Tax Digest

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

October 2014

FEDERAL

IRS issues final *transition* guidance on disposition regulations

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On Sept. 18, 2014, the IRS released guidance to adopt the final regulations on dispositions of tangible property. Specifically, the guidance provides automatic method change procedures to adopt the final regulations governing the federal income tax treatment of dispositions of tangible property, as well as the treatment of assets included in one or more general asset accounts. As expected, the guidance allows taxpayers to treat a late partial disposition election as an accounting method by filing one or more Forms 3115 for tax years beginning before Jan. 1, 2015. Failure to take advantage of this limited window may preclude a taxpayer from recognizing past partial dispositions. For a limited time, the guidance also waives certain scope limitations under the general automatic method change procedures for taxpayers making concurrent changes for depreciation. Furthermore, the guidance provides transition rules for taxpayers that have one or more Forms 3115 under the proposed or final disposition regulations currently pending with the IRS National Office. Now that the IRS has released the final piece of guidance on the tangible property regulations, taxpayers can work with their tax advisors to fully implement the regulations and ensure compliance by their first tax year beginning after 2013.

IRS releases final regulations on retail inventory methods

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The IRS has released final regulations allowing retailers to approximate the cost, or the lower of cost or market value, of goods in ending inventory by using the retail inventory method (RIM). Under RIM, taxpayers value ending inventory by multiplying the retail selling prices of the goods on hand at the end of the tax year by a cost complement. The regulations generally prohibit reducing the cost complement for sales-based vendor allowances and margin protection payments. For taxpayers that may have difficulty removing these types of discounts from the cost complement, the regulations provide two alternative methods. The accompanying transition guidance allows taxpayers to implement the regulations either using a section 481(a) adjustment or using a cut-off basis for a limited time. To the extent a taxpayer using the last-in, first-out (LIFO) method with RIM has reduced its cost complement for these types of discounts and the discounts are captured in its LIFO layers, the use of the cut-off basis would provide audit protection and allow the taxpayer to leave its LIFO layers undisturbed. The regulations apply to tax years beginning after Dec. 31, 2014.

A shareholder's worthless stock deduction may trigger section 382 limitations on the corporation

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A corporation's ability to utilize net operating losses (NOLs) and built-in losses (e.g., depreciation, amortization and depletion deductions) may be limited following

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certain ownership changes due to a section 382 limitation. An ownership change is often conspicuous where shareholders sell or acquire stock, the loss corporation issues significant shares or both. In those cases, the loss corporation is generally aware of such stock changes and can address the impact of the changes, in some instances by avoiding a change altogether. However, a trap for the unwary exists where a shareholder owning 50 percent or more of a loss corporation (e.g., a private equity fund) writes-off their investment by taking a worthless stock deduction to accelerate loss recognition, yet continues to hold such shares. The shareholder is treated as disposing of and reacquiring those shares on day one of the following tax year, potentially triggering an unintended section 382 limitation and thereby, disallowing the use of not only NOLs, but also current deductions.

Are you authorized to represent your company before the IRS?

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A recent announcement published by the IRS Office of Professional Responsibility (OPR) highlights the IRS's position on which employees of a company are authorized to represent the company before the IRS, differentiating the Large Business & International (LB&I) Communications Agreement from a Form 2848, *Power of Attorney and Declaration of Representative*. The LB&I Communications Agreement provides a means for taxpayers to identify and designate employees to 1) discuss tax matters, 2) provide and receive information, or 3) receive and discuss adjustments (or some combination of these three). However, the agreement does not replace the requirement to file Form 2848. According to the OPR announcement, any employee who is advocating, negotiating or disputing issues with the IRS on behalf of a corporation (i.e., does more than deliver facts or explanations or merely receive documents) *must* be authorized to do so pursuant to the filing of a Form 2848. Furthermore, the Form 2848 must be signed by a "duly elected officer or director" who is appropriately identified in the corporation's corporate articles or bylaws. The announcement goes on to state that "vanity-titled" officers of a corporation are not legally authorized to file Form 2848. This announcement has widespread implications for corporations, as most vice presidents of tax, tax directors, tax managers and corporate controllers are not duly elected officers or directors, yet commonly perform functions beyond simply providing and receiving documents from the IRS. While the announcement focuses on employees representing a corporation, the instructions to Form 2848 address the definitions of authorized individuals for other legal entities, including partnerships (the tax matters partner), estates (the executor) and employee plans (generally a duly authorized trustee). Companies should ensure that their tax directors or employees who will be discussing technical issues with the IRS or will be advocating on behalf of their companies have a Form 2848 in place.

Court opinion tackles treatment of payments under the False Claims Act

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The First Circuit Court of Appeals recently held that in determining the extent to which a settlement under the False Claims Act (the FCA) is allocable to deductible, compensatory payments, a court may look to factors beyond the mere presence or absence of a tax characterization agreement between the settling party and the government. The court did, however, state that a tax characterization agreement between a taxpayer and the government would be very difficult to overcome. Although a taxpayer-favorable decision

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in an area that often causes controversy with the IRS, this court decision represents a potential circuit split regarding the ability to look beyond the absence of an explicit tax characterization agreement. Thus, to support the deductibility of settlement amounts under the FCA, taxpayers should, as part of any settlement proceedings, consider entering into an agreement with the government that specifies the intended tax treatment. However, because the government often refuses to enter into such tax characterization agreements, taxpayers should make sure to maintain documentation that supports the treatment of amounts in excess of single damages as compensatory. In all cases, taxpayers that are currently, or have been, engaged in actions under the FCA should work with their tax advisors to determine the appropriate federal income tax treatment of any damages or settlements incurred.

Health plan sponsors must pay new reinsurance fee

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The Affordable Care Act added a new reinsurance fee on major medical plans of $63 per employee, spouse and dependent enrolled in the plan. The plan sponsor must pay the fee if the health plan is self-insured, and 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 2014 fee is based on the average number of covered lives in the plan during the nine-month period from Jan. 1-Sept. 30, 2014, 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, 2014, and pay the fee by Jan. 15, 2015, using an online system called Pay.gov.

Investor issues surrounding tax inversions

Charles Schultz, Partner, Washington National Tax

Tax inversion mergers have certainly been in the news this year. A tax inversion occurs when a U.S. company uses an offshore merger to shift some of the corporate income to a more tax-friendly country. Although a tax inversion may provide substantial corporate tax benefits, this strategy can also result in capital gains recognition to the shareholders upon completion of the inversion. This can be problematic for older or retired investors lacking the liquidity or financial ability to pay the associated tax. Since investors have limited opportunities to avoid capital gain consequences once a tax inversion deal is set in motion, the key is to execute proper planning prior to completion of the inversion. For example, a gift of a "pre-inversion" investment to a beneficiary in a lower tax bracket may materially reduce the capital gains tax. High-income taxpayers can be subject to a 23.8 percent tax rate, while lower-income beneficiaries may be subject to a much lower 15 percent rate. Charitably minded shareholders may otherwise look to transfer the pre-inversion investment to a charity. The donor may receive a charitable income tax deduction for the fair market value of the donated investment, and the charity would not be subject to any capital gains tax on the investment after inversion. Taxpayers holding an interest in a corporation that is considering a tax inversion should consult with their tax advisors to ensure proper upfront tax planning occurs.

Medical device excise tax repeal on the table again

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Ever since the medical device excise tax (MDET) was enacted as part of the Affordable Care Act, members of Congress from both parties have been trying to repeal it. MDET repeal is once again being proposed as part of the Jobs for America Act (HR 4), which recently passed

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the House in a 253-163 vote. While MDET repeal has been blocked by Senate Majority Leader Harry Reid, that could change if Republicans win back control of the Senate in the upcoming midterm elections. However, the hurdle to enacting MDET repeal would remain high as President Obama would likely veto such legislation. That veto could only be overcome by a two-thirds majority vote in the House and the Senate. Although there has been some talk of retroactive repeal, it is highly unlikely due to the cost. In the meantime, affected companies need to continue to comply with the MDET rules.

Merger involving corporate-owned LLC ruled a tax-free reorganization

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The IRS recently ruled that a corporation's merger with and into a limited liability company (LLC) disregarded as an entity separate from its corporate owner represented a tax-free section 368(a)(1)(A) merger. As a result of the merger, the subsidiary ceased its separate legal existence yet remained in a legal entity separate from the acquiring corporation. The ruling serves as a reminder of the flexibility available through the use of disregarded entities (DREs) in corporate reorganizations and provides an example of why LLCs and DREs have become so common in mergers and acquisitions. Understanding how the corporate reorganization provisions treat DREs is crucial for achieving tax-efficient transactions, and the specific facts and steps underlying the reorganization are crucial. For example, had the reorganization in the ruling been structured as an acquisition of stock followed by a conversion into a DRE, the transaction would have been treated differently for tax purposes. As such, taxpayers contemplating a reorganization involving use of DREs should consult their tax advisors.

INTERNATIONAL

Borrowing money from offshore subsidiaries can create taxable income

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U.S. owners of successful foreign businesses with significant foreign earnings subject to low foreign tax rates should plan carefully before bringing those earnings home. Generally speaking, the United States does not tax a foreign corporation's earnings until those earnings are repatriated. However, in some cases, taxpayers may trigger repatriation by accident. For example, a foreign corporation's purchase of stock or debt issued by a U.S. company may constitute a repatriation resulting in taxable income to the corporation's U.S. shareholders. Many businesses with significant earnings accumulated offshore may wish to repatriate such earnings to service or reduce onshore debt of the U.S. parent. If a foreign subsidiary lends money to its U.S. parent, the loan will generally result in income to the U.S. parent equal to the full amount of the loan. However, with proper planning, a foreign subsidiary can lend to its U.S. parent without triggering income. For example, a loan extended and repaid within a quarterly reporting period generally will not trigger any income inclusion. In addition, loans that straddle quarter-end dates will not trigger income if the loans are repaid within 30 days and the total number of days during the year in which loans are outstanding does not exceed 60 days. Taxpayers must also plan with great care because the IRS may "step together" a series of loans made in a single year and view those loans as a single lending transaction, which could result in an unexpected income inclusion. Businesses with foreign operations that frequently enter into intercompany transactions should carefully analyze whether their intercompany debt could trigger an accidental repatriation.

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The OECD releases first seven elements of BEPS action plan

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On Sept. 16, 2014, the Organisation for Economic Co-operation and Development (OECD) released the first seven deliverables of its 15-item Base Erosion and Profit Shifting (BEPS) action plan designed to prevent taxpayers from transferring profit to low- or no-tax jurisdictions and taking advantage of inconsistencies between global tax regimes. The first seven elements of the action plan focus on: 1) the digital economy, 2) hybrid arrangements, 3) harmful tax practices, 4) preventing abuse of tax treaties, 5) revising transfer pricing rules (in particular with respect to intangibles), 6) improving transparency by requiring taxpayers to use a global information reporting template and 7) possibly implementing all BEPS recommendations in a multiplicity of jurisdictions through adoption of a multilateral agreement. The recommendations of the OECD BEPS initiative are not binding, though the G20 nations have expressed broad support. However, all taxpayers with international operations could be affected by the implementation of parts of the BEPS initiative. Particularly, the proposal to require taxpayers to file information returns using a global template could impose new reporting obligations and could increase the cost, complexity and burden of international tax compliance. Companies that are active internationally should monitor these developments in order to effectively plan for the impact of these potentially significant proposals.

STATE & LOCAL

California FTB releases new forms for reasonable cause claims for refund

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On Sept. 11, 2014, the California Franchise Tax Board (FTB) released two new forms and instructions for reasonable cause claims for refund. Form 2917, *Reasonable Cause - Individual and Fiduciary Claim for Refund*, is for use by individuals and fiduciaries, while Form 2924, *Reasonable Cause - Business Entity Claim for Refund*, is for use by business entities. California does not conform to federal penalty relief based upon a taxpayer's good filing history or "first-time abatement" relief. The FTB may abate a penalty if IRS documentation is provided that clearly states that the IRS abated the same penalty for "reasonable cause." These two new forms are only applicable to reasonable cause refund claims for penalties already paid. To contest a penalty that has not been paid, written reasonable cause abatement requests will still need to be sent to the FTB. The FTB is hopeful that the new forms will provide a smoother submission to allow the FTB to process the requests more quickly. Though the FTB recommends the use of the forms, it will continue to accept written reasonable cause claims for refund.

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