November 2014

Tax Digest

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

EVENTS

Fall tax summit series

FEDERAL

Recent ruling provides roadmap for successful marital planning

Charles Schultz, Partner, Washington National Tax
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Assets in a qualified terminable interest property (QTIP) trust should be considered for tax and estate planning since the assets will be subject to estate tax upon the surviving spouse's death. Current law often deters tax advisors from QTIP planning as it imposes a tax on the lifetime termination by the surviving spouse of his or her qualifying income interest. A recent IRS private letter ruling showcases a planning strategy for making gifts of QTIP assets while preserving sufficient income for the surviving spouse. Under the facts addressed in the ruling, the trustees divided the QTIP marital trust into three equal trusts, using a state statute that permitted the division of a trust with beneficiary consent. Trust 1 was untouched, while Trust 2 was converted to a total return unitrust. Trust 3 was terminated and the trust assets were distributed to the decedent's children. The IRS ruled that the unitrust payout qualified as a lifetime income interest for the surviving spouse. This termination was deemed a gift, and the resulting gift tax was paid by the decedent's children as a net gift. The IRS indicated that Trust 3 was removed from the surviving spouse's taxable estate. Planning with QTIP trust assets is an excellent way to help a surviving spouse actively manage his or her estate tax liability while pursuing a gifting strategy.

Corporations must file this "sleeper" report or face penalties

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Corporations that take an organizational action that affects the basis of all holders of a security (i.e., the shareholders) must file Form 8937, *Report of Organizational Actions Affecting Basis of Securities*, by the earlier of 45 days of taking such action or Jan. 15 of the ensuing year or face penalties. Examples of such organizational actions include stock splits, stock dividends, nondividend distributions and some reorganizations. This reporting requirement is a "sleeper" because it is triggered only by occasional events and not on a recurring basis, which minimizes the ability to plan for it on a quarterly or annual basis. To comply, Form 8937 must be sent to security holders and the IRS to allow transferors of the security to report the correct basis and therefore, the correct taxable gain or loss. As an alternative, a taxpayer may post its Forms 8937 on its primary public website dedicated to this purpose if it is kept accessible for 10 years, or if the taxpayer is an S corporation, it may report the effect of any organizational action on its shareholders' timely filed Schedules K-1 (Form 1120S). In fact, reporting the required information on Schedules K-1 eliminates the otherwise applicable penalties if the S corporation misses the 45-day filing window. To avoid IRS penalties, taxpayers should remain alert for organizational actions that trigger this sleeper report.

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IRS issues advice on restaurants and UNICAP

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In a recent memorandum, the IRS Office of Chief Counsel addressed capitalizing costs to ending inventory in the restaurant industry. The IRS generally considers the purchasing, processing and combining of ingredients to produce food for sale to customers as a production activity, and therefore, the taxpayers must capitalize certain costs in preparing the food. The memorandum advised examination agents against compelling restaurants to employ certain capitalization safe harbors that could create distortive results by requiring restaurants to capitalize kitchen labor and similar costs to raw materials that often make up the only ending inventory. There are three items to note in this memorandum. First, the IRS has a number of restaurants under examination. Second, the IRS generally considers restaurants to engage in production activities. Third, the IRS will permit restaurants to use a reasonable facts and circumstances approach to capitalizing kitchen labor and other similar costs, which should reduce distortion. Taxpayers in the restaurant industry should contact their tax advisors to discuss the implications of this memorandum.

IRS issues guidance on the codified economic substance doctrine

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The IRS recently issued a notice providing additional guidance on the economic substance doctrine. The Internal Revenue Code provides that transactions lacking economic substance or a "similar rule of law" are subject to 40 percent accuracy-related penalties. However, the terms *transaction* and *similar rule of law* are not defined. As a result, the notice was issued to define these terms. Transaction is defined as either a series of steps under a plan or a single step, determined based on the taxpayer's facts and circumstances. Similar rule of law is defined as a rule or doctrine that applies the statute's two-prong test (i.e., the requirements for a transaction to have economic substance and a nontax business purpose), even if different terms are used to describe the rule or doctrine. The notice raises new questions on how a taxpayer's facts and circumstances will drive the IRS' decision to analyze either a series of steps under a plan, versus a single step, for economic substance. Additionally, the notice's inclusion of the sham transaction doctrine as a similar rule of law potentially expands the applicability of the 40 percent penalties, but only where a transaction also fails the two-prong test. Taxpayers should consult with their tax advisors about economic substance concerns relevant to any current or planned transactions.

McGladrey survey finds the middle-market tax burden is rising and threatening job growth

In October, McGladrey revealed the results of a recent survey that sought to understand the effects of the "fiscal cliff" deal on middle-market companies. According to the survey of 525 executives, the American Taxpayer Relief Act of 2012 has contributed to slowed hiring, increased tax compliance burdens and limited expansions. The results of McGladrey's survey confirm that these tax code changes not only failed to protect midsized companies, but also created new burdens that are holding back the most prolific job creators of the past five years. Review the complete survey results to understand how the Act is affecting middle-market companies.

Tax Digest

INTERNATIONAL

Companies doing business in Europe should monitor EU attack on tax subsidies

Ramon Camacho, Principal, Washington National Tax
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In the last month, the European Commission (the EC), which is the executive branch of the European Union (EU), opened investigations into whether various tax incentives provided by Ireland and Spain constitute illegal "state aid." Under EU law, member countries may not provide "aid" or financial assistance to a business that gives it a competitive advantage (including a tax benefit) over other businesses. The Ireland case involves certain tax rulings that Ireland granted to Apple. In that case, the EC alleged that Ireland granted Apple state aid by approving Apple's transfer pricing policies in an effort to lure more jobs to Ireland. The EU alleges that Ireland failed to consider whether Apple's transfer pricing policies satisfied the arm's-length standard, which is the international standard used to evaluate intercompany transfer pricing. In the other case, the EU alleged that Spain granted state aid when it allowed taxpayers to amortize certain goodwill created in connection with certain acquisitions of indirectly held Spanish companies. While affecting large companies like Apple, these decisions may also impact middle-market companies that have received favorable tax rulings under similar tax incentive regimes. In addition, these activities underscore the importance of thoroughly documenting transfer pricing policies in Europe. Obtaining a ruling from a national tax authority may no longer be enough because the EU can not only challenge an otherwise favorable ruling, it can also order a country to set aside a prior ruling and collect from the taxpayer any state aid previously granted under the ruling. In light of these activities, taxpayers should carefully analyze their transfer pricing policies.

Proposed inversion regulations may bring unexpected results to corporate transactions

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The Treasury and IRS recently published a notice outlining their intent to issue new regulations targeted at reducing the tax benefits of corporate tax inversions that are perceived as abusive. The regulations will address the following perceived abuses: repatriations of accumulated offshore earnings to the new foreign parent, post-transaction dilution of ownership to eliminate controlled foreign corporation status, and transactions designed to skirt current law ownership thresholds. As described, the regulations raise the possibility of numerous unintended consequences. For example, companies with significant amounts of cash could be adversely affected by these rules because a significant portion of their stock could be treated as attributable to passive assets, which could increase the likelihood that the transaction would qualify as an inversion. According to the notice, the new regulations will also address so-called "skinny down" transactions in which the U.S. target distributes a portion of its assets (including via a spin-off) to avoid the inversion ownership thresholds. To address this practice, the regulations will increase the value of a U.S. corporation by the amount of "nonordinary course distributions." However, this rule will not apply to the foreign parent in a potential inversion transaction, which could produce unexpected results. Middle-market companies that have completed an inversion, or that intend to, should review the notice immediately. Companies that have completed an acquisition or a restructuring involving a foreign corporation should become familiar with the inversion rules because the inversion rules can apply unexpectedly.

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STATE & LOCAL

Custom software included in transactions subject to Minnesota sales tax

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On Sept. 10, 2014, the Minnesota Supreme Court issued a decision upholding the Minnesota Tax Court's decision that a software company was required to collect and remit sales tax on the entire sales price of its sales of heavily customized software because the transactions involved mixed prewritten and customized software, and the company failed to separately state its charges for customization. Under Minnesota statutes, sales of prewritten software are subject to sales tax, while sales of custom software and software customization services are exempt. However, when prewritten software and custom software are sold as part of a bundled transaction, sales tax applies to the entire purchase price, unless there is a reasonable, separately stated charge on an invoice or other statement of price given to the purchaser for the custom software. The taxpayer, appealing an assessment of tax, interest and penalties, contended (1) that its software was so heavily customized that its sales qualified as exempt sales of custom software, and (2) that its failure to separately state the portion of the sales price attributable to custom software was irrelevant. However, the court rejected these contentions on the grounds that any element of prewritten software mixed in with custom software was sufficient to support bundled transaction treatment, and that, therefore, the entire transaction was taxable absent separate statement of the charges for custom software. The rules governing the application of sales tax to bundled sales of prewritten and custom software vary substantially from state to state, and procedures implemented to qualify for exemptions in one state often do not meet the requirements of other states. Accordingly, it is important to review your bundled software contracts and billing policies on a state-by-state basis to determine whether you are properly collecting and remitting tax.

Sales tax issues with fractional aircraft ownership

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Fractional aircraft ownership, under which the ownership of an aircraft is divided into shares as small as a one-sixteenth interest and all owners are entitled to annual use of the aircraft in proportion to their ownership interest, is a popular method for businesses and individuals to obtain business air travel without the capital outlay of full ownership. However, the sales and use tax treatment of the purchase of a fractional aircraft interest remains largely unsettled. Some states, such as New York, treat these arrangements as nontaxable purchases of transportation services, while others, such as Illinois, view these arrangements as purchases of tangible personal property subject to use tax when the purchaser is an Illinois domiciliary and the aircraft lands in the state. Most states, however, are silent regarding the sales and use tax treatment of these transactions, and taking a conservative position—subjecting the fractional interest to tax in the same manner as the outright purchase of an aircraft—may result in overpayment of tax. Additionally, factual variations, such as fractional programs where a large number of aircraft are pooled under one management company and a fractional owner never actually uses the aircraft it owns, may not be fully addressed by the states that do provide some guidance and may impact the availability of exemptions. Before purchasing a fractional interest in an aircraft, a business or individual should fully consider the sales tax implications of the particular arrangements in question in their state of domicile, as well as where the aircraft will be hangared and used.

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