Swiss bank account that earned interest. In an effort to avoid paying U.S. tax on the earnings, Warner did not file FBARs or report the majority of the interest income on his income tax returns. Warner went as far as transferring the funds to a second account in the name of a nominee foundation to mask his ownership. While the IRS has had multiple voluntary disclosure programs, Warner chose not to participate in any of them to properly disclose his Swiss accounts. Through a recent step-up in IRS enforcement efforts, including pursuing Swiss banks for depositor lists, Warner was caught holding an account that at one point held a value of over $93 million. Although he has managed to avoid jail time (he recently received probation), Warner's penalties to date still remain intact. This case clearly demonstrates that the IRS is actively pursuing FBAR violations. Taxpayers should perform an FBAR "health check" to ensure compliance and take advantage of applicable IRS amnesty programs before they expire.

STATE & LOCAL

Texas trial court dismisses taxpayer's compact election claims on summary judgment

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On Jan. 15, 2014, the Texas District Court in Travis County issued an order without opinion in *Graphic Packaging v. Combs* (Docket No. D-1-GN-12-003038), denying the taxpayer's motion for summary judgment and granting the comptroller's partial cross-motion for summary judgment in relation to whether the taxpayer had the right to apportion using the Multistate Tax Compact's equally-weighted, three-factor apportionment formula. The taxpayer's arguments regarding the constitutionality of Texas' single-sales factor apportionment formula and the franchise tax rate structure, as well as the taxpayer's argument that the comptroller abused her discretion in failing to waive interest and penalties, remain before the court, and no appeal of this decision will be allowed without the issuance of a severance order until the court renders its decision in relation to these remaining issues. This decision marks another step on the path of what is likely to be a very long road for compact apportionment election appeals.

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