Tax Digest

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

July 2016

FEDERAL

Plan sponsors must pay health plan fee by July 31, 2016

Jill Harris, Director, Washington National Tax

The Patient-Centered Outcomes Research Institute (PCORI) fee on health plans for plan years ending in 2015 is due by July 31, 2016. The plan sponsor must pay the fee if the health plan is self-insured, whereas the insurance company pays the fee for insured plans. The fee applies to all types of employers, including tax-exempt organizations and governmental entities. Most health plans, including major medical, prescription drug and retiree-only plans, are subject to the PCORI fee regardless of the number of plan participants. Special rules apply to health reimbursement accounts (HRAs) and health flexible spending accounts (FSAs). The fee is based on the average number of employees, spouses and dependents covered by the plan and is up to $2.17 per covered person. PCORI fees are reported on Form 720, *Quarterly Federal Excise Tax Return*, which must be filed each year by July 31.

Grantor's death can compromise S corporation's status

Scott Ruby, Senior Director, Raleigh, North Carolina

For estate tax purposes, individuals often establish living or 'grantor' trusts to hold their assets. Although the assets are held in trust, the grantor is typically treated as the owner of the assets for income tax purposes. In the case of S corporation shareholders, individuals who transfer their S corporation shares into a living trust will still be treated as the owner of the shares and, therefore, not compromise the corporation's subchapter S status. Once the grantor dies, however, issues often arise. At that point, the trust generally becomes irrevocable, but will remain an eligible shareholder—but only for two years after the decedent's death. The trust administrator must act within that two-year window to ensure the corporation's status is not compromised, often by making either a qualified subchapter S trust or electing small business trust election for the trust. If these steps are not taken, the S corporation status may be terminated. Especially in the case of a living trust, it is possible that an S corporation may be unaware of the death of the grantor, as the legal title to the shares is often unchanged. In addition, the individual administering the estate may not be aware of these important S corporation rules. As a result, it is vital that S corporations monitor changes in the legal title to their shares and remain aware of events that could change the identity of a deemed shareholder for income tax purposes, such as in the case of the death of the grantor of a living trust.

Potential tax traps for employees who become partners

Jennifer Kalla, Partner, Minneapolis, Minnesota

Recently proposed regulations have renewed discussions regarding the IRS position that a partner in a partnership cannot also be an employee of that partnership. While some question the validity of that view, if it is deemed to be correct, a partner receiving fixed payments as compensation for services must treat them as guaranteed payments reported on Schedule K-1 and not as a salary reported on Form W-2. If an existing employee's wages are converted into partner guaranteed payments, more will change than the tax forms. The partners receiving such a payment may seek an increase in gross compensation to make up for the fact that they will now be responsible for a greater share of their Social Security taxes under the self-employment tax rules. In addition, there will be changes to the tax treatment of certain fringe benefits. For example, a partner who is eligible to participate in a spouse's health care plan, but chooses not to, will likely not qualify for the deduction for self-employed health insurance premium deductions and will also not enjoy the ability to receive tax-free health insurance from the partnership. Before making any changes, employers should consider discussing the tax and other consequences with their workers.

How research tax credits are limited for partners and S corporation shareholders

Tom Windram, Partner, Washington National Tax

When determining the extent to which a shareholder in an S corporation or a partner in a partnership may benefit from the tax credit for qualified research activities performed by the pass-through entity, it is important to understand the special rule that applies to the pass-through of the research tax credit. This rule limits the credit to the portion of tax that would apply to the individual owner's taxable income that is derived from that person's interest in the business entity that performed the research and generated the tax credit. For example, assume Shareholder 1 has a 20 percent interest in S Corporation A and is taxed at the top marginal tax rate of 39.6 percent on income from the S corporation. The S Corporation A computes a research tax credit of $100,000 and passes through a credit of $20,000 on Shareholder 1's Form K-1. S Corporation A also passes through $40,000 of taxable income to Shareholder 1. The research tax credit limitation for Shareholder 1 is then computed as $40,000 of taxable income multiplied by the marginal tax rate of 39.6 percent to compute a limitation of $15,840. Any credit in excess of the limitation cannot be used in the current year but may be carried back one year or carried forward for 20 years until it is fully utilized. In the example above, the $20,000 total credit minus the $15,840 utilized credit would result in a $4,160 credit carryback or carryforward.

Proposed regulations could affect subchapter S status

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Corporate inversions and the related erosion of the domestic tax basis have been hot topics recently. In an attempt to address the issue, the Treasury released proposed regulations that would, in certain circumstances, give the IRS the ability to recast related-party debt as equity (or as part debt and part equity). Although these rules are meant to address inversions, they could have serious implications for S corporations that have borrowed money from related parties, even if the S corporation has no international activity. Consider a situation where an S corporation borrows money from a related S corporation. If any portion of the loan were recast as equity, the borrower's subchapter S status would be jeopardized because it would then have an ineligible shareholder and likely a second class of stock. In the case of large S corporations, these proposed regulations would require extensive recordkeeping to avoid reclassification. But even for smaller S corporations, these proposed rules would give the IRS the ability to recharacterize debt without regard to whether the entity has any international operations. This proposal has caused significant angst within the S corporation community. Fortunately, recent indications from the Treasury suggest the regulations may not be finalized until later this year because of a desire to take some of these concerns into account, including the issues related to S corporations. As these regulations take final form, S corporations will need to assess whether any related-party debt could be impacted and possibly restructure that debt accordingly to avoid putting the entity's S election at risk.

Look for upcoming 'hot dog stand' guidance on corporate spin-offs

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Completing a tax-free spin-off provides significant tax advantages. In a spin-off, a corporation distributes stock of a subsidiary to its shareholders. To qualify for tax-free treatment, the distributing corporation and the spin-off corporation both must conduct an active trade or business. (Numerous other requirements must be met, too.) Recently, the question of whether the active trade or business must be valuable in relation to the corporation's other assets has been the topic of numerous discussions. For example, what if the spin-off corporation actively operates a "hot dog stand" business worth $10,000 and also has passive assets worth $1 million? In a recent meeting, a Treasury official mentioned that the government is planning to address the hot dog stand issue in an upcoming spin-off guidance. The approach the government will take in this guidance is not yet known. Corporations should discuss future spin-off plans with their tax advisors to address the tax treatment and be aware that changes to the tax law may be in the works.

Controlling shareholder is liable as a transferee for corporate level tax

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The U.S. Court of Appeals for the 11th Circuit recently affirmed the Tax Court's decision to hold a controlling shareholder liable for the unpaid corporate-level taxes of the company he sold. The case involved a tax shelter (Midco) transaction designed to eliminate corporate-level tax on the company's sale of its assets. The IRS examined the corporation and ultimately assessed tax, penalties and interest on the sale. The Midco transaction was structured to allow the buyer to get a fair market value basis for the assets purchased and allow the selling corporation to escape tax on the sale and incur no reduction in the proceeds distributed to the controlling shareholder for any corporate-level tax resulting from the sale. The facts of the transaction are complex and involve the use of an intermediary to shelter gain on the sale of the assets by transferring distressed debt to the selling company, creating losses that absorbed the built-in gain on the asset sale. The transaction and post-sale distribution of the proceeds rendered the company insolvent. The Tax Court found, and the Court of Appeals confirmed, that the IRS could collect from the controlling shareholder (transferee) based on the applicable state law that recognized the transfers as fraudulent. Taxpayers who are contemplating similar transactions should be aware of potential exposure as transferees if the sale of assets, followed by a distribution of the proceeds, renders the company insolvent and unable to pay its tax liability.

IRS addresses deferred revenue treatment in taxable stock acquisition

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In situations where the target is deferring revenue, a taxable stock acquisition may create an inconsistency between the total amount of revenue recognized under generally accepted accounting principles (GAAP) and the amount of revenue recognized for income tax purposes. In general, for income tax purposes, a corporation may be eligible to defer the recognition of an advance payment for one year, provided the corporation is deferring the revenue in its audited financial statements. If the stock of the corporation is acquired pursuant to a taxable stock acquisition, GAAP will generally require the deferred revenue liability to be written down to the fair value of the future performance obligation. The write-down of deferred revenue for GAAP is not controlling for tax purposes, and the full amount of the advance payment must be recognized. For example, assume that in 2015, a corporation receives $120 as an advance payment. On its audited financial statements, the corporation will recognize $40 of revenues in 2015, $60 in 2016, and $20 for 2017. During 2015, the corporation is acquired, creating a short taxable year. As of that date, the corporation recognized only $20 of the revenue in its audited financial statements. For GAAP purposes, if the fair value of the future performance obligation was determined to be $10, the opening balance sheet at the date of the acquisition would only reflect $10 of deferred revenue. The remaining $90 will never be recognized for GAAP. For income tax purposes, the full amount of the remaining deferred revenue ($100) is recognized in full during the short taxable year created upon acquisition. Recently released guidance confirms the IRS' view that a taxpayer is not able to escape the recognition of revenue through a transaction or change in fair market value for GAAP purposes, and buyers should be aware of the potential tax consequences when deferred revenue is acquired in such a situation.

Tax Digest

INTERNATIONAL

Global survey reveals BEPS middle-market impact

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RSM and Euromoney Institutional Investor recently conducted a global survey regarding the Base Erosion and Profit Shifting (BEPS) Project. The BEPS Project will undoubtedly result in the most significant changes in international taxation in decades. The survey gathered feedback from multinational organizations (with a heavy focus on the middle market) around the perceived risks and sentiments regarding BEPS. Based on over 500 detailed responses from leaders at multinational enterprises on how they expect BEPS to affect their organizations, the survey found that the BEPS Project will have direct and significant consequences for middle-market companies. Over half of the respondents indicated that BEPS will result in increased compliance costs and global effective tax rates. Over 70 percent of respondents indicated that BEPS is creating considerable strategic uncertainty, and over 40 percent of respondents anticipate a significant restructuring or complete overhaul of their group structure.

Multinationals with Indian or Singapore investments should evaluate whether to change investment structures

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India and Mauritius recently announced a protocol to amend their tax treaty to restore India's right to tax capital gains. Many multinational entities have traditionally chosen to invest through a Mauritius intermediary in order to obtain the favorable capital gains treatment available under the treaty. Other jurisdictions, such as Singapore, Cyprus, Luxembourg and the Netherlands, have also served as tax-friendly jurisdictions for investments into India. However, the protocol ends this favorable treatment, and capital gains arising from the sale of shares of an Indian resident company acquired after April 1, 2017, will be taxed by India. Investors who acquired shares before April 1, 2017, will not be taxed by the Indian authorities, and capital gains will be taxed at a concessional tax rate during a two-year transitional phase. The protocol also introduced a limitation on benefits clause, requiring substance in Mauritius in order to take advantage of the treaty benefits, and a new 7.5 percent withholding tax on interest income arising from India. Pursuant to the Indian government's focus on anti-avoidance and the worldwide focus on base erosion and profit shifting, the Indian government has already commenced negotiations with Cyprus and the Netherlands to amend the existing tax treaties and protect its tax base. Amendments to these treaties are expected to be consistent with the amendments to the India-Mauritius treaty. The protocol will affect investments made through Singapore because the favorable capital gains treatment available under the India-Singapore tax treaty is available only while such benefits are available under the India-Mauritius treaty. Multinationals with Indian or Singapore investments should evaluate whether to change their investment structures.

STATE AND LOCAL

Oklahoma eliminates 'double' state and local tax deduction

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On May 25, 2016, Oklahoma Gov. Mary Fallin signed a bill requiring an addback of state and local income taxes deducted on the federal return for personal income tax purposes, effective for tax years beginning on or after Jan. 1, 2016. The amount of the addback is limited to the amount deducted on the federal return. Oklahoma was one of a few states that allowed taxpayers who itemized their deductions to essentially deduct their state and local taxes on their state tax returns. According to the Oklahoma Tax Commission, the addback is projected to increase state income tax collections by over $97 million. Taxpayers should be cognizant of the new addback when completing their 2016 state returns.

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