Tax Digest

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

October 2012

FEDERAL

Effects on mid-sized manufacturers and their owners of dying tax cuts and extenders

Bob Adams, partner, Washington National Tax

With the terms "Taxmageddon, fiscal cliff" and "budget deficit" often heard these days, mid-sized manufacturers and their owners worry about the tax effects on themselves and their businesses from the ultimate resolution of expiring tax cuts and "extenders." It will not be possible to determine the precise impact on any taxpayer until sometime after the congressional and presidential elections have occurred in November and Congress has done some major work on these matters. As illustrated by recent testimony before the House Committee on Ways and Means, many mid-size manufacturers feel frozen in place due to this lack of clarity on expiring provisions. An exhibit provided along with that testimony projected a range of tax effects to companies based on their tax rates and the expiration of specific benefits. The exhibit provides food for thought and an impetus for manufacturing companies and their owners to begin working with their tax advisors to analyze and plan for the potential impact of scheduled tax increases and other changing provisions.

Estate planning in a low interest rate environment

Charles Schultz, partner, Washington National Tax

In the current low interest rate environment, self-cancelling installment notes (SCINs) represent a particularly attractive planning technique for use in sales between related parties. Generally, the older generation sells a highly appreciating asset to the buyer or borrower in exchange for a low interest rate SCIN. If the seller dies before the end of the note term, the remaining principal balance is completely canceled and excluded from the seller or lender's taxable estate. A related-party SCIN must be structured as an arms-length transaction, cannot exceed the seller or lender's life expectancy and must charge a mortality risk premium to the buyer or borrower (typically, a required increase in the interest rate). The current low interest rate environment makes this an affordable planning option. For example, a 60-year old taxpayer can set up a 24-year SCIN at a 4 percent rate. The 4 percent rate appears very manageable when compared to the huge reduction in estate taxes that a SCIN can potentially provide.

Opportunity for refund of FICA taxes

Steve Levin, director, Washington National Tax

Many companies have paid FICA tax on severance benefits paid to involuntarily terminated employees, where the termination resulted from a reduction in workforce or the closing of a plant or business operation. In light of a recent court decision, these companies should consider claiming a refund of such FICA taxes for open tax years. The Sixth Circuit Court of Appeals recently ruled that supplemental unemployment compensation benefits are not taxable wages for FICA purposes. While the IRS is likely to appeal this decision to the U.S. Supreme Court, a refund claim may still be worthwhile. The refund process

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differs for employers within the Sixth Circuit (Michigan, Ohio, Kentucky and Tennessee) and employers outside of that circuit. Though the IRS will likely reject any claim from outside of the Sixth Circuit, filing a protective claim will preserve the statute of limitations pending the final resolution of this matter.

Look beyond labels to determine stock redemption treatment

Nick Gruidl, partner, Washington National Tax

When a corporation redeems a shareholder's stock, the redemption may qualify as a sale or exchange, allowing for capital gain treatment and basis recovery. On the other hand, the redemption may represent a dividend, resulting in ordinary income treatment and no basis recovery. A redeeming corporation's relative proportions of common and preferred stock immediately after the redemption can be critical to the tax treatment. However, labeling stock as common or preferred is not determinative. The IRS recently considered the status of a stock labeled as preferred stock for purposes of determining the tax treatment of a stock redemption and ruled that, despite its label, the preferred stock represented common stock, which resulted in the redeemed shareholders receiving sale or exchange treatment. This instructive ruling reinforces the need to look beyond the mere label of an instrument and into the economic rights and substance of the instrument.

Practical considerations for fixed assets

Mike Metz, partner, Minneapolis, Minn.

While likely aware that the IRS has substantially changed the rules for fixed assets and repairs, many company executives have not yet determined the impact to their companies. The following five questions can be helpful in assessing the situation:

1. Can the company use the de minimis rule to write off amounts up to a company-established threshold (e.g., $500, $1,000 or $5,000)?
2. Is the company claiming allowable deductions for materials and supplies, repairs and routine maintenance?
3. Are the company's depreciable property elections made with the greatest flexibility to ensure the company does not permanently lose deductions but can still claim losses on the disposal of a component of property?
4. How do the new restoration, betterment or adaptation capitalization tests apply to company improvements?
5. Do these rules have a material impact on the financial statements?

All companies that acquire, produce or improve tangible property should work with their tax advisors to review current capitalization policies and methods, file any necessary accounting method changes, identify any financial statement implications, and pinpoint required changes to fixed asset accounting systems.

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STATE AND LOCAL TAX

Physical nexus challenge – a new twist to an old problem

James Barash, director, Phoenix, Ariz.

Earlier this year, the Tennessee Court of Appeals held that Scholastic Book Clubs, Inc. (SBC) had nexus in Tennessee. Distinguishing SBC's use of teachers as agents, the court stated that because the teachers and schools in the state "amounted to a *de facto* marketing and distribution mechanism within Tennessee's schools," SBC was doing business in the state. Such a holding paves the way for the state's imposition of income, sales and use taxes. This case serves as a reminder that the mere presence of in-state sales and distribution activities of independent third-party agents of a seller can establish nexus in that state for the seller. This Tennessee case and similar cases in other states demonstrate how difficult it has become for companies employing a multi-level marketing model to avoid sales tax collection requirements.

INTERNATIONAL TAX

Applying proposed rules may benefit taxpayers with foreign operations

Ramon Camacho, principal, Washington National Tax
Larry LeBlanc, partner, Vienna, Va.

U.S. taxpayers conducting foreign operations through disregarded entities or branch offices have an important choice to make that could have a significant financial statement impact. Specifically, such taxpayers should decide whether to seek permission from the IRS to apply proposed rules associated with the calculation of income from non-U.S. business activities. Some U.S. taxpayers doing business abroad through disregarded entities or branch offices have obtained permission from the IRS to adopt the approach contained in the proposed rules, which could allow significant amounts of unrecognized gain to be eliminated under certain circumstances. While the approach may not be suitable for everyone, it could provide certain companies with significant tax benefits and simplify federal tax compliance burdens with respect to foreign operations. Impacted companies should work with their tax advisors to determine the optimal approach and submit any necessary method change or ruling requests to the IRS.

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For additional information or change of address, contact Hyong Sik Yoon or Kiho Choi at (213)480-9100 or e-mail them at hyongsikyoon@ckpcpas.com or kihochoi@ckpcpas.com.

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