Tax Digest

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

November 2015

EVENTS

More tax events and webcasts

FEDERAL

S corporation shareholders should require documentation of shareholder loans with a formal note

Jay McEvoy, Manager, Davenport, Iowa

S corporation shareholders are allowed to deduct flow-through losses in excess of their stock basis against their basis in loans personally made to the S corporation, thereby reducing the debt basis of the shareholder by the claimed losses and deductions. Subsequent repayment of the reduced-basis debt must be treated in part as a return of the shareholder's basis in the loan and in part as taxable income to the shareholder. The character of the taxable income is contingent on whether the corporation issued a formal note to the shareholder. An IRS ruling held that the income portion of the repayment of the reduced basis debt was a gain from the sale or exchange of a capital asset because the corporation had issued a note to the shareholder, which was a capital asset in the hands of the shareholder. Thus, provided the shareholder held the note for more than one year, the income portion of the repayment would be considered a long-term capital gain eligible for favorable tax rates. Another IRS ruling analyzed a similar scenario but found the income from the repayment of the reduced basis debt to be ordinary income because the shareholder debt was not documented with a note, and therefore, there was no capital asset in the hands of the shareholder. Due to the favorable tax rates for long-term capital gains, shareholders should ensure their loans to the S corporation are documented with a formal note.

Cases showcase strict application of charitable gift rules

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For charitable gifts of assets (other than cash and marketable securities) valued in excess of $5,000, the deduction must be substantiated by a *qualified appraisal* by an appraiser experienced in the valuation of the gifted asset and documented with a Form 8283. Recent cases showcase the trend of judicial affirmation of the IRS' strict application of the regulations. In a June 2015 Tax Court case, a veterinarian donated fossils to a scientific organization and included a Form 8283 and an appraisal with his income tax return. However, the appraisal was not *qualified*, the Form 8283 was incomplete, and the charity's letter acknowledging the gift lacked the required terms. The Tax Court denied the deduction. Similarly, the 8th Circuit Court of Appeals ruled in July 2015 that the chief executive of a company could not claim a charitable deduction for charitable contributions made by his company because the taxpayer could not prove that he had a legal obligation to repay the debt despite considerable evidence that the taxpayer consistently reimbursed the company for his personal expenses. Taxpayers, charitable organizations and tax preparers have to strictly comply with IRS charitable regulations in order to be certain that the deductions will be allowed by the IRS.

Year-end tax planning–not just tax legislation

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Year-end tax planning typically involves reviewing legislation passed by Congress or regulations issued by the Treasury and determining the impact. In what is becoming

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an unfortunate theme, no significant tax legislation has yet been enacted in 2015, and taxpayers are again faced with uncertainty. However, just because Congress has not provided taxpayers a roadmap for the 2015 tax year does not mean that taxpayers cannot begin planning. In fact, now is the right time to focus on several tax strategies that could improve the bottom line. One of these planning opportunities involves a review of tax accounting methods and periods. Generally, a method of accounting determines when items of income or expense are recognized, and reviewing these methods could generate tax saving opportunities. However, changing a method of accounting requires IRS consent, and some requests to change a method of accounting must be submitted before a taxpayer's year-end. Changes that require taxpayers to submit consent requests before a taxpayer's year-end are 'nonautomatic' method changes, and the IRS formally rules on these changes, which can take a considerable amount of time (sometimes as long as eight months or more). It is important to file these nonautomatic change requests as early as possible to allow enough time for the IRS to review and grant approval. If the IRS has not granted approval before the taxpayer's return filing deadline (including extension), the taxpayer is not allowed to adopt the new method of accounting on that return. Taxpayers should work with their tax advisors to determine if a method of accounting review could be beneficial.

Beware of wellness programs too good to be true

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Recently, various employee benefit plan administration firms have been promoting cafeteria plan and wellness-related programs that purport to provide employees tax-free benefits while not reducing their take-home pay. However, these programs may have tax risks that may not be disclosed. The programs appear to use plans that allow employees to elect to set aside a portion of their wages into an account and, if certain requirements are met (typically that the money is used for certain expenses), those wages are not taxable wages to the employee. This basic premise appears to qualify as an allowed cafeteria or medical expense reimbursement plan under tax rules. Where many of these new programs introduce risk, however, is by offering a 'loan' to employees to ensure the employees' take-home pay does not change. The IRS previously disallowed similar arrangements, and it is unclear whether these new programs are properly structured to prevent the loans from being taxable to employees. Employers should consult with their tax advisors before implementing such a program as the consequences could include unpaid payroll and income taxes, interest and numerous penalties for failures to withhold taxes, deposit taxes, pay taxes and file correct information returns.

Certain partnership restructurings may trigger a technical termination

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It is not uncommon for a group of investors in an entity taxed as a partnership to restructure their holdings without materially changing the economic ownership of their endeavor. A good example would be the creation of a holding company that will also be taxed as a partnership. A typical restructuring might involve the contribution by 99 limited partners of their 99 percent interest in an existing limited partnership to a new partnership in exchange for 100 percent of its interests. The remaining 1 percent partner in the original partnership will keep that interest. While restructurings of this nature are generally tax-free to the partners, they may cause a termination of any partnership in which more than 50 percent of the interests are exchanged, even in a tax-free transaction. A technical termination of a partnership results when more than 50 percent of the partnership interests are sold or exchanged within 12 months and triggers the requirement to file a short-year partnership return, in addition to other potentially negative effects. Interestingly, tax-free contributions for newly issued partnership interests technically count as 'exchanges' that might trigger a technical termination. However, the IRS sometimes rules, on policy grounds, that the technicalities will be disregarded where the same partners hold all or substantially all of the interests in a partnership, directly or indirectly, both before and after the transaction. Such an exception does not exist in the statute or regulations. Thus, what is supposed to be a strictly mechanical rule can in practice have its subjective elements. Before consummating any type of restructuring transaction, partners should investigate the potential impact on the underlying partnership's tax year, accounting methods and elections.

Due date is approaching to carry back 2014 NOLs for quick refund

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Net operating losses (NOLs) must be carried back first before being carried forward unless a timely election to forego the carryback period is made under section 172(b)(3). The election is made on the loss year's timely filed return. A missed election will result in a mandatory carryback requirement unless section 9100 relief is available for consolidated group elections under Reg. section 1.1502-21(b)(3)(i). A corporation's NOL carryback claim can be filed via Form 1120X, *Amended U.S. Corporation Income Tax Return*, within three years of the date the loss year return was filed. The Form 1120X claim is generally subject to examination (including review by the Joint Committee on Taxation (JCT), if applicable) before it is paid. However, a carryback claim filed via Form 1139, *Corporation Application for Tentative Refund*, is paid quickly and before any examination or JCT review. The IRS must perform a limited review of the Form 1139 claim and pay it within 90 days of the date the claim was filed. Any examination of the claim is performed after the refund has been paid, and any excessive refunds are assessed and collected using normal IRS processes. Many companies choose to file Form 1139 for cash flow reasons because the refund is paid quickly. The Form 1139 must be filed within one year of the last day of the loss year. For calendar-year 2014 losses, the Form 1139 must be filed on or before Dec. 31, 2015. Carryback claims for the 2014 loss year filed after Dec. 31, 2015, must be filed using Form 1120X and will be paid under the normal claim process.

Health plan sponsors must pay reinsurance fee by Jan. 15, 2016

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The Affordable Care Act added a new reinsurance fee on major medical plans for 2014, 2015 and 2016. For 2015, the fee is $44 per employee, spouse and dependent enrolled in the plan. The plan sponsor must pay the fee if the health plan is self-insured, whereas the insurance company pays the fee for insured plans. The fee applies to all types of employers, including tax-exempt organizations and governmental entities. Most major medical plans are subject to the fee regardless of the number of plan participants. The 2015 fee is based on the average number of covered lives in the plan during the nine-month period of Jan. 1 through Sept. 30, 2015, regardless of the actual plan year. Employers must report this enrollment count to the U.S. Department of Health and Human Services by Nov. 15, 2015, and pay the fee by Jan. 15, 2016, using an online system called Pay.gov.

IRS releases final Forms 1095-C and 1094-C

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Due to the Affordable Care Act (ACA), every large employer must report information about its 2015 workforce and health plans to its employees and the IRS using new Forms 1095-C and 1094-C. The IRS recently issued final versions of the 2015 forms and instructions that are substantially similar to the draft forms previously made available. The forms disclose whether the employer offered ACA-compliant health coverage to its employees. The IRS will use the information on these forms to assess employer shared responsibility payments on employers that did not offer health coverage that meets ACA standards. Employers with self-insured health plans must also report the names and Social Security numbers (or birthdates) of employees and family members enrolled in the plan. The forms must be provided to employees by Jan. 31, 2016, and filed with the IRS by Feb. 29, 2016 (March 31 if filed electronically). Large employers should take action now to ensure that their internal systems are able to collect the needed data. Small employers with less than 50 full-time employees (including full-time equivalent employees) generally are exempt from this reporting requirement. However, small employers that are related to one another due to common owners or services may be required to file.

INTERNATIONAL TAX

BEPS final reports issued

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The G20 and Organisation for Economic Co-operation and Development (OECD) recently released a package of final reports from their base erosion and profit shifting (BEPS) project. In these reports, the OECD identifies 15 major proposals designed to curtail tax avoidance by multinationals. Because the OECD has been transparent throughout the BEPS project, many of the concepts presented in the final reports have already been publicly vetted. Key provisions of the final reports focus on reinforcing transfer pricing rules, strengthening tax treaty provisions, addressing preferential tax regimes, limiting benefits from hybrid entities, and addressing the challenges to the tax system posed by the emerging digital economy. The next challenge for the BEPS project will be ensuring consistent worldwide implementation through development of a multilateral instrument that implements BEPS recommendations by amending existing tax international tax treaties. The U.S. Treasury has indicated it will participate in this effort. Given the broad reach of the proposals and growing international support, the BEPS proposals likely will have a significant impact on the operational structures and compliance obligations of multinational businesses. Such taxpayers should carefully review their operations and international tax positions to assess the continued viability of their planning structures if the BEPS proposals are adopted.

Innovation box proposal

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The House Ways and Means Committee released bipartisan draft legislation that would create an 'innovation box' regime in the United States. The legislation, entitled *The Innovation Act of 2015* (the Act), would offer a 10 percent tax rate on qualifying intellectual property (IP) income. Eligible income would include profits from patents, inventions, formulas, designs, know-how or any similar items, including motion pictures and computer software. Significantly, the Act would also allow U.S. companies to transfer foreign-based IP to the United States without paying any U.S. transfer taxes, and that IP would be eligible for the reduced tax rate. The Act is designed to encourage U.S. companies to keep research and innovation in the United States and to counter the recent implementation of similar regimes in Ireland and the United Kingdom. While the legislation is only in draft, it serves as an important indication of what U.S. tax reform may ultimately entail. Multinational businesses should pay attention to tax reform proposals now more than ever as they are increasingly likely to result in actual change that will alter the competitive landscape. Businesses should speak with their tax advisors to learn more about the innovation box proposals and how tax reform may affect their business operations.

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