Tax Digest

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

October 2015

FEDERAL

S corporations should be cautious about property distributions when basis differs from fair market value

Kathy Miller, Senior Manager, Peoria, Illinois

S corporations that distribute noncash property will generally trigger gain to the extent the property's fair market value (FMV) exceeds its tax basis. However, if the reverse is true and the property's tax basis exceeds its FMV, the loss is not allowed unless the distribution is in liquidation of the corporation. Nonetheless, the shareholder's basis in the property received must be reduced to its FMV, and the unrecognized loss will reduce both the S corporation's AAA account and the shareholder's tax basis in the company's stock. For example, if a corporation makes a nonliquidating distribution to a shareholder of land with a tax basis of $1 million and a FMV of $500,000, the company cannot recognize the loss of $500,000. The shareholder's basis in the property will be reduced to $500,000, and any future gain recognized by the shareholder on the sale of the property will not be offset by the disallowed loss. In addition, the AAA account and the shareholder's basis must be reduced by the $500,000 disallowed loss. Before an S corporation distributes property (other than cash), it's important to first understand the related implications to the company and the recipient shareholder.

IRS releases draft 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 draft versions of the 2015 forms and instructions. Final versions are expected later this year. 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 do 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.

IRS provides guidance for fiscal- and short-year filers regarding extension of bonus depreciation and section 179 provisions

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The IRS recently released guidance related to the extension of various accelerated depreciation and expensing provisions under the Tax Increase Prevention Act of 2014 (TIPA). TIPA was enacted on Dec. 19, 2014, and includes, among other items, the following extenders:

- Fifty percent bonus depreciation under section 168(k) was generally extended to qualified property placed in service before 2015.

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- The election to forego bonus depreciation in exchange for an increased alternative minimum tax credit limit was generally extended to qualified property placed in service after 2013 and before 2015.
- The ability to carry over disallowed amounts under section 179 (providing for immediate expensing of specified property up to certain dollar limits) for qualified real property was extended to tax years beginning before 2015.

By the date of TIPA's enactment, certain taxpayers with fiscal tax years beginning in 2013 or short tax years beginning in 2014 had already filed 2013 tax returns or 2014 short-year tax returns that did not take into account the above extenders for property acquired and placed in service during 2014. The new IRS guidance allows these taxpayers to amend a prior-year return(s) or, in certain cases, request a current-year accounting method change to reflect the above extenders. The options provided by the guidance come with time-limits that must be carefully considered and adhered to. Affected taxpayers should work closely with their tax advisors to understand each potential option and its corresponding deadline.

Don't get too excited about House proposal for permanent extenders

Tom Windram, Partner, Washington National Tax

The House Ways and Means Committee recently approved legislation to permanently extend several tax breaks, including the following popular business incentives:

- 50 percent bonus depreciation
- Exemption from U.S. taxation for foreign active financing income
- Look-through treatment for payments between related controlled foreign corporations
- 15-year recovery period for qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property

This follows the Ways and Means Committee approval of legislation to permanently extend the research tax credit and section 179 expensing. Neither of these proposals have been brought to the House floor for a vote. Several recent attempts to permanently extend the most popular tax incentives have failed because members of Congress have been unable to agree on budget priorities. Even though the administration and Congressional leaders have all stated they support the permanent extension of certain popular tax breaks, they have been unable to agree on how to pay for them. The tactics of repeated "symbolic" votes and threats of government shutdown to advance political agendas also cause delays in voting on tax legislation. Ultimately, it is likely that sometime in very late December, Congress will enact a short-term extenders package that will be retroactive to Jan. 1, 2015, and effective through Dec. 31, 2016.

Employer-owned life insurance—benefits and pitfalls

Bob Adams, Partner, Washington National Tax

Employer-owned life insurance policies provide a certain amount of tax-advantaged utility to businesses with directors, executives or other highly compensated employees who are particularly instrumental to the company. These policies help companies to continue operations with the proceeds received in the event that one of the company's "key players" dies. They also provide businesses with certain opportunities in business succession planning, securing loan covenants and informal funding of nonqualified deferred compensation programs. Under the law, employers that want to have the tax benefits of an employer-owned life insurance policy must provide written notice to the employee of the terms of such a policy that is to be taken out on his or her life, such as the maximum amount of coverage on the policy and that the business will be the beneficiary. Prior to issuance of the policy, the employee must consent in writing to being insured and to having coverage continue after he or she terminates employment. Once the consent is obtained, the employer is required to annually report the policy to the IRS on Form 8925, *Report of Employer-Owned Life Insurance Contracts*. Failure to comply with the notice and consent requirements results in the death benefits from the employer-owned life insurance policy being included in the gross income of the business for tax purposes. The effective tax rate could be as high as 35 percent of the policy death benefit. Consequently, the penalty for not properly implementing and reporting employer-owned life insurance can be a large, unnecessary tax bill. Companies should consult their tax advisors to discuss the benefits of employer-owned life insurance and how to implement such policies in the tax-efficient manner the law permits.

Federal appeals court decides important case on gain on the sale of residence

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Most taxpayers find the $250,000 exclusion of gain ($500,000 for married taxpayers) from the sale or exchange of a personal residence to be straightforward. To qualify for the exclusion, the taxpayer has to have owned and used the house as his or her residence for two years or more during the five-year period prior to the sale or exchange date, and the exclusion can be utilized only once in a two-year period. The relative simplicity of the statute belies the complications that occur when certain taxpayers seek to fall within the rule. In *DeBough v. Shulman*, the 8th Circuit Court of Appeals recently affirmed a Tax Court opinion on the effect of property repossession on the gain exclusion. In *DeBough*, the taxpayer sold his house in an installment sale and excluded $500,000 of gain. Three years later, the buyer defaulted and the taxpayer repossessed the house. The taxpayer recognized the long-term capital gain in excess of the exclusion under the reacquisition of real property rules. However, the reacquisition rules require a taxpayer to resell his or her residence within one year to preserve the gain exclusion. In essence, the two-step transaction is deemed one transaction as long as the property is resold within a year. The taxpayer in *DeBough* did not resell the residence and thus was not permitted to use the $500,000 exclusion to offset the capital gain realized on the sale and reacquisition of his house. The lesson learned is that even straightforward provisions such as this may still demand review from a qualified tax advisor to avoid adverse tax consequences, particularly if the transaction is complicated by an installment sale.

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