Tax Digest

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

July 2015

FEDERAL

Relief for an inadvertent S corporation termination? Just ask the IRS

Ed Decker, Director, Washington National Tax

In recent years, the IRS has demonstrated a sincere interest in helping S corporations maintain pass-through status despite infractions that might otherwise cause the company to lose that status and become a taxable entity. In some cases, particularly with respect to late elections, the remedy may simply involve the filing of a form with a related explanation. In other cases, getting relief may be more involved. But the IRS has generally been willing to provide relief as long as the taxpayer requests it. Two recent rulings highlight this predisposition. In one ruling, a taxpayer made an S election despite provisions within its governing documents that allowed for disproportionate distributions, which could have been construed as indicative of a second class of stock. Although the taxpayer never made disproportionate distributions, the provision itself technically may have made the S election ineffective. In another ruling, two shareholders transferred their S corporation shares to a partnership, an ineligible S corporation shareholder. In both cases, the IRS provided relief to the taxpayers, enabling them to correct the issues and maintain S corporation status without interruption. These rulings emphasize the importance of monitoring the company's and its owners' activities to help avoid inadvertent terminations. They also emphasize the importance of quickly taking action once an issue is identified. In almost all cases, the IRS will work with taxpayers to avoid the unfortunate consequences of a termination–as long as the taxpayer is proactive and requests relief.

Fringe benefits can cause confusion for S corporations

Scott Ruby, Director, Raleigh, North Carolina

A company can provide many fringe benefits to employees on a tax-free basis. However, special rules apply to 2-percent shareholders of an S corporation. Under these rules, some, but not all, fringe benefits are taxable to the shareholder. The most common fringe benefit is health insurance. The value of premiums paid by an S corporation on behalf of a 2-percent shareholder represents taxable compensation that must be included on the shareholder's Form W-2. The same is true in situations where a shareholder purchases the health insurance in his or her own name, with the S corporation either paying the premium or reimbursing the shareholder for the premium. Proper reporting is critical because IRS guidance indicates that a failure to report the premiums on Form W-2 may prevent the company from deducting the expense. Even if the company fails to report the premium, the value of the premium represents taxable income to the shareholder. Thus, proper reporting helps minimize the chance that a shareholder will recognize income without an offsetting deduction for the S corporation.

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Don't trust your K-1 when determining COD exclusions

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When an entity taxed as a partnership transfers property to satisfy a note of indebtedness, cancellation of debt income (COD income) may be realized. Generally, COD income is excluded from taxable income when the taxpayer is insolvent. The insolvency of the partnership itself is not determinative; instead, the law demands a partner-by-partner determination. This may result in some partners recognizing taxable COD income and others excluding COD income. The calculation of COD income requires each partner to determine if the debt is recourse or nonrecourse to that specific partner. In the event that the note is nonrecourse debt, the taxpayer recognizes proceeds equal to the outstanding amount of the note. However, when the debt is recourse, proceeds are deemed to be equal to the fair market value of the asset, and any amount in excess is COD income. In a recently released memorandum, the IRS refused to apply the section 752 definitions of recourse and nonrecourse indebtedness for purposes of determining gain or loss under the COD income rules for partnership entities. Section 752 determines the allocations shown on the Schedules K-1 issued to the partners. In light of this recent IRS position, owners in an entity taxed as a partnership should not assume that amounts shown as recourse or nonrecourse indebtedness on Schedule K-1 are correct for determining the exclusion of COD income. Accordingly, it is important that owners of organizations contemplating a transfer of property to satisfy a debt obligation discuss the tax implications with their advisors before consummating the transaction to prevent any unanticipated tax consequences.

Rising interest rates affect estate planning strategies and valuations

Audrey Young, Director, Washington National Tax

Interest rate hikes affect wealth transfer strategies differently. Certain types of irrevocable trusts are highly sensitive to interest rates and are particularly advantageous when established in periods of low interest rates. Other types of trust planning benefit from higher interest rates. For example, grantor retained annuity trusts (GRATs) and charitable lead annuity trusts (CLATs) are successful when the pretax return on the assets placed in the trust exceeds the IRS' assumed rate of return. When interest rates are higher, the trust assets have to grow more in order for value to be passed to the trust beneficiaries free of gift and estate tax. The Internal Revenue Code permits the grantor of a CLAT to either choose the interest rate in effect on the valuation date or to "look back" and utilize the rate in effect in either of the preceding two months. Qualified personal residence trusts, where the grantor contributes his or her personal residence or vacation home and retains the right to live in the home for a term of years, also benefit from rate increases because as rates rise, the remainder interest (the taxable gift portion) decreases in value relative to the retained interest. Though also interest-rate sensitive, intrafamily loans generally can carry lower interest rates than those utilized in establishing GRATs.

IRS extends transition guidance for method changes

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In January 2015, the IRS issued new guidance to change the way taxpayers receive permission from the IRS to change an accounting method. In that guidance, the

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IRS provided calendar-year taxpayers with the option to continue to use prior guidance from 2011 when seeking automatic consent changes for the 2014 tax year. The IRS recently issued additional guidance that gives fiscal-year taxpayers with tax years beginning before Jan. 1, 2015, that same opportunity for the 2014 tax year. While the January 2015 guidance makes it easier to obtain automatic consent to change a method of accounting, it also changes the way the IRS grants audit protection when taxpayers are under examination by the IRS. It may not be as advantageous to file for certain method changes (for example, adopting the tangible property regulations) under the January 2015 guidance when under exam. All calendar- and fiscal-year taxpayers should work with their tax advisors to ensure that the appropriate and most optimal procedures are selected when filing a method change for the 2014 tax year.

IRS launches a collaborative effort to combat identity theft refund fraud

Patti Burquest, Principal, Washington National Tax
Bob Adams, Partner, Washington National Tax

In June, the IRS Commissioner announced a public-private "partnership" between the IRS, state tax administrators, tax preparation and software firms, and payroll, tax and financial product processors to combat identity theft refund fraud and enhance taxpayer protections. The members of the partnership have agreed to implement several new initiatives, including:

- **Taxpayer authentication.** Data elements such as Internet protocol numbers, computer device identification data, and metadata will be shared between the return "originators," the IRS and the states.
- **Fraud identification.** A post-return filing review process will be implemented to identify fraud leads and trends based on aggregated data from filed returns.
- **Information assessment.** The group will look at establishing a formalized Refund Fraud Information Sharing and Assessment Center to more aggressively and efficiently share information to stop the proliferation of fraud schemes with the help of law enforcement.
- **Cybersecurity framework.** All participants agreed to adopt the National Institute of Standards and Technology (NIST) cybersecurity framework for IT infrastructure. The IRS and the states (and many in the tax industry) currently operate under the NIST framework.
- **Taxpayer awareness and communication.** All parties will focus on improving outreach efforts to inform taxpayers and raise awareness about the protection of sensitive personal, tax and financial data to prevent fraud and identity theft.

Many system and process changes will be made this summer and fall to ensure readiness for the 2016 filing season.

INTERNATIONAL

FATCA and foreign financial account reporting to face constitutional challenge

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A law suit is expected to be filed in U.S. District Court challenging the constitutionality of the U.S. Foreign Account Tax Compliance Act (FATCA) and the requirement to disclose ownership of foreign financial accounts under the Bank Secrecy Act. Expected plaintiffs include U.S. Senator and 2016 presidential candidate Rand Paul of

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Kentucky and several U.S. expatriates. The lead attorney will be Jim Bopp, who previously led the successful effort to strike down the Bipartisan Campaign Reform Act of 2002 (the McCain–Feingold Act). The case will primarily focus on the way the Treasury has enacted FATCA through the use of intergovernmental agreements (IGAs), and plaintiffs will likely claim that IGAs are a violation of the Senate's treaty powers. FATCA and foreign financial account reporting will also be challenged as a violation of the Fourth Amendment right to privacy. While the case will unlikely result in significant changes, the filing of such a case serves as a reminder of the need for international tax reform, which Congress continues to debate. While FATCA and foreign financial account reporting will continue for the foreseeable future, taxpayers with international activities should monitor potential legislative and judicial developments in the international tax arena.

Final inversion regulations retain bright-line test

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In June, the IRS and Treasury released final regulations governing corporate inversions. The final regulations are substantially similar to the temporary and proposed rules originally published in 2012 and include the rigorous bright-line "substantial business activities" test that a business group must satisfy in order to avoid the U.S. anti-inversion rules. Under the substantial business activities test, a multinational corporation may avoid the anti-inversion rules if the expanded affiliated group (EAG) to which it belongs has at least 25 percent of its employees, compensation, assets and income in the foreign country of the new foreign parent. The 25 percent threshold has been controversial among taxpayers because the standard could make it difficult for multinational corporations to rely on the substantial business activity exception, especially when companies invert to a jurisdiction where the EAG conducts no significant business activity. These regulations affirm that companies that wish to invert should consider inverting to a country where they conduct significant activity. Taxpayers contemplating an inversion should carefully consider the plethora of tax, legal and financial reporting concerns before doing so.

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