Tax Digest

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

October 2013

FEDERAL

Changes coming for small business health care tax credit

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

Employers with fewer than 25 full-time equivalent employees (FTEs) and average annual wages of less than $50,000 per FTE may qualify for a tax credit for health insurance premiums they pay for employees. In 2014, the maximum credit increases to 50 percent for taxable entities and 35 percent for tax-exempt entities, up from 35 percent and 25 percent, respectively, in 2013. Average annual wage limits will also increase based on inflation. However, employers will not be able to claim the credit unless they purchase health insurance for their employees through the new Small Business Health Options Program (SHOP), a component of the Internet-based health insurance marketplace that launched on Oct. 1, 2013.

Window of opportunity closing

Rick Bailine, Principal, Washington National Tax
Nick Gruidl, Partner, Washington National tax

Code section 1202 is designed to encourage investment in smaller C corporations. The encouragement offered is an exemption from tax of a portion of the gain realized upon the sale of stock, provided the stock had been held for at least five years. This potential exemption applies only to investors who are not themselves a C corporation. Typically, the amount of gain excluded is 50 percent. However, the American Taxpayer Relief Act of 2012 makes it possible to exclude 100 percent of the gain, but this 100 percent exclusion will apply only to certain stock acquired upon original issuance before Jan. 1, 2014. The rules of section 1202 are complex, but those considering an acquisition or investment should consider structuring their investment to comply. If successful, the sale of such stock in the future will potentially be 100 percent free of tax, provided the stock sold was held for at least five years.

Proposed regulations released clarifying the treatment of prototypes in determining deductible costs under section 174

Tom Windram, Partner, Washington National Tax
Steve Pashley, Manager, Washington National Tax

The Interanl Revenue Service (IRS) issued proposed regulations on Sept. 5, 2013, that resolve uncertainty regarding the definition of "research or experimentation" for purposes of section 174 with respect to prototypes developed and produced by taxpayers. These regulations also have important implications for purposes of the section 41 research tax credit. This guidance is significant because it provides taxpayer-favorable guidance on several issues that have generated substantial controversy in IRS exams.

Corporate reserves for uncertain tax positions are on the rise

Bob Adams, Partner, Washington National Tax

A recent study of SEC disclosures made by Fortune 500 companies indicates reserves for income taxes are on the rise. According to the study, the reserves increased over 2 percent, to a total balance of $191.7 billion for 2012. Although this study focuses on the 500 largest public

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corporations, corporations of much smaller size, whether public or private, must report to the IRS uncertain tax positions, for which U.S. income tax liability reserves are established in audited financial statements, if they own $50 million in total assets. In 2014, that dollar threshold drops to $10 million. Corporations meeting these criteria are required to describe their uncertain tax positions on Schedule UTP (Uncertain Tax Position Statement), which must be attached to their U.S. income tax returns. The IRS inspects and analyzes each and every such issue description, as part of its risk analysis for choosing companies to audit. When the IRS deems a taxpayer's description of an issue in Schedule UTP inadequate, a letter is sent to the taxpayer stating that the description is inadequate, and the letter "serves as notice that future returns will be reviewed." In order to minimize the risk of an IRS audit, corporations should seek professional advice for drafting issue descriptions when Schedule UTP is required to be filed.

Ensure short-year partnership tax returns are filed to avoid penalties

Rob Wagner, Partner, Wilmington, N.C.

At $195 per partner, per month, the penalty for the late filing of a partnership's income tax return warrants a review of any partnership that recently had an ownership change, sold or distributed all property, or merged with another entity. Under section 708(b)(1), a partnership is considered terminated if either: (1) no part of any business, financial operation or venture of the partnership continues to be carried on by any of its partners in a partnership, or (2) within a 12-month period, there is a sale or exchange of 50 percent or more of the total interest in the partnership. Regulations further provide that a partnership's tax year closes, with respect to all partners on the date the terminating event occurs, and a short-year return is required to be timely filed by the 15th day of the fourth month thereafter. When a termination occurs, the timely filing of a short-period return should be a priority in order to avoid any penalties.

Planning to minimize the parachute payment excise tax

Steve Levin, Director, Washington National Tax

Are you an officer, highly compensated employee or 1 percent or greater owner of a C corporation likely to be sold in 2014? Do you expect to receive sizable compensation payments associated with the sale (e.g., accelerated stock options, severance, change-in-control bonuses, etc.)? Is your company ineligible to elect to be taxed as an S corporation? If you answered "yes" to each of the above questions, you could end up being subject to a 20 percent excise tax on excess change-in-control payments. In addition, the company could lose the tax deduction for the payments. The excise tax is triggered if the change-in-control payments equal or exceed three times your average base period compensation (generally your average taxable compensation for the five years prior to the year of the sale). If the "three times" threshold is exceeded, the excise tax applies to payments in excess of the average annual compensation. Accelerating income into 2013 is a strategy to increase your threshold amount and help to minimize or avoid the parachute payment excise tax, as well as the loss of the tax deduction to the company.

Tax Digest

STATE & LOCAL

Indiana Tax Court calls into question application of economic nexus principles to corporate income tax

Craig Ridenour, Partner, Raleigh, N.C.
Brian Kirkell, Principal, Washington National Tax

On Sept. 16, 2013, the Indiana Tax Court granted summary judgment to the Indiana Department of Revenue in *UPS v. DOR*, holding that foreign captive reinsurance companies were not subject to Indiana premiums tax because they were not physically present in the state, and, therefore, the adjusted gross income of the captives had to be included in the UPS affiliated group's consolidated adjusted gross income for corporate income tax purposes. Interestingly, in its decision, the court stated that the state's premiums tax and corporate income tax utilize the physical presence standard for determining nexus, as opposed to the state's financial institutions tax (FIT), which applies an economic nexus standard based on *MBNA v. DOR*. This language potentially represents a significant opportunity for taxpayers, as it appears to limit the economic nexus analysis applied in *MBNA* to the FIT, an apparent rejection of the Indiana DOR's stated policy that physical presence is not required, in order for a foreign corporation to have nexus for Indiana corporate income tax purposes.

Kansas DOR issues policy requiring individual partners to file separate returns to take advantage of modifications

Scott Riley, Director, St. Louis, Mo.

On Sept. 12, 2013, the Kansas Department of Revenue issued Notice 13-17, explaining that it is the Department's policy that composite returns may not reflect modifications to individual adjusted gross income. Hence, to take advantage of addition and subtraction modifications enacted by 2012 HB 2117 for tax years beginning after Dec. 31, 2012, individual partners must file separate returns. The modifications in question are discussed in detail in Notice 12-11 and include subtractions for net profit from a business, income from certain entities or of certain types (e.g., qualified income from partnerships and royalties) and farm income. Depending upon the nature of the partnership and the income involved, it is advisable for partners to explore whether compliance cost savings from continuing to file on a composite basis in Kansas offset the inability to utilize addition and subtraction modifications.

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