March 2014

Tax Digest

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

FEDERAL

Careful documentation required to support tax positions

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A decision in a recent Tax Court case examined the characterization of gain on the sale of real estate by a limited liability company (LLC) and emphasizes the importance of carefully documenting tax positions. Judicial decisions over the years have established criteria for determining a taxpayer's status as a real estate dealer versus a real estate investor, and that status has implications with respect to the tax treatment of realized gains. In this case, the owners of an LLC took the tax position that the gain from a sale of land included in a planned unit development (PUD) should be characterized as long-term capital gain and not as ordinary, "dealer"-type income. Among other facts, the court noted that the LLC's initial Form 1065 identified the LLC's activity as real estate development and that an affidavit the LLC filed to comply with a county regulation classified the LLC as a subdivision developer. The court agreed with the IRS that these two documents "suggest[ed] that the LLC purchased the PUD to develop the land and sell it to customers"–an indication of dealer status. Stating that the taxpayers had not produced any evidence that indicated a change of intended status from dealer to investor or even produced evidence to show how many sales the LLC made, the court sided with the IRS, finding that the taxpayers had failed to carry the burden of proof in support of their position. This case serves as a good reminder for taxpayers to properly and adequately document the facts related to positions taken on tax returns to ensure sufficient support for the desired tax consequences.

Tax Court disallows ordinary loss on abandonment of securities

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In a recent case, the Tax Court recharacterized a loss on the abandonment of stock as ordinary rather than capital. The case involved a taxpayer's abandonment of corporate stock with a tax basis of approximately $100 million. In an effort to strengthen its financial reporting position, the taxpayer was looking to dispose of its investment. Though offered approximately $20 million for the stock, the taxpayer declined in favor of abandoning the stock, as the tax benefit on an ordinary loss from abandonment was more valuable to the company than the $20 million in potential sales proceeds plus an $80 million capital loss. However, the court disallowed the ordinary loss, claiming the loss on the securities should be capital in nature since the stock represented a right or obligation as to property that constituted a capital asset. Though the taxpayer argued that the relevant law applied only to "rights or obligations with respect to capital assets" and not to directly held capital assets, the court disagreed after analyzing the plain language of the statute and Congressional intent. While many taxpayers and tax practitioners disagree with the court's holding, taxpayers planning to take an ordinary loss on abandonment as opposed to a capital loss on the sale or exchange of property should proceed with caution.

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Tax Digest

S corporation planning using stock redemptions

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An S corporation stock redemption is treated as either a payment in exchange for stock or a distribution. With distribution treatment, the redemption proceeds are distributed to the redeeming shareholder tax-free to the extent of the corporation's accumulated adjustments account (AAA) balance and the taxpayer's stock basis. When exchange treatment applies, regulations require an adjustment to the corporation's AAA based on the ratio of the shares redeemed to the shares outstanding before the redemption. In order for exchange treatment to apply, the redemption must: (1) result in a complete termination of the shareholder's interest, (2) represent a partial liquidation of the corporation, (3) equate to a substantially disproportionate redemption, or (4) be deemed not essentially equivalent to a dividend. Taxpayers have the ability to plan redemptions to suite their AAA options and needs. For example, for taxpayers with sufficient stock basis and corporate AAA, a redemption structured to receive distribution treatment can allow for tax-free ownership transfers from one generation to the next. Or, taxpayers with a negative AAA balance and a goal of increasing AAA to a positive level can ensure exchange treatment in order to achieve an increase in AAA. Due to variances among taxpayer facts and circumstances, potential tax treatments, and the organizational goals of entities and owners, taxpayers considering S corporation stock redemptions should work with their tax advisors to optimally structure the redemptions.

IRS expands the definition of eligible milestone payment

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The IRS's Large Business & International Division recently issued a directive expanding the definition of milestone payments eligible for the success-based fee safe harbor provided in Rev. Proc. 2011-29. The directive provides additional clarity to taxpayers on what portions of their investment banking fees are eligible for the safe harbor's favorable treatment. The directive broadens the definition of a milestone to include "any event, including the passage of time, occurring in the course of a covered transaction. " The directive applies only to nonrefundable milestone payments for investment banking services that are creditable against a success-based fee. The directive effectively upholds a taxpayer's application of the safe-harbor method of Rev. Proc. 2011-29 to such nonrefundable milestone payments and is welcome news for taxpayers that presently have tax returns under exam for years in which the safe-harbor method was applied to eligible milestone payments. Taxpayers currently incurring eligible milestone payments in connection with a covered transaction should discuss with their tax advisors whether they are eligible to apply the safe-harbor method to milestone payments paid or incurred during any taxable year for which a tax return has not yet been filed.

Court provides guidance for buyer's treatment of assumed liabilities

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In *AmerGen Energy Co. v. U.S., 113 Fed. Cl. 52 (2013)*, the Court of Federal Claims ruled that an accrual-method buyer in a taxable asset acquisition could not increase its cost basis by the amount of assumed liabilities until such liabilities vested under a three-pronged timing test applicable to accrual-method taxpayers (referred to as the "all-events" test). The court's holding may affect many buyers in taxable asset acquisitions, and taxpayers that have entered into or will be entering into taxable asset acquisitions should be aware that, under the court's holding, their cost basis in the acquired assets may not reflect assumed liabilities until the liabilities meet the three-pronged all-events test. In light of the court's holding in *AmerGen*, taxpayers should consult with their tax advisors to determine how the timing and vesting of assumed liabilities could affect the calculation of cost basis.

Tax Digest

IRS extends deadline for portability election

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After years of espousing the goal of allowing married couples to pool their applicable exclusion amounts, Congress finally moved in 2010 to create so-called "portability." Portability allows a surviving spouse to use any applicable exclusion amount remaining after accounting for the first spouse's taxable estate. Under current law, the combined exclusion amount for a married couple is now $10,680,000. To take advantage of portability, the executor of the deceased spouse's estate (typically the surviving spouse) must prepare and file a Form 706, even in instances where the estate does not otherwise have a filing requirement under the estate tax rules. A Form 706 requires itemizing and valuing all of the property owned by the decedent at death. For those estates that could have elected portability but failed to file a Form 706, the IRS has extended the deadline for filing a Form 706 and claiming the deceased spouse's unused exemption amount (DSUE) until Dec. 31, 2014. This extension was seemingly driven by two factors. First, portability has dramatically altered estate planning for married couples, and the IRS had previously designated a fairly arbitrary date for automatic extensions of Form 706 deadlines for portability elections and had granted relief to certain taxpayers. In addition, a Supreme Court decision and recent IRS guidance recognized all valid same-sex marriages for federal tax purposes, opening the door to retroactive portability claims. The IRS decided that forcing such surviving spouses to seek relief was unfair and possibly unconstitutional. Taxpayers whose spouses died in 2011, 2012 or 2013 and who have yet to make a portability election should work with their tax advisors to analyze the potential benefits.

Dealing with the IRS — expect delays and added costs

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David Click, Director, Denver, Colo.

Have you received an IRS notice in the mail or tried calling IRS taxpayer assistance with a technical problem? Tax return preparers and tax representatives have been encountering long and irritating delays. Such difficulties will not get better soon, and tax services may end up costing more. Funding problems and constrained resources at the IRS have resulted in significant cuts to IRS services. The recently enacted Consolidated Appropriations Act reduced funding for the IRS by $526 million from last year. The IRS budget over the past several years has been either frozen or reduced, causing significant reductions in enforcement, customer service and training activities. Overall staffing for the IRS has dropped from 95,000 full-time employees in 2010 to 87,000 employees in 2013. According to the IRS Taxpayer Advocate's office, in 2013 only 61 percent of the 109 million telephone calls got answered, and the wait time was more than 17 minutes. In addition, only 53 percent of the more than eight million letters the IRS received in 2013 got answered within established IRS timeframes. For business taxpayers, the reduced IRS budget and resources mean more delays, frustrations and costs. Over the past 10 years, tax filings with the IRS have increased 23 percent while IRS personnel levels have dropped. This means longer wait times in dealing with routine issues at IRS Service Centers and little guidance on complex filing and reporting issues. It appears taxpayers will have to rely more on their tax accountants and other professionals and that dealing with the IRS will be more time-consuming, and costly, for everyone.

IRS releases second component of tangible property transition guidance

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On Feb. 28, 2014, the IRS released the second of two documents providing guidance on adopting the final (and proposed) tangible property regulations. Rev. Proc. 2014-17 provides automatic method change procedures to adopt the re-proposed regulations covering the federal income tax treatment of dispositions of tangible property, as well as the treatment of assets included in one or more general asset accounts. The IRS released the first of these two documents, which provided automatic method change procedures under the final regulations governing the treatment of materials and supplies and costs to acquire, maintain and improve tangible property, on Jan. 24, 2014. Highlights of Rev. Proc. 2014-17 include the ability to treat a late partial disposition election or the revocation of a general asset account election as an automatic accounting method change that may be accomplished through the filing of one or more Forms 3115 during a specified transitional period. As a reminder, the re-proposed disposition regulations may be relied on for tax years beginning on or after Jan. 1, 2012, and before Jan. 1, 2014. We anticipate that the regulations will be finalized with little to no substantive changes in the spring of 2014. Taxpayers should consult with their tax advisors to determine whether any of the method changes provided by Rev. Proc. 2014-17 are advisable for their 2013 tax years.

FinCEN postpones FBAR filing deadline

Bob Adams, Partner, Washington National Tax
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The Financial Crimes Enforcement Network (FinCEN) has announced a further extension of time for the filing of certain Foreign Bank Account Reports (FBARs). Individuals with signature authority over but no financial interest in certain types of accounts, have until June 30, 2015, to file their "signature authority only" FBARs. The additional time will allow FinCEN to add clarity on the exceptions to file FBARs filing requirements for certain individuals with only signature authority over foreign financial accounts. For example, exceptions apply to officers and employees of entities subject to select federal regulations, including financial businesses regulated or overseen by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, the National Credit Union Administration, the Securities and Exchange Commission (SEC), or the Commodity Futures Trading Commission. Another exception is provided for officers or employees of an authorized service provider, defined as a provider of services to investment companies registered with the SEC. FinCEN continues to receive questions regarding signature authority filing requirements for potentially affected individuals due to a lack of clarity in these exceptions.

INTERNATIONAL

New FATCA intergovernmental agreements

Ramon Camacho, Principal, Washington National Tax
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Under the Foreign Account Taxpayer Compliance Act (FATCA), U.S. persons must withhold 30 percent of any payments to a foreign entity unless the entity provides information regarding its U.S. owners or otherwise enters into an information sharing agreement with the IRS. To facilitate compliance with FATCA's information reporting requirements, the U.S. Treasury Department has negotiated agreements (intergovernmental agreements or IGAs) directly with foreign governments under which a foreign entity may disclose account holder information notwithstanding contrary prohibitions under relevant local country privacy laws. Many of these IGAs contain special exemptions and provide relief from many of FATCA's stringent requirements. The United States recently entered into IGAs with Canada, Hungary, Italy and Mauritius and is currently negotiating IGAs with many other countries around the world. FATCA withholding is set to begin on July 1, 2014, and the rules will have a significant impact on both financial institutions and nonfinancial businesses that make payments to foreign entities. U.S. withholding agents that fail to comply will be primarily liable for the 30 percent FATCA withholding tax along with penalties and interest. Taxpayers that conduct business with non-U.S. entities should immediately assess their obligations under FATCA and develop a compliance strategy because, in some cases, taxpayers must register with the IRS by April 25, 2014, in order to avoid FATCA withholding.

IRS releases transfer pricing audit roadmap

Ramon Camacho, Principal, Washington National Tax

The IRS recently issued its long-awaited transfer pricing audit roadmap, providing its examiners with audit techniques and tools to conduct more effective transfer pricing examinations. In recent years, the IRS has focused heavily on transfer pricing, aggressively pursued taxpayers with questionable or poorly documented transfer pricing methodologies, and brought several high-profile court cases against taxpayers. The roadmap codifies the IRS' transfer pricing audit strategy and provides taxpayers with an approach to use in preparing for, or managing, an existing IRS transfer pricing audit. In sum, the roadmap illustrates that a robust transfer pricing methodology is based on a thorough analysis of the taxpayer's functions, assets and business risks. Taxpayers who fail to observe *arm's length* transfer pricing principles will expose themselves to significant transfer pricing penalties (potentially as high as 40 percent of the underlying tax liability). In addition, a transfer pricing adjustment creates the risk of double taxation because in many cases the IRS seeks to tax income which has already been taxed in a foreign jurisdiction. Since the IRS is clearly focused on transfer pricing, taxpayers should evaluate whether their current transfer pricing for intercompany transactions (including sales, intercompany debt, licenses and other common arrangements) complies with the arm's length standard.

STATE & LOCAL

New York court rules in favor of nondomiciliary taxpayer in statutory residency case

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John Fielding, Director, New York

The New York Court of Appeals recently issued its opinion in a "statutory residency" case, *holding that* an individual who was domiciled in New Jersey but owned a business and a multifamily apartment building in New York and spent more than 183 days during the calendar year in the state was not a statutory resident of New York. The court based its decision on the fact that the individual did not reside at the apartment and there was, therefore, no basis to conclude that he maintained the apartment as his permanent place of abode. In arriving at this conclusion, the court rejected the strict reading of New York's statutory residency rules and found that an individual "maintains a permanent place of abode" in New York only if the subjective facts (e.g., whether the individual had free and continuous access to the dwelling, received visitors there, kept clothing and other personal belongings there, and used the premises for convenient access to and from a place of employment) show that the individual actually dwells in the abode. This decision resolves a significant inequity resulting from the strict interpretation of the language of the permanent place of abode rule and provides more clarity on this issue going forward.

North Carolina announces trust tax amnesty

Steve Parish, Principal, Charlotte, N.C.

The North Carolina Department of Revenue (DOR) recently issued a release announcing the launch of the Trust Tax Recovery Program, an amnesty program covering sales, withholding and other trust taxes. Under the terms of the program, qualifying taxpayers that have fallen behind on trust tax payments may enter into a payment arrangement with the DOR and obtain a full waiver of penalties and collection assistance fees. To qualify, a taxpayer (1) must have an outstanding balance of trust taxes due; (2) must not have defaulted or had a previous penalty waiver under this program, the Small Business Counseling Program or the Small Business Taxpayer Recovery Program; and (3) must not be facing criminal charges or be the subject of a criminal investigation by the DOR. This amnesty presents a perfect opportunity for businesses subject to North Carolina trust taxes to review their procedures and come into compliance.

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