Tax Digest

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

June 2016

FEDERAL

Pension maximization—aka 'pension max'

Charlie Ratner, Senior Director, Washington National Tax

Assume Sue is a corporate executive who plans to retire in a few years. She will be entitled to a pension of $150,000 a year for life on a 50 percent joint and survivor basis (i.e., if she predeceases her husband, Sam, he will get $75,000 for the rest of his life). However, if (with Sam's consent) Sue takes a single-life pension, her annual benefit will be $165,000, though Sam will get nothing if Sue predeceases him. A life insurance agent proposes a strategy called 'pension max,' in which Sue would take the single-life benefit and buy enough insurance for Sam to invest or buy an annuity to 'replicate' the $75,000 survivor benefit. Sue and Sam are intrigued but realize there are issues. For example, because it could be years before Sam has to invest the proceeds or buy an annuity, there is no way to know today how much he would need to securely fund the survivor benefit (i.e., any amount of coverage projected as adequate today is inherently a guesstimate). Meanwhile, the premium for the insurance should be sufficiently less than the after-tax difference between the single and joint life pensions to justify the strategy in the first place. One way to reduce the cost of the insurance would be to combine some term insurance with some permanent insurance to track the amount and duration of the need. And of course, Sam needs to consider the implications of a divorce after Sue retires or Sue's outliving the insurance company. Is pension max worth the risk at the end of the day? Maybe, but since a do-over here would not be in the cards, Sam should think long and hard before signing that consent form.

Tax treatment of a simple agreement for future equity is not a lock

Stefan Gottschalk, Senior Director, Washington National Tax

Developed in 2013, a startup-friendly funding mechanism called the simple agreement for future equity (SAFE) was conceived as a substitute for convertible debt. Many investors have purchased SAFE interests in startups. Because a SAFE's features differ from those of more traditional debt and equity interests, the tax treatment of a SAFE may be unclear. A SAFE typically is not debt under state law because it lacks both a maturity date and an interest rate. A SAFE typically converts automatically to stock (or other equity) during the company's next equity financing. Conversion can also occur upon sale of the company. If there is no sale or equity round, the SAFE holder typically has no rights to payment except a liquidation preference for its original investment amount. Like warrants and convertible debt, most SAFEs clearly are derivatives of the company's equity. Like debt or preferred stock, however, they may also carry repayment rights. Answering the question of whether a SAFE should be treated as debt, equity or an equity derivative for tax purposes involves weighing these legal rights in the context of the specific facts and circumstances. Because the SAFE's tax characterization may affect the tax treatment of transactions such as fundraisings, sales and business combinations, companies and investors should consult with their tax advisors about their SAFE arrangements.

Employer action advised on new health insurance notices

Jill Harris, Director, Washington National Tax

Due to the Affordable Care Act (ACA), employers with at least 50 full-time or full-time equivalent employees can be penalized by the IRS if they fail to offer ACA-compliant health coverage and their employees obtain coverage with

Choi, Kim & Park, LLP
CERTIFIED PUBLIC ACCOUNTANTS & CONSULTANTS

An Independently Owned Member
McGLADREY ALLIANCE
McGladrey

tax subsidies through the Health Insurance Marketplace (also known as the exchange). When employees enroll in marketplace coverage, they are asked whether they were offered ACA-compliant health coverage by their employers. The employee's response to this query could trigger a penalty for the employer. So how will an employer know whether an employee is receiving marketplace coverage? Starting in 2016, the marketplace will mail an employer a notice indicating that a given employee is receiving tax subsidies for health insurance and that the employer may be subject to a penalty. The notice will contain details about how the employer can appeal the determination. An employer has 90 days to respond and can include evidence in the appeal that it offered the employee ACA-compliant coverage. An appeal judge may request a hearing or additional documentation prior to making a decision on the appeal. Since the penalty exposure could be over $2,000 for each full-time employee, employers should promptly review and respond to marketplace notices. For further details about this ACA penalty on employers, see this article.

Gasoline gallon equivalents for alternative fuel tax credits

Trina Pinneau, Supervisor, Washington National Tax
Tom Windram, Partner, Washington National Tax

The credit for alternative fuels is the product of the credit rate, currently $0.50 per gasoline gallon, multiplied by the amount of fuel sold or used by a taxpayer. At first blush, this may appear to be a straight-forward calculation. However, the amount of fuel sold is based on the gasoline gallon equivalent of the alternative fuel sold. Alternative fuels generally require more gallons of fuel to equal the amount of energy contained in one gallon of gasoline. Therefore, in order to compute the tax or credit on alternative fuels, a gasoline gallon equivalent (GGE) is needed. The GGE varies depending upon what type of alternative fuel is used. For liquefied petroleum gas (LPG or propane), the GGE is 1.353 gallons, meaning it takes 1.353 gallons of propane to equal the energy in one gallon of gasoline. Liquefied natural gas (LNG) has a GGE of 1.71. In order to calculate the credit, an alternative fueler must first find the GGE for the total amount of alternative fuel used by dividing the gallons of alternative fuel used by the GGE for one gallon. That amount is then multiplied by $0.50 to find the amount of the credit. Taxpayers should consult an excise tax specialist for assistance with the alternative fuel computation or to discuss GGEs for other alternative fuels.

Deductibility of accrued customer rewards

Ryan Corcoran, Manager, Washington National Tax
Christian Wood, Principal, Washington National Tax

A U.S. Court of Appeals decision recently overturned the Tax Court's determination regarding the deductibility of the estimated future cost of fuel discounts earned by its customers as part of a customer reward program. The original Tax Court ruling denied a taxpayer's ability to deduct accrued customer rewards until the customer redeemed the rewards. The Court of Appeals reversed this decision, and this reversal could be very beneficial for taxpayers. Although the case focused only on a specific program, the conclusion and its underlying principles could potentially apply to a wide variety of customer reward programs. The crux of the determination was whether the taxpayer's liability for the customer reward program was fixed. The Court of Appeals concluded that the taxpayer formed a unilateral contract with its customers during the purchase of groceries. This contract provided customers future discounts on fuel if they purchased groceries. As unilateral contracts only require one party to make a promise in exchange for performance, the purchase of groceries fixed the reward liability for the taxpayer. Based on this appeals court decision, taxpayers should now be able to match the costs of providing future fuel discounts in the same tax year the associated grocery revenues are recognized. Taxpayers that wish to revisit the tax treatment of their reward programs in light of this decision should contact their tax advisors.

INTERNATIONAL

International impact of the proposed debt-equity regulations

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

Controversial proposed regulations allowing the IRS to recast certain related-party debt as equity may cause unintended international tax consequences. Although the new rules were intended to limit certain tax planning techniques involving related-party financing arrangements, the reclassification of debt into equity required by the new rules could have significant adverse tax consequences. For example, reclassifying foreign-issued debt as equity could affect the availability of foreign tax credits and withholding tax exemptions and could result in the current taxation of certain types of income otherwise not currently taxable. Additionally, in some situations, a mere distribution of previously taxed foreign income could trigger unfavorable consequences under the new rules. The new rules could encourage leveraged buyouts of U.S. companies by foreign groups because foreign acquirers would be able to finance acquisitions with higher debt loads than any potential U.S.-based buyer. The proposed regulations had a general effective date of April 4, 2016, but certain documentation requirements would generally not be effective until final regulations are issued. While the Treasury continues to take comments on the proposed regulations, it has indicated the intent to finalize the new rules as soon as possible. In light of the numerous concerns raised by the public, it is unlikely the regulations will fully address the issues raised if they are finalized in short order. Multinationals with intercompany debt should evaluate the potential impact the proposed regulations may have on their business operations. For more details, see our article, IRS issues guidance on inversions and earnings stripping.

New proposed reporting requirements for foreign-owned DREs

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

Newly announced proposed regulations would impose foreign information reporting requirements on domestic disregarded entities (DREs) wholly owned by a foreign person. Under the new rules, a domestic DRE wholly owned by a foreign person would be treated as a domestic corporation separate from its owner. Therefore, such entities would be required to file IRS Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*, when engaged in certain related-party reportable transactions. This requirement does not exist under current law and would result in a new filing requirement for a variety of taxpayers. In particular, Mexican- and Canadian-based groups with U.S. DREs, such as U.S. limited liability companies (LLCs), would likely need to complete these forms though they had no filing requirement before. The proposed regulations are generally expected to be effective for taxpayers with tax years ending on or after the date falling one year after final regulations are issued. In order to comply with the new rules, DREs would first need to obtain a U.S. employer identification number. Should the proposed regulations be adopted, foreign-based multinationals operating in the United States through single member LLCs or other DREs should expect an additional and potentially costly compliance burden.

STATE AND LOCAL

Colorado department clarifies treatment of electronically delivered software and maintenance agreements

Mo Bell-Jacobs, Manager, Washington National Tax
Steve Riddle, Principal, Denver, Colorado

On May 18, 2016, the Colorado Department of Revenue released a general information letter dated Jan. 12, 2016, addressing a taxpayer's request for state guidance on whether purchases of electronically downloaded software updates and software maintenance agreements are subject to sales and use tax when those purchases relate to software purchased before July 1, 2012. Prior to July 1, 2012, Colorado law specifically included electronically delivered software in the definition of tangible personal property, generally subjecting those purchases to sales and use tax. Effective July 1, 2012, the law was amended to exclude electronically delivered software from the tax by modifying the definition of tangible personal property. In the general information letter, the department concluded that electronically delivered updates and maintenance agreements purchased after July 1, 2012, are not subject to tax, regardless of whether those purchases are for software originally taxable before July 1, 2012. The department's conclusion should clarify the treatment of software updates and maintenance agreements purchased after July 1, 2012. Taxpayers should also consider reviewing their purchases of software updates and long-term maintenance agreements that may relate to software originally purchased before July 1, 2012, for tax charged in error after July 1, 2012.

Tax Digest

Missouri Supreme Court takes narrow view of grocery exemption

Chris Baltimore, Director, Kansas City, Missouri

On May 3, 2016, the Missouri Supreme Court issued its decision in *Krispy Kreme Doughnut Corp. v. Dir. of Revenue*, holding that doughnuts and other food items sold at Krispy Kreme stores did not qualify for the lower sales tax rate applicable under RSMO section 144.014 to retail sales of groceries, because the weight of the evidence indicated that more than 80 percent of the gross receipts of Krispy Kreme stores were derived from the sale of food prepared for immediate consumption. Missouri and many other states provide reduced sales tax rates and exemptions for groceries that are not intended to apply to prepared food sold in restaurants and similar establishments, and a wide variety of definitions and thresholds are used to distinguish between the two. However, as the prepared food and grocery sales activities of both restaurants and traditional grocery stores have blurred together, the nuances of these reduced rate and exemption provisions have become the focus of significant litigation. Taxpayers engaged in a mix of these activities should review state reduced rate and exemption provisions to determine whether, and to what extent, they apply.

Tennessee court disallows retailer's bad debt deduction for third-party write-offs

Mo Bell-Jacobs, Manager, Washington National Tax
Jon Miller, Senior Manager, Charlotte, North Carolina

On May 11, 2016, the Tennessee Court of Appeals issued a decision holding that a retailer could not receive bad debt deductions for a third-party credit card provider's bad debt write-offs. In 2003, the taxpayer outsourced its private label credit cards to a third-party bank operating under an agreement where the bank would compensate the taxpayer for customer card purchases, including the applicable sales tax. If a customer subsequently defaulted on their credit card debts, the bank became responsible for the losses, writing them off as bad debts on the bank's federal income tax returns. In 2005, the taxpayer began deducting the bank's write-offs on its own sales tax returns. On appeal, the taxpayer argued that it was entitled to the deduction because the statute did not specifically require the party taking the deduction to be the party that wrote off the debt. The court disagreed with that interpretation, emphasizing that the taxpayer was fully compensated for the tax by the bank and had no obligation to reimburse the bank for bad debts. The court additionally found the taxpayer ineligible for the deduction under a revised version of the statute permitting the deduction for debt written off by a 'claimant,' or a group or combination acting as a unit. Taxpayers in arrangements with third-party credit card providers should review their eligibility for the bad debt deduction and determine whether the deduction is appropriate.

Texas comptroller denies COGS deduction for technology service provider

Mo Bell-Jacobs, Manager, Washington National Tax
Mike Williams, Partner, Dallas, Texas

On May 17, 2016, the Texas Comptroller of Public Accounts released a decision denying the costs of goods sold (COGS) deduction for costs incurred by a taxpayer in the business of information technology consulting services because the taxpayer did not demonstrate it was entitled to the deduction. The taxpayer entered into service agreements with a company to provide contract workers for various technology services to that company's customers. The services were charged based on approved time entries. The taxpayer also agreed to terms allowing the customer companies to have exclusive, unlimited ownership rights to all results of any services performed by the contract workers, including any and all types of intellectual property rights, software and computer programs. Additional agreements were submitted as evidence under review, but were executed outside the periods at issue. Significant to the decision was the fact it was not clear whether the taxpayer was selling software and that the taxpayer agreements indicated that the customers maintained exclusive ownership of the software, thus disqualifying the deduction within the meaning of Texas Administrative Code section 3.588(c)(8), which requires that an entity "own the goods" sold. Although the Texas courts have recently expanded the applicability of the COGS deduction, it is not surprising the comptroller took this position considering the evidence submitted. Taxpayers should review their business activities to determine whether a COGS position can be substantiated under audit.

Choi, Kim & Park, LLP

CERTIFIED PUBLIC ACCOUNTANTS & CONSULTANTS

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.

Tax Digest

June 2016

Printed in the U.S.A.

Tax Digest

June 2016