Tax Digest

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

February 2016

FEDERAL

IRS approves restructuring around the 100-shareholder limit for S corporations

Mark Forde, Partner, McLean, Virginia

The IRS recently ruled that an S corporation could proactively restructure its ownership in order to avoid exceeding the 100-shareholder limit that applies to S corporations. The ruling concerned three existing S corporations, including one (X) that had close to 100 shareholders. The shareholders of X planned to restructure their business by undertaking several steps that would result in X becoming a general partnership under state law and being wholly owned by the other two S corporations. The current shareholders of X would become shareholders in one of the remaining two S corporations. Over time, the number of shareholders in the two S corporations likely would exceed 100 on a combined basis. However, neither corporation would itself have more than 100 shareholders. The ruling provides that the two S corporations will retain S status as long as each separately remains below the 100-shareholder limit. This ruling provides an additional avenue for an S corporation approaching the 100-shareholder limit to restructure its activities and successfully stay under the statutory limit by bifurcating the shareholder group into separate ownership entities.

Partner's investment in state tax credits ruled a disguised sale

Larry Hirsh, Partner, Cleveland, Ohio

In January 2016, the Fourth Circuit Court of Appeals ruled that a capital contribution to a partnership followed by an immediate allocation of Virginia's state tax credits to the partner was a disguised sale of property. This decision affirmed an earlier Tax Court decision that recharacterized the investor's intended cash contribution to the partnership as gross income received by the partnership in exchange for the tax credits. This decision is similar to the result in a 2011 Fourth Circuit case and represents a continuation of the IRS' recent trend of deeming partnership transactions resulting in the allocation of tax credits to investors to be something other than bona fide partnership investments. The IRS has provided a safe harbor under which it will not challenge an allocation of federal historic tax credits, and the associated requirements are intended to ensure a partner's investment is a bona fide investment with the possibility of sharing in future profits or losses in addition to the partner's tax credit allocation. In light of this recent court decision and IRS actions, taxpayers should carefully review their structures to ensure tax credit allocations will be respected by the IRS in the event of an audit.

Will the Affordable Care Act be repealed?

Jill Harris, Director, Washington National Tax
Bill O'Malley, Senior Director, Washington National Tax

On Jan. 6, 2016, Congress passed a bill to repeal major portions of the Affordable Care Act (ACA). However, President Obama vetoed the legislation on Jan. 8, 2016. Since Congress has indicated that it does not have enough votes to override a presidential veto, this bill is not expected to become law. The bill, known as the *Restoring Americans' Healthcare Freedom Reconciliation Act of 2015*, would have eliminated penalties for 2015 and future years on companies that do not offer ACA-compliant coverage

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and individuals who do not have health coverage. In addition, it would have eliminated government subsidies, known as premium tax credits, on health insurance purchased through the marketplace/exchange starting in 2018. Although Congress may have further discussions about repealing the ACA, employers should not wait on a repeal and instead should focus their attention on complying with the current law, including the new information reporting requirements effective for 2015.

IRS extends the filing dates for Affordable Care Act information returns

Jill Harris, Director, Washington National Tax
Bill O'Malley, Senior Director, Washington National Tax

Employers required to file Forms 1095-B or 1095-C for 2015 with the IRS to report information about their workforce and health plans now have additional time to comply. The due date for providing the forms to employees has been extended from Feb.1 to March 31, 2016. The due dates for filing the returns with the IRS have been extended from Feb. 29 to May 31, 2016 (if filed on paper), and from March 31 to June 30, 2016 (if filed electronically). These extensions of the filing due dates are automatic, and employers do not need to submit an extension request with the IRS to take advantage of the delayed due dates. Employers face penalties of up to $500 per return for failing to timely file the returns and furnish statements to employees. Penalties also apply for failing to provide complete or correct returns. However, the IRS has indicated that it will not impose penalties for incomplete or incorrect returns for 2015 if the employer makes a good-faith effort to comply with the information reporting requirements and provides the forms to employees and the IRS on a timely basis.

IRS expands favorable treatment of employer-provided ID theft services

Ryan Corcoran, Manager, Washington National Tax
Bob Adams, Partner, Washington National Tax

The IRS recently released guidance expanding the favorable tax treatment it previously provided for victims of identity theft to include identity protection services provided by organizations to employees or other individuals before a data breach occurs. Prior to this guidance being issued, only when an organization was the victim of a data breach was the value of credit reporting and monitoring services, identity restoration services, or other similar services that the organization provides to its customers, employees or other impacted individuals not includable in the gross income of the impacted individual. With this guidance, the IRS extends that tax treatment to include identity protection services provided to employees or other individuals before a data breach occurs. An organization wishing to provide these types of services as an attractive employee benefit should consult with its tax advisors to ensure the benefit will not be taxable to its employees.

Nontax purpose of a family LLC and gifts of LLC interest respected

Rebecca Warren, Manager, Washington National Tax

In a recent case out of Washington state, the IRS challenged the nontax purpose for the creation of a family limited liability company (LLC) and the present interest treatment for gifts of the family LLC interest. Prior to the formation of the LLC, the decedent held five brokerage accounts at three management firms, as well as commercial real estate. Following contribution, the assets were consolidated under one management group, and the financial decisions were made jointly by the decedent's children. The children, along with their advisors, held documented annual meetings. The court ruled the transfer of assets to the LLC was a bona fide sale for full and adequate consideration. While a Crummey notice was issued for each gift, the IRS also challenged the present interest of the LLC interest gifts transferred to the family trust over a series of years. The court ruled the recipients received a present interest in the income because the cash flow from the LLC interest was consistently distributed to the beneficiaries. On both IRS assertions, the nontax purpose and management actions were respected and documented, leading to an unsuccessful challenge. This case demonstrates the need for consistent documentation and respecting the nontax purposes for creating family LLCs.

INTERNATIONAL

IRS provides significant relief under FATCA

Justin Yonowitz, Supervisor, McLean, Virginia
Jamison Sites, Manager, Washington National Tax
Ramon Camacho, Principal, Washington National Tax

The Treasury Department recently issued a notice announcing its plan to amend select regulations under the Foreign Account Tax Compliance Act (FATCA). The notice contains four main elements. First, it delays the date by which pre-existing account certifications must be reported to the IRS by certain foreign financial institutions (FFIs); the certifications of participating FFIs and Model 2 FFIs are now due July 1, 2018. Second, the notice specifies the certification period and due date applicable to registered deemed-compliant FFIs. Third, it eliminates the requirement for certain FFIs to report to the IRS gross proceeds paid to accounts held by nonparticipating foreign financial institutions (NFFIs) in the 2015 calendar year. Fourth, the notice states the conditions under which a withholding agent may rely on electronically furnished Forms W-8 and W-9 collected by intermediaries and flow-through entities. A withholding agent may rely on these electronically furnished forms to the extent the intermediary or flow-through is a direct or indirect account holder of the withholding agent and the withholding agent obtains a written statement confirming the accuracy of the form's contents. Taxpayers may rely on the guidance provided in this notice until regulations are issued. Taxpayers subject to FATCA reporting requirements should carefully consider these changes with their tax advisor in order to understand how the notice may affect their reporting obligations.

PATH Act provides several changes to FIRPTA

Jamison Sites, Manager, Washington National Tax
Ramon Camacho, Principal, Washington National Tax

The recently enacted Protecting Americans from Tax Hikes Act of 2015 (PATH Act) provides significant benefits for non-U.S. investors in U.S. real estate. Generally, Foreign Investment in Real Property Tax Act (FIRPTA) imposes U.S. federal income tax on the disposition of U.S. real property interests (USRPI) by non-U.S. persons. Such property interests include not only real property located in the United States, but also the stock of certain corporations with significant holdings of USRPI. The PATH Act provides several significant modifications to the FIRPTA rules. First, it provides a new exemption from FIRPTA for certain *qualified foreign pension funds*. Subject to some exceptions, capital gain distributions received by a qualified foreign pension fund from a real estate investment trust (REIT) will be exempt from FIRPTA taxation. Second, the ownership threshold for the publicly traded REIT FIRPTA exception increased from 5 percent to 10 percent. Third, a nonpublicly traded REIT's *qualified shareholders*, a newly defined term, owning 10 percent or less will also be exempt from FIRPTA. Fourth, gain from the sale of stock in a qualified investment entity will not be subject to tax under FIRPTA if the qualified investment entity is domestically controlled. Fifth, the *cleansing rule* for regulated investment companies and REITs has been eliminated. Finally, the PATH Act increased the rate of FIRPTA withholding from 10 percent to 15 percent on certain dispositions of USRPIs. Taxpayers currently subject to FIRPTA taxation should speak to their tax advisor in order to determine how the PATH Act may impact them.

STATE

Michigan issues guidance on the application of sales tax to cloud computing

Tom Chrzanowski, Senior Manager, Indianapolis, Indiana

On Jan. 6, 2016, the Michigan Department of Treasury issued a notice to taxpayers conceding that the department's stated policy in RAB 1999-5 that access to software over the Internet is taxable without the delivery of either the code that enables the program to operate or a desktop client is inconsistent with the decision of the Michigan Court of Appeals in *Auto-Owners Insurance Company v. Department of Treasury* and, therefore, invalid. Taxpayers may request a refund for use tax paid for a product falling within the *Auto-Owners* decision by filing amended returns and a written refund request with the department. If the tax was paid to a vendor, the taxpayer must request a refund from the vendor, and the vendor may then request a refund from the department.

MTA surcharge rate increase

Harlan Kwiatek, Partner, New York

On Dec. 31, 2015, the New York Department of Taxation and Finance adopted emergency corporate franchise tax regulations increasing the Metropolitan Transit Authority (MTA) surcharge rate from 25.6 percent of the tax imposed under New York Tax Law section 209 for tax year 2015 to 28 percent for tax year 2016. Pursuant to the regulation, the 28 percent rate will remain in effect until changed by the Commissioner. Taxpayers may need to adjust estimates and deferred tax assets as a result of this rate change.

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For additional information or change of address, contact Tim Yu or Kiho Choi at (213)480-9100 or e-mail them at timyu@ckpcpas.com or kihochoi@ckpcpas.com.

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