May 2014

# Tax Digest

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

## FEDERAL

### Entity versus aggregate in partnership gain recognition situations

*Dick George, Director, Cedar Rapids, Iowa*

The unique nature of partnership taxation, which blends entity (partnership treated as entity separate and apart from its partners) and aggregate (each partner takes into account the partner's share of partnership items) concepts, can produce situations where there is no clear answer as to which is to apply. In situations where a partner is trying to limit gain recognition, the aggregate approach may be better. For example, there is a favorable IRS ruling that serves as an illustration. In the ruling, a corporate partner contributed its own stock to a partnership with the partnership later exchanging the stock with a third party in a taxable transaction. Using the aggregate approach, the IRS held there would be no recognition of gain to the corporate partner and that the partner's basis in its partnership interest should be increased by the amount of the gain not recognized in order to permanently preserve the nonrecognition available under section 1032. It is wise to keep the distinction between the aggregate and entity concepts in mind when planning partnership transactions.

### IRS study of employment tax returns identifies risk areas for employers: Part 1 of a three-part series

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With its National Research Program (NRP) on employment taxes nearly complete, the IRS has identified four potential areas that may lead to an increased risk of audit exposure for employers. The IRS conducts NRPs to discover tax compliance weaknesses in order to focus audit resources on "hot" areas. Representing the first such employment tax compliance study in 25 years, this NRP involves the review of 6,000 employment tax returns, about 300 of which remain to be completed. The most significant areas that the IRS has identified as troubling include backup withholding, fringe benefit reporting, tip reporting and worker classification. This is the first in a three-part series of articles on these identified risk areas, which could affect any business with a significant number of employees.

Backup withholding is required for payments reported on Form 1099 if: 1) the recipients of the payment do not provide a taxpayer identification number (TIN) to the payer; 2) the IRS notifies the payer that the TIN is incorrect; 3) the IRS notifies the payer to withhold because the recipient has underreported income; or 4) the recipient failed to certify that they are not subject to backup withholding. Penalties for failure to file information returns, failure to include all required information on a return, and inclusion of incorrect information on an information return are tiered and can stack up quickly. Additionally, backup withholding is treated similarly to withholding on wages–meaning that the payer is ultimately responsible for paying the tax due, regardless of whether the payer withheld. Employers should assess their backup withholding tax exposure and consult with their tax advisors to determine the necessary tax withholding and filing requirements. This series will continue next month when we discuss the tip reporting and fringe benefit reporting risk areas.

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## IRS sheds light on the tax treatment of Bitcoin and other virtual currencies

*Peter Enyart, Manager, Washington National Tax*
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On March 25, 2014, the IRS issued guidance holding that a virtual currency (VC), such as Bitcoin, represents property for federal tax purposes rather than foreign money or real currency. As loosely defined, a VC is a currency substitute that has a convertible value compared to real currency and is exchanged on a digital market for goods and services or held for investment. Despite operating like a currency, transactions involving a VC, such as Bitcoin, must be reported like any other property-bartering transaction. An investor holding VC will recognize gain or loss when the VC is sold, just as with any other investment. However, taxpayers who pay for goods or services with VC will also incur gains if their basis in the VC is less than the value of the property or services received in exchange. This may come as quite a surprise to many unsuspecting taxpayers utilizing VCs as currency.

## Ownership of escrowed shares critical in determining eligibility to file consolidated return

*Peter Enyart, Manager, Washington National Tax*

The IRS recently ruled that escrowed stock was not held by a purchasing corporation for purposes of determining whether the corporation met the 80 percent ownership requirement needed to include a subsidiary in a consolidated tax filing. The purchase agreement unconditionally and irrevocably required the purchasing corporation to acquire 100 percent of the target's stock in a series of transactions. Shares were held in escrow until purchase; however, the selling shareholders retained voting rights and rights to receive dividends and proceeds upon liquidation. The retention of these rights by the selling shareholders led the IRS to hold that the escrowed shares, which represented greater than 20 percent of the vote or value of the acquired corporation, were not owned by the purchasing corporation. Consequently, the acquired corporation was not eligible for inclusion in the consolidated return. The ruling highlights the importance of understanding whether a taxpayer has obtained tax ownership of escrowed stock (e.g., rights to dividends, proceeds in liquidation and voting power) for purposes of determining affiliation. Careful review of purchase agreements and escrow arrangements may be necessary to achieve the intended tax results.

## 2014 depreciation limits for certain passenger automobiles released

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The IRS has released information regarding the limits on depreciation deductions for passenger automobiles first placed in service by taxpayers during 2014 (as well as amounts required to be included in income for lessees of passenger automobiles with respect to leases entered into in 2014). Taxpayers are generally limited with respect to the deductions that may be taken for passenger automobiles, and the 2014 limits reflect the applicable annual automobile price inflation adjustments. Subject to certain exceptions, passenger automobiles include four-wheeled vehicles manufactured primarily for use on public streets, roads and highways and with an unloaded gross vehicle weight rating (gross vehicle weight rating for trucks and vans) of 6,000 pounds or less. Taxpayers with passenger automobiles used in their trade or business should take note of the applicable limits to ensure that such vehicles are depreciated appropriately.

## Determining the employer under the Affordable Care Act

*Jill Harris, Director, Washington National Tax*
*Bill O'Malley, Director, Washington National Tax*

Under the Affordable Care Act, large employers with at least 50 full-time or full-time equivalent employees could pay penalties if they fail to offer affordable, minimum value health coverage to their employees. Consequently, employers must determine if they meet the 50-employee threshold. Making this determination can be complex because of the IRS controlled and affiliated group rules, which state that employees of entities in a controlled group are added together since controlled group members are treated as a single employer.

Thus, a company with less than 50 employees could be considered a large employer subject to the large employer mandate. There are several types of controlled groups. A parent-subsidiary controlled group exists when one company owns at least 80 percent of one or more other companies. For employee plan purposes, brother-sister controlled groups occur when the same five or fewer individuals, estates or trusts have both a controlling interest (80 percent common ownership) and effective control (50 percent identical ownership). Firms that provide professional services (e.g., health care, law, engineering and accounting firms) or management services might be in an affiliated group if they have common owners, provide services for each other or work together to provide services to customers. Tax-exempt organizations could be in a controlled group if at least 80 percent of the directors or trustees of one organization are representatives of or controlled by another organization. Because many special rules apply, taxpayers should consult with their tax advisors when making controlled group determinations.

### IRS examines fewer large partnerships than large corporations

*Patti Burquest, Principal, Washington National Tax*

The number of businesses organized as partnerships increased by 47 percent between tax years 2002 and 2011, but the number of large partnerships (with 100 or more direct partners and assets of $100 million or more) increased by more than 200 percent during that same period. Despite the tremendous growth in the number of large partnerships, the IRS is examining a relatively small percentage of them. A recent interim report of the U.S. Government Accountability Office (GAO) to the Senate Finance Committee depicts the audit rate for large partnerships with assets of $1 billion or more at 6.8 percent in 2012. During that same period, the audit rate for corporations with assets of $1 billion to $5 billion was 31.4 percent, and the audit rates for those corporations with assets of $5 billion to $20 billion and over $20 billion were 45.4 and 93.0 percent, respectively. The GAO report also supports the conclusion that during the last 10 years, large businesses doing business in the partnership form have experienced significantly lower rates of IRS examination than businesses of a similar size doing business in the corporate form.

## INTERNATIONAL

### New FBAR form, same filing deadline

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U.S. persons with a financial interest or signature authority over a foreign bank account with a value of $10,000 or more at any point during the tax year are required to file electronically the new Form 114, *Report of Foreign Bank and Financial Accounts* (FBAR), by June 30, 2014, with the Financial Crimes Enforcement Network (FinCEN). Taxpayers with multiple financial interests or signature authority must aggregate the value of all accounts and file an FBAR if the aggregate value exceeds $10,000. Additionally, U.S. citizens, resident aliens and certain nonresident aliens may be required to complete and file Form 8938, *Statement of Specified Foreign Financial Assets*, with their U.S. tax return if the value of all financial assets exceeds certain reporting thresholds based on the taxpayer's filing status–beginning as low as $50,000. Reporting an account on Form 8938 does not relieve the taxpayer of any obligation to file corresponding FBARs. It is imperative that taxpayers assess their financial interests in all foreign accounts and properly disclose such interests on their tax returns filed with the IRS and FinCEN. Taxpayers who fail to report such interests face steep penalties, including potential incarceration. Taxpayers should work with their tax advisors to determine the applicability and timing for filing all necessary disclosures.

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## IRS announces relief for owners of PFICs

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Owners of passive foreign investment company (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, and PFIC shareholders may also be subject to annual reporting obligations. Under IRS regulations, a shareholder of a PFIC includes any U.S. person that owns PFIC stock directly or indirectly through attribution. However, many taxpayers objected to this definition because individuals who owned PFIC shares indirectly through exempt organizations or tax-deferred retirement accounts became subject to the PFIC tax and interest charge rules. To address these concerns, the IRS recently announced future regulations that will amend the definition of a shareholder for PFIC ownership and reporting purposes to provide that U.S. persons who own PFIC stock through a tax-exempt organization or tax-exempt account will not qualify as shareholders of a PFIC. This is welcome news for many individuals who indirectly hold PFIC shares through an exempt organization or account. These rules will be effective for U.S. persons owning PFIC stock for tax years ending on or after Dec. 31, 2013, and calendar-year taxpayers may rely on this guidance for purposes of filing their 2013 tax returns.

# STATE & LOCAL

## Personal liability for business taxes

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The economic downturn and long road to recovery have left many businesses across the nation bankrupt or on the verge of bankruptcy. This has given rise to an unfortunate trend in particularly hard-hit states and industries–the activation of statutes allowing the states to levy against the personal assets of individuals deemed to be responsible parties when their business is unable to pay its entity-level taxes. Depending on the state, responsible parties can include board members, upper-level management with general authority over the activities of the business, and anyone with specific authority over the business' taxes. Recent rulings in this area have shown that, within the framework of a state's rules, ultimate responsibility can fall on unlikely parties and can even be based on title and authority on paper rather than business reality. For example, on April 10, 2014, the New York Supreme Court Appellate Division recently held that the titular chairman of a corporation that owned a restaurant could be held personally liable for the restaurant's unpaid sales and use tax because he had the authority to manage the corporation, regardless of the fact that the only time he ever exercised that authority was when his wife, the manager of the daily operations of the restaurant, was terminally ill. With these types of decisions becoming all too commonplace, it is important to consider this hidden risk.

## Use tax on business aircrafts

*Brad Hershberger, Des Moines, Iowa*

The application of sales and use tax to the purchase of a business aircraft can be very complicated. States provide a variety of exemptions that turn on the narrowest of factors, including the location of the first use of the aircraft, the aircraft's primary purpose or use, the percentage of interstate use of the aircraft as evidenced in flight logs, the aircraft's hangaring location, and the FAA regulation under which the aircraft is licensed. In general, states interpret these exemptions very narrowly. However, even a narrow interpretation can have broadly beneficial implications. For example, the Nevada Supreme Court recently ruled that, under the statutory language of the state's aircraft exemption, two of a taxpayer's four aircrafts based in the state were not exempt from the state's use tax because the first use of the aircrafts was to fly between the state of purchase and Nevada, but that the taxpayer's other two aircrafts were exempt because their first flight was from the state of purchase to another state before flying to Nevada. With all the state-to-state variations in aircraft exemptions, aircraft purchasers should take great care in analyzing and structuring transactions and use, as one seemingly minor difference can cost tens, if not hundreds, of thousands of dollars in tax.

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