Tax Digest

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

June 2014

FEDERAL

IRS study of employment tax returns identifies risk areas for employers – Part II

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Continuing the series on employment tax risk areas identified by the IRS' National Research Program (NRP), this article focuses on tip reporting and employee fringe benefit reporting, both of which find themselves atop the NRP's results. Tip reporting is an especially risky area for small and midsize businesses, which are often unaware of the differences between a tip (potentially eligible for an employment tax credit) and a service charge (includable in wages and subject to withholding) for tax purposes. A payment is considered a tip if the following conditions apply: (1) the payment is free from compulsion, (2) the customer must have an unrestricted right to determine the amount of the payment, (3) the payment is non-negotiable and not dictated by an employer policy and (4) the customer has control over who receives the payment. This contrasts with service charges, which include auto-gratuities, banquet service charges or additional mandatory charges found on service bills. The widespread misreporting problem of tips versus service charges is substantiated in the NRP results, which show that 48 of 50 sample returns selected in the NRP contained tip reporting errors.

Fringe benefits include cash or noncash compensation provided in addition to or in lieu of regular taxable wages for services provided. In addition to regular employees, independent contractors can be eligible for fringe benefits. These benefits include employee discounts, educational assistance, meals, lodging, transportation, moving expense reimbursements, employer-provided cellphones, and other items. Fringe benefits are fully taxable to the recipient and subject to employment taxes if provided to an employee, with the value being determined as if the employee paid a third party in an arm's length transaction at fair market value. This value may not be the actual cost to the employer or personal value to the employee, according to IRS valuation rules. Many small and midsize businesses reviewed in the NRP failed to properly compute the taxable value of fringe benefits or include such value in the employee's W-2 form or contractor's Form 1099, which indicates the existence of significant underreporting of income and withholding issues. Employers should consult with their payroll consultants and tax advisors to ensure processes are in place to ensure compliance and to identify any areas of tip reporting, service charge and fringe benefit valuation exposure. This series will conclude next month with a discussion of worker classification and the IRS amnesty program for that risk area.

Deferred compensation compliance initiative project

Steve Levin, Director, Washington National Tax

The IRS recently announced it has commenced deferred compensation audits of fewer than 50 taxpayers as part of a limited scope compliance initiative project. The audits are intended to provide information to the

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IRS with regard to employers' practices and compliance with section 409A of the tax code, which governs the taxation of nonqualified deferred compensation. The initiative focuses on fewer than 50 taxpayers that were selected from a universe of existing IRS employment tax audits. The audits are limited to a review of (1) initial deferral elections, (2) subsequent deferral elections and (3) payouts under section 409A and focus only on the taxpayer's 10 highest-paid employees. The IRS is interested in learning how nonqualified plans are satisfying, or not satisfying, the 409A requirements in operation; how employers are handling the affect of 409A failures on their employees (e.g., grossing up employee compensation to cover the adverse 409A taxes); and whether IRS self-correction programs are being utilized. Typically, such IRS initiatives are precursors to larger audit initiatives. Now is the time for employers to review their deferred compensation plans and, when possible, correct errors before the onset of an IRS examination.

Extending the statute of limitations for S corporation returns–implications for shareholders

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Imagine that an S corporation is currently under examination and the IRS agent has asked to extend the statute of limitations (SOL) applicable to the corporation–will this affect the shareholder's individual return? For years beginning after Dec. 31, 1996 (post-TEFRA), the extension of the SOL for an S corporation does not extend the SOL for the shareholder's return. As an example, in a recently closed examination, a taxpayer granted the IRS an extension of the S corporation's 2009 return SOL from Sept. 15, 2013, to Jan. 31, 2014, which was beyond the normal SOL for the shareholder's return (Oct. 15, 2013). The IRS did not ask to also extend the SOL for the shareholder's Form 1040. Subsequent to Oct. 15, 2013, the IRS proposed changes to the S corporation return, which would normally pass through to the shareholder. However, since the shareholder's SOL expired on Oct. 15, 2013, the agent could not assess any additional tax on the shareholder's tax return. This assumes that the adjustment would not result in a substantial omission of items that would extend the normal SOL under section 6501(e). This result is further supported by the Supreme Court's decision in *Bufferd v. Commissioner*, 113 S. Ct. 927. Taxpayers should always be cautious about agreeing to extend the SOL for corporate or shareholder returns and should consult their tax advisors on the implications of an extension.

Plan sponsors must pay health plan fee by July 31, 2014

Jill Harris, Director, Washington National Tax

The patient-centered outcomes research (PCOR) fee on health plans for plan years ending in 2013 is due by July 31, 2014. 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 PCOR fee regardless of the number of plan participants. The fee is based on the average number of employees, spouses and dependents that are covered by the plan, and is up to $2 per covered person. Special rules apply to Health Reimbursement Accounts and Health Flexible Spending Accounts. PCOR fees are reported on Form 720, *Quarterly Federal Excise Tax Return*, which must be filed each year by July 31.

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IRS issues final regulations on miscellaneous itemized deductions of trusts and estates

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Making only minor changes to the 2011 proposed regulations, the IRS last month issued final regulations that govern which trust and estate expenses are subject to the 2 percent floor on miscellaneous itemized deductions. The regulations apply to tax years beginning on or after May 9, 2014. The 2011 proposed regulations were very controversial, and the few modifications made to the final regulations will not quell the practical and policy disagreements directed at the proposed regulations. The most contentious aspect of the final regulations is the requirement that investment advisory fees be unbundled to segregate costs that are "commonly" or "customarily" incurred by an individual from the incremental cost attributable to advice or services that are uniquely tailored to a trust or estate. By 2015, fiduciaries and investment advisors likely will have guidelines for unbundling their fees where a savings to the taxpayer is possible. For larger estates and trusts, these final regulations also impact the calculation of net investment income subject to the 3.8 percent Medicare surtax. The surtax is assessed on the lesser of the trust or estate's undistributed net investment income or the trust or estate's adjusted gross income (AGI) in excess of $12,150 (for 2014), and costs subject to this 2 percent floor likely will not reduce the calculation of AGI. Finally, the final regulations provide that the costs associated with preparing all estate tax returns, fiduciary income tax returns and a decedent's final income tax return are not subject to the 2 percent limitation, but the expense of preparing gift tax returns, which are commonly prepared for individuals, is subject to the 2 percent floor.

IRS continues to scrutinize open transactions

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Under the open transaction doctrine, a transaction is generally treated as ongoing, or "open," until payments exceeding the basis of the transferred property are received. Payments received are first treated as reducing the taxpayer's basis in the transferred property, and gain is not recognized until the payments exceed such basis. Because open transaction treatment delays gain recognition, it is often favorable for taxpayers. However, open transaction treatment is permitted only in rare and extraordinary cases, where the realized value in a transaction cannot be ascertained or reasonably estimated. A recent IRS ruling serves as a reminder that the IRS will scrutinize a taxpayer's use of the open transaction doctrine. In the ruling, the IRS determined that a change from open transaction treatment to realization (or closed) treatment constitutes a change in accounting method, which resulted in an adjustment that could take into account amounts from closed tax years. Taxpayers presently treating one or more transactions as open should consult with their tax advisors to determine whether such treatment is permissible. To the extent this treatment is determined to be impermissible, taxpayers should consider requesting a change in method of accounting to obtain audit protection for prior-year treatment.

Proposed regulations clarify which party receives tax attributes and E&P in asset reorganizations

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Newly proposed regulations provide that the corporation that directly acquires the assets in certain asset reorganizations will retain the tax attributes and earnings and profits (E&P) of the transferring business, regardless of any subsequent transfers of the acquired assets. Presently, an acquiring corporation can either: (1) drop all of the target corporation assets into a subsidiary, where the tax attributes and E&P tag along, or (2) retain the tax attributes and E&P by dropping some, but not all, of the target corporation assets into one or more subsidiaries (tax practitioners have argued that the retention of as little as one dollar by the transferor will cause tax attributes and E&P retention by the transferor). These proposed regulations effectively eliminate this second alternative. The IRS believes the change will yield more appropriate results while preserving simplicity for the taxpayer. Since the proposed regulations directly impact transactions that are influenced by the entity location of tax attributes, taxpayers should consult their tax advisors regarding the effect these proposed regulations may have on present or future dealings.

IRS rules contract manufacturer not subject to MDET under certain circumstances

Tom Windram, Partner, Washington National Tax

The medical device excise tax (MDET) became effective in 2013, and is governed by certain tax rules applicable to the category of "manufacturer's excise taxes." In contract manufacturing arrangements, it is often unclear which party is the true "manufacturer" liable for the MDET. Until now, the most recent IRS guidance on the issue was from 1978; 35 years before the MDET. On May 16, 2014, the IRS issued its first private letter ruling on a medical device manufacturing contract. A private letter ruling only applies to a specific taxpayer and cannot be used as precedent. It is, however, instructive to the likely IRS position in similar contexts. In this case, Company 1 was a contract manufacturer producing a taxable medical device for Company 2. Intellectual property rights related to the device had been transferred from Company 1 to Company 2. Company 2 had complete control over the quantity of the device to be produced by Company 1, and Company 1 could only sell the device to Company 2. The IRS ruled consistent with prior guidance that Company 1 was not the manufacturer, making Company 2 liable for the excise tax on these items.

INTERNATIONAL

Recent PFIC regulations provide limited relief to tax-exempts

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A foreign corporation is a passive foreign investment company (PFIC) if 75 percent or more of its income is "passive," or 50 percent of its assets generate passive income. Owners of PFIC shares typically pay a special tax and deferred interest charge at ordinary income tax rates on the excess distributions or gains from a PFIC. Prior law did not require taxpayers to report their interest in a PFIC to the IRS unless a triggering event occurred (e.g., a disposition of, distribution from or an election made with respect to the PFIC). In addition, tax-exempt organizations were generally exempt from reporting unless income from the PFIC was taxable under the rules that generally apply to tax-exempt entities (e.g., because the PFIC shares were held in connection with an unrelated trade or business or the PFIC shares were debt-financed). However, for tax years ending after Dec. 31, 2013, Treasury regulations now generally require taxpayers to disclose their interest in a PFIC, even if no triggering event occurs. Current regulations contain a limited exemption for specifically listed tax-exempt organizations. Beginning in tax years ending after Dec. 31, 2013, all other persons must report ownership in a PFIC on Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*, unless another exemption applies, even if no reporting was required in prior years. Moreover, taxpayers must report each PFIC on a separate Form 8621 because the regulations do not permit consolidated filings, which could add significant burden and cost to the tax return preparation process.

A certificate of residency may help avoid foreign withholding tax

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Many U.S. companies receive payments from foreign customers, and some of these payments may be subject to withholding tax in the customer's foreign jurisdiction. To mitigate potential double taxation, U.S. taxpayers may be able to claim a foreign tax credit for any withholding tax collected on payments from non-U.S. customers. Additionally, under the provisions of various U.S. income tax treaties, a U.S. taxpayer can often have the foreign customer eliminate or reduce the withholding tax by providing the customer with an official certificate of U.S. residence from the IRS. Generally speaking, U.S. corporations can easily obtain such a certificate by certifying that the corporation is a U.S. resident taxpayer. However, because a U.S. partnership is not a taxpayer, it must obtain a certificate of residence with respect to each of its partners. While the partnership may initiate a request for a certificate of residence, it must obtain the consent of each of its partners, and each partner must certify that they are a U.S. resident. If there are many partners, it may take a significant amount of time to obtain the certificate of residence. In order to avoid foreign withholding tax and potential delays in customer payment, U.S. taxpayers (especially U.S. partnerships) should consider obtaining a U.S. certificate of residence in advance. Taxpayers must obtain a new certificate for every tax year, and many countries require country-specific certificates from the IRS. Obtaining appropriate residency certificates may help improve cash flow and minimize exposure to double taxation.

IRS provides FATCA relief to US withholding agents

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Beginning July 1, 2014, the Foreign Account Taxpayer Compliance Act (FATCA) generally requires U.S. withholding agents (including U.S. nonfinancial businesses) to withhold 30 percent of the gross amount of certain U.S.-source payments made to foreign persons unless an exemption applies. However, under Treasury regulations, U.S. withholding agents must begin withholding on July 1, 2016, on payments made on "pre-existing" accounts, which are accounts established prior to July 1, 2014. Further, the regulations require withholding to begin immediately on accounts established on or after July 1, 2014. Many taxpayers complained that these deadlines created substantial compliance burdens because the IRS was late in releasing the forms taxpayers must use to comply with FATCA. As a result, the IRS announced in a recent notice that withholding agents may treat entity accounts opened on or after July 1, 2014, but before Jan. 1, 2015, as pre-existing accounts and that no withholding is required on such accounts prior to Jan. 1, 2015. This notice provides significant relief to taxpayers that have not yet developed new onboarding procedures for non-U.S. customers and related entities that would otherwise be subject to FATCA withholding. This notice also provides U.S. withholding agents transitional relief for calendar years 2014 and 2015 (relief also applies to foreign financial institutions and nonfinancial foreign entities). During these years, the IRS will take into account the reasonable efforts of U.S. withholding agents to modify their account opening practices and procedures to conform to FATCA. While taxpayers should welcome a relaxed enforcement approach, it is not clear what the IRS considers a "reasonable effort" to comply. To minimize potential exposure, taxpayers should develop and implement a FATCA compliance strategy as soon as practicable.

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STATE & LOCAL

Pay close attention to state electronic payment rules

Pat Carney, Director, Los Angeles

Most states require businesses that reach certain filing, income or liability thresholds to pay one or more taxes via electronic payment. In general, electronic payments are simple and convenient. However, there are hidden pitfalls that can hit taxpayers in the wallet, particularly in relation to timing and due dates. For example, on May 12, 2014, the California State Board of Equalization released a quick reference guide that discusses when automated clearing house (ACH) debit payments, third-party vendor electronic funds transfer (EFT) payments, and ACH credit payments must be executed for the payment to be considered timely. The guide provides that, to be considered timely, electronic payments must settle into the state's bank account one banking day following the due date. To do so, (1) ACH debit payments must be executed by 3 p.m. Pacific time, on the due date; (2) third-party vendor EFT payments must be executed by 3 p.m. Pacific time, on the due date, and next-day processing must be selected; and (3) ACH credit payments must be initiated with a financial institution according to the financial institution's initiation-to-settlement schedules, which may require initiation one or more days before the due date. Taxpayers should review their method of payment and the timelines and due dates involved in each state in which they are required to make electronic payments. Failure to meet settlement deadlines, which can differ from due dates and often have strict time cutoffs, may result in the imposition of interest and penalties.

Personal liability for business taxes… another brick in the wall

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States continue to focus on rules allowing the taxing authorities to levy against the personal assets of individuals deemed to be responsible parties for businesses that are unable to pay their entity-level taxes. As the current legislative session draws to a close, legislation broadening the applicability of these rules has been bubbling to the surface. For example, on May 12, 2014, Oklahoma enacted SB 1228, which substantially broadened the state's ability to hold individuals personally liable for entity-level unpaid sales taxes, withheld income taxes and motor fuel taxes collected, but not remitted. Under prior law, personal liability could apply to the principal officers of a corporation or the tax matters member or manager responsible for taxes of a limited liability company. The new law both expands the list of entities to which personal liability can apply and extends personal liability to any individual responsible for withholding or collection and remittance of taxes or with direct control, supervision or responsibility for filing returns and making payments of the tax due the state of Oklahoma. This type of expansion in the classes of individuals who could be at risk has become a rising trend. Potential responsible parties should pay close attention to the state taxing authorities' continued aggressiveness in this area, particularly since these rules apply without having to pierce the corporate veil.

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