Tax Digest

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

May 2016

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More tax events and webcasts

FEDERAL

New Forms 1095-C due to IRS by May 31 or June 30

Jill Harris, Director, Washington National Tax

Employers with at least 50 full-time or full-time equivalent employees were required to provide Forms 1095-C for 2015 to their employees by March 31, 2016. The form contains information about the employee's enrollment in the employer's health plan. Employers are required to submit Forms 1095-C to the IRS by May 31, 2016 (if filed on paper) or June 30, 2016 (if filed electronically). Employers with at least 250 Forms 1095-C must transmit them to the IRS electronically, unless they request a waiver of the electronic filing requirements by submitting Form 8508, *Request for Waiver from Filing Information Returns Electronically*, to the IRS by May 15, 2016. Since electronic filers need to register with the IRS and obtain a transmitter control code prior to transmitting Forms 1095-C, employers should act now to ensure receipt of the code prior to the June 30 filing due date. The IRS has additional details about electronic filing on its Web page for the Affordable Care Act Information Returns Program. Employers face penalties of up to $500 per employee for failing to furnish Forms 1095-C to their employees and the IRS.

Employers beware: Cybercriminals unleash new schemes to get employee W-2 information

Patti Burquest, Principal, Washington National Tax
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Bob Adams, Senior Director, Washington National Tax

A new scheme has tricked several well-known companies into unknowingly placing employee Form W-2 information directly into the hands of cybercriminals who quickly file fraudulent tax returns claiming refunds or sells the information on the 'dark Web.' The scheme uses an authentic-looking email sent to a company's human resources or payroll department that appears to be from a company executive requesting a copy of Forms W-2 for all employees. When the department replies to the request with the Forms W-2, the email is redirected to the scammer's website where the Form W-2 information may be sold to other cybercriminals who open credit applications or bank accounts with the information or who file federal and state income tax returns showing the data from the Forms W-2s and claim a refund. Because real data has been provided, the refund returns may escape other IRS or state filters and refunds may be paid. Prevention is the best medicine to cure this ill. All departments with access to sensitive employee information (such as the human resources or payroll departments) should be made aware of this scheme, and procedures should be developed to prevent a response without confirmation from the requester. If a data breach occurs, employers should advise employees on tax and data protection based on the IRS's Taxpayer Guide To Identity Theft. The Social Security Administration recommends that each employee creates a My Social Security account to monitor benefit activity.

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Tax Digest

Proposed debt-equity regulations would disrupt tax planning

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If finalized, recent proposed regulations would recharacterize certain related-party debt instruments as equity and cause a significant disruption to certain tax planning activities. The rules generally would apply to affiliated corporations, whether foreign or domestic. The regulations target transactions with or among foreign corporations that can have significant tax effects due to introduction of related-company debt but that have limited nontax economic effects. These transactions include (but are not limited to) earnings stripping transactions. Although the proposed regulations exclude transactions within federal consolidated groups, there could be significant state tax effects given that many states do not conform to the federal consolidated return rules. The proposed rules would (1) authorize the IRS (but not taxpayers) to conclude that an instrument should be characterized as part debt and part equity, (2) require taxpayers to maintain documentation with respect to certain related-company debt, and (3) require equity treatment of debt issued to related companies in specified distribution, asset acquisition and stock acquisition contexts. For example, the distribution of a note from a subsidiary to its parent corporation would fall under category (3) above, and the note generally would be treated as equity, not debt. Certain exceptions would apply to categories (2) and (3) above, but not to category (1). The category (3) rule is proposed to apply retroactively to transactions occurring on or after April 4, 2016.

Monitoring shareholder activity critical to avoiding S corporation terminations

Ed Decker, Partner, Washington National Tax

Each week, the IRS releases its latest batch of private letter rulings. Invariably, each batch includes several rulings where the IRS grants relief to an S corporation that has realized that its Subchapter S election has inadvertently terminated. In most cases, the inadvertent termination can be traced to a failure on the corporation's part to monitor the activities of its shareholders. These rulings are littered with situations where shareholders, unbeknownst to the company, have transferred shares to ineligible shareholders–partnerships, nonresident aliens, ineligible trusts, etc. These transfers will typically cause an immediate termination of the company's S election, thereby impacting all of the company's shareholders. Fortunately, the IRS will typically grant relief to entities that realize that a termination has occurred. However, this relief comes at a price–currently $28,300 for the IRS to issue a ruling. It is much more economical for an S corporation to put safeguards in place to ensure that it becomes aware of any transfer of shares by an owner, particularly when a shareholder passes away. Putting these procedures in place will help avoid an inadvertent termination and the cost associated with fixing it.

FASB lease standard and the tax treatment of leases

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With the FASB's February 2016 release of a new standard for the accounting treatment of leases, companies should review the standard and determine the impact on their financial statements. Though the lease standard generally has an effective date of 2019 for public companies and 2020 for all other entities, many companies have already begun analyzing how the new standard will affect current leases and future decisions on whether to lease or purchase capital items. This review process also creates an opportunity for companies to review existing agreements for conformity with federal income tax principles. When characterizing an agreement as a true lease for federal income tax purposes, many companies simply follow the GAAP treatment and are unaware that the federal income tax rules differ when determining whether a lease agreement is treated as a sale, a lease or a financing transaction. Taxpayers may also be unaware that a change in the GAAP characterization of a lease

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does not automatically change its characterization for federal income tax purposes. To the extent a taxpayer has not properly classified an agreement as a sale, lease or financing transaction, a taxpayer cannot change its tax treatment without obtaining consent from the IRS, and it is often difficult to get consent from the IRS to change the treatment of an existing lease without both parties to the agreement appearing before the IRS. The release of the GAAP lease standard provides a good opportunity for taxpayers to review any GAAP to tax lease treatment differences with their advisors, determine best practices and, if necessary, correct the tax treatment of leases on a prospective basis.

Interplay between reduced research credit election and domestic production activities deduction

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Taxpayers engaged in research and experimentation (R&E) activities can generally deduct related expenses. Taxpayers may also qualify for the research credit for certain expenses incurred in performing qualified research. The rules governing the interaction between the deduction and the credit provide that a taxpayer must reduce its R&E expense deduction by its research credit amount. However, taxpayers can elect to take a reduced research credit in lieu of this R&E expense add-back. If a reduced credit election is made, a taxpayer no longer has to reduce the research deduction claimed and instead claims a research credit that is reduced by the maximum 35 percent corporate tax rate. Corporations subject to the top corporate rates would be subject to the same tax liability with or without the election. Taxpayers seeking to lower taxable income because of state tax or alternative minimum tax may realize a benefit from electing the reduced credit. However, a taxpayer taking a domestic production activities deduction (DPAD) may prefer not to elect the reduced research credit. In the situation where a taxpayer's DPAD is limited to 9 percent of taxable income, electing the reduced research credit would also reduce the DPAD. Taxpayers should work with their tax advisors to analyze all possible outcomes before electing the reduced research credit.

INTERNATIONAL TAX

Supreme Court refuses to overturn foreign tax credit case

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On April 18, 2016, the U.S. Supreme Court let stand a Federal Circuit decision disallowing claims for refund related to foreign taxes paid because the taxpayer failed to file its claims within the statutory 10-year limitation period. The Federal Circuit is the first appellate court to address this issue, and taxpayers paying foreign taxes need to be aware of the ramifications of the decision. Generally, a taxpayer must file a claim for refund within the later of three years from the time the return was filed or two years from the time the tax was paid. However, the Internal Revenue Code extends the refund limitation period to "10 years from the date prescribed by law for filing the return for the year in which such taxes were actually paid or accrued." In this case, the taxpayer from 1997 through 2001 received interest from its Belgian subsidiary free of local withholding tax. However, the Belgian authorities later asserted the payments were subject to withholding tax, and the taxpayer paid the tax in 2002. In 2009, the taxpayer filed refund claims based on these foreign tax payments and the IRS disallowed the amounts relating to 1997 and 1998 because the claim was outside the 10-year statutory limitation period. The IRS argued that the period begins in the year in which liability for the taxes arises and not the date on which the tax is paid, despite contrary language in the statute. The Federal Circuit agreed with the IRS, and the U.S. Supreme Court's refusal to hear an appeal leaves the circuit court's decision intact. The decision could have a significant effect on the financial statements of taxpayers with accumulated foreign tax credits because it could result in a loss of credits. Taxpayers should evaluate the impact of this decision immediately.

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Tax Digest

Treasury issues inversion regulations

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The Treasury and IRS recently issued temporary and proposed regulations to address corporate inversion transactions. While U.S. businesses often expand operations through combinations with foreign companies, a company that inverts and changes its tax residence to a foreign country may achieve significant U.S. tax benefits. Despite the Internal Revenue Code limiting the tax benefits of certain inversions, several recent high-profile transactions have shed light on how corporations have structured acquisitions in order to circumvent existing law. In the absence of legislation, the Treasury and IRS have issued a series of notices to address various aspects of corporate inversion transactions, and the recent regulations formalize prior guidance and would provide additional rules. The new rules address certain inversions that occur over time (serial inversions) and also provide broad rules that would allow the IRS to recharacterize debt as equity, which would limit the benefits of post-inversion planning. Treasury Secretary Jacob J. Lew continues to urge Congress to enact broad anti-inversion legislation that stops inversions because the Treasury has very limited authority to curtail inversions on its own. The business community and former government officials have criticized the Treasury's piecemeal approach to inversions. For example, in a letter to Secretary Lew, former Treasury Secretary George P. Shultz claims the Treasury's course of action has chilled investments in the United States by adding uncertainty, bypassed the legislative process, and diverted resources away from urging Congress to pass new inversion legislation. Given the current congressional focus on elections, no inversion legislation is likely to be passed this year. Taxpayers contemplating international merger and acquisition transactions should carefully consider the potential impact of the new regulations on their structures.

STATE AND LOCAL TAX

Nebraska extends sunset dates for credits and incentives

Kevin Foral, Senior Manager, Omaha, Nebraska

On April 19, 2016, Nebraska Gov. Pete Ricketts signed a law extending the sunset date for a number of Nebraska tax credit and incentive programs. Per the bill, the sunset date for tax credits and incentives under the New Markets Job Growth Investment Act, Nebraska Advantage Rural Development Act, Nebraska Job Creation and Mainstreet Revitalization Act, and Nebraska Advantage Research and Development Act is extended from Dec. 31, 2019, to Dec. 31, 2022. Further, the highly popular, most-often utilized incentive program, the Nebraska Advantage Act, is extended from Dec. 31, 2017, to Dec. 31, 2020. It is important for businesses considering any type of expansion in either urban or rural areas of the state to pursue application of incentives under these programs prior to commencing with the projects. These extended sunset dates are a great opportunity for expansion in Nebraska.

Pay attention to deadlines for filing an appeal—they really do matter

Harlan Kwiatek, Partner, New York, New York

When a taxpayer reaches the end of the audit process and a state issues a deficiency notice, the taxpayer has a limited amount of time to respond, generally either 30, 60 or 90 days from the date of the notice. Whether requesting additional administrative consideration or appealing the assessment to an administrative tribunal or court of law, failing to meet these deadlines can result in a significant narrowing of avenues for appeal or can even result in complete forfeiture of appeal rights. Across the country, state tax authorities and the courts are taking a hard line on appeal deadlines, throwing out on a regular basis appeals filed after the due date. For example, the New York Tax Tribunal recently dismissed two cases, DTA No. 826765 and DTA No. 826645, for failure to meet petition filing deadlines. Taxpayers should consider keeping a notice log, entering notices into the log immediately upon receipt and addressing notices in advance of the deadline.

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