# Tax Digest

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

September 2013

## FEDERAL

### IRS disallows abandonment loss for costs related to *postponed* transactions

*Kate Abdoo, Manager, Washington National Tax*
*Nick Gruidl, Partner, Washington National Tax*

The IRS recently released a field attorney advice memorandum stating that a taxpayer was not entitled to an abandonment loss for certain costs incurred in pursuing a plan of reorganization and public offering where such a plan was determined to be postponed and ultimately completed, rather than terminated. The memorandum serves as a good reminder that mutually exclusive transactions must be carefully analyzed before writing off any related costs. However, based on the taxpayer facts provided in the memorandum, it appears the taxpayer had a supportable position to write off the costs related to the terminated, initial plan under section 165 and that the relevant authorities would continue to support the deduction of abandonment losses where a taxpayer subsequently enters into a similar but separate transaction. Taxpayers pursuing one or more forms of a transaction should work with their tax advisors to analyze whether costs related to any abandoned plans may constitute deductible losses versus capitalizable costs of the ultimately consummated transaction.

### Guidance released on repair and maintenance costs for steam or electric generation property

*Natalie Tucker, Director, Washington National Tax*
*Kate Abdoo, Manager, Washington National Tax*

The IRS recently issued a directive providing guidance to industry directors and field specialists with respect to examinations involving whether costs incurred to maintain, repair or improve steam or electric generation property should be deducted versus capitalized, and instructing exam agents to discontinue examining a taxpayer's treatment of such costs for taxable years beginning before Dec. 31, 2012 (and to refrain from examining the treatment of such costs for a taxpayer's first, second and third taxable year ending after Dec. 31, 2012). The directive is welcome news for taxpayers in the power generation industry and should help to encourage such taxpayers to evaluate existing methods of accounting for costs related to their plant property to determine whether changing to use one or more of the unit of property or major component definitions provided for in Rev. Proc. 2013-24 is advisable.

### IRS issues favorable guidance on the treatment of advance payments from the sale of gift cards

*Natalie Tucker, Director, Washington National tax*
*Kate Abdoo, Manager, Washington National Tax*

The IRS recently issued a revenue procedure providing that taxpayers that sell eligible gift cards redeemable by unrelated third parties may be eligible to use the deferral method of Rev. Proc. 2004-34 even if the taxpayer never recognizes in revenues in its applicable financial statements (AFS) (or for a taxpayer without an AFS, never earns) payments from the sale of such gift cards. The issuance of Rev. Proc. 2013-29 provides favorable guidance and eliminates an area of uncertainty for taxpayers that sell gift cards redeemable by unrelated third parties. Taxpayers that receive advance payments from the sale of eligible gift cards should take time to review their methods of accounting for the sale of gift cards and determine whether filing for a method change to adopt the deferral method of Rev. Proc. 2004-34 is beneficial.

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## IRS extends relief for late elections under Subchapter S

*James Sansone, Director, Schaumburg, Ill.*

Since 1997, the IRS has issued multiple revenue procedures dealing with relief for late elections under Subchapter S. These include the election to be treated as an S corporation, Electing Small Business Trust (ESBT), Qualified Subchapter S Trust (QSST), or Qualified Subchapter S Subsidiary (QSub), as well as entity classification elections as a corporation coupled with an S election. In Rev. Proc. 2013-30 the IRS consolidated all prior procedures covering relief for late S elections. The procedure specifies the forms to be filed, attachments and statements to be included and legends for tax returns filed under the procedure. Requirements for *reasonable cause* statements and explanations of *inadvertent* errors are described. In addition, the period during which relief may be requested without filing a ruling request has been extended to three years and 75 days from the date the election was intended to be effective.

## New 3.8 percent net investment income tax planning opportunities

*Samuel Cohn, Partner, Chicago, Ill*

Effective Jan. 1, 2013, the Affordable Care Act introduced a new 3.8 percent tax on investment income applicable to (1) "high-income" individuals, and (2) trusts and estates with undistributed income in excess of a nominal amount. Investment income generally includes interest, dividends, capital gains, annuities, royalties and rents, as well as income generated from businesses that constitute *passive activities* or trade in financial assets. An important exception is provided for income from businesses (other than those engaged in trading financial assets) in which the taxpayer is *active* for purposes of the passive loss rules. These complex passive loss rules will now be of critical importance in determining whether an *activity* exception applies for purposes of the new 3.8 percent tax. Accordingly, it may be appropriate to review your trade or business activities with your tax advisor. Another potentially valuable exception exists for investment income earned by a minor child and taxed at a parent's rate under the *kiddie tax*. If the minor child does not have total income over the applicable threshold ($200,000 for single taxpayers), the income may be exempt from the 3.8 percent add-on tax, even if the parents would be otherwise subject to that tax. Taxpayers must be careful, however, to file a separate tax return for the child and not elect to include the child's income in the parent's tax return. Finally, arrangements involving trusts or estates holding pass-through interests in businesses should be scrutinized to determine if the activity exception applies to the trustee's activities, and if not, to consider distributions to trust beneficiaries not subject to the 3.8 percent tax due to their income levels. Taxpayers should take the time now to discuss with their tax advisors the new 3.8 percent tax on investment income, its potential effect on them, and related planning opportunities.

## Satisfying a subsidiary's liability: Capital item or expense?

*Amy Kasden, Manager, Boston, Mass.*
*Nick Gruidl, Partner, Washington National Tax*

A recent IRS field attorney advice serves as a reminder that when a parent corporation sells the stock of a subsidiary, its contractual obligation to pay the former subsidiary's liabilities generally does not, upon payment, result in an ordinary deduction, but rather is capital in nature. However, the legal underpinning arguably applies beyond sale transactions to any situation where a shareholder satisfies a corporation's liabilities. The specific issue in FAA 20132801F related to a deduction claimed by a selling parent for costs to settle a legal liability of its former subsidiary. In disallowing the selling parent's deduction, the IRS reiterated the longstanding principle that a taxpayer may take a deduction for its cost of doing business but cannot take a deduction for

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another taxpayer's cost of doing business. Therefore, the IRS treated the former parent's payment as a contribution to capital relating back to immediately before the stock sale, resulting in an increase in the parent's basis in the subsidiary for purposes of determining its gain or loss on such sale. In order for a shareholder to claim an ordinary deduction for this type of payment, it would need to establish the payment was in fact made in furtherance of its business. For example, if the settlement was made in order to protect the shareholder's business reputation, a position may exist that the expense was ordinary and necessary at the shareholder level.

## Health insurance marketplace open enrollment starts soon

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

Due to the Affordable Care Act, there will be an online marketplace established for each state where individuals can comparison shop for health insurance coverage starting Oct.1, 2013. The marketplace, also known as an exchange, will be open to all individuals and to businesses with less than 50 employees. Individuals with household income below certain levels may qualify for government subsidies to help pay for their health insurance. Although some states are setting up their own marketplaces, the majority of states will be using a marketplace operated by the federal government. To access information about any state's marketplace, visit the federal government's website and click on the link to the state. Employers subject to the Fair Labor Standards Act are required to provide a written notice about the health insurance marketplace to their employees by Oct. 1, 2013, and to new hires after Oct. 1 within 14 days of their start date. Two model notices are available – one for employers that offer a health plan and another for employers that do not offer a plan. Since the notices provide information about the employer and its plans, employers will need to customize the model notices prior to distribution.

## Limit on tax deductibility of compensation paid by covered health insurance providers

*Steve Levin, Director, Washington National Tax*

With respect to "covered health insurance providers" (CHIPs), the Patient Protection and Affordable Care Act (ACA) limits, for tax years beginning on or after Jan. 1, 2013, the compensation deduction related to any applicable individual to $500,000. A CHIP is generally a state-licensed health insurance issuer with at least 25 percent of gross premiums received from providing health insurance coverage under employer-sponsored group health plans. Employers that sponsor self-insured medical reimbursement benefits are not considered CHIPs. Although employers that are CHIPs are likely aware of the compensation limit, unique elements of the limitation can have unexpected consequences. First, unlike the limit on tax deductions for compensation paid to certain senior officers of public companies, the CHIP limitation applies to any officer, director, employee or individual who provides services for or on behalf of a CHIP. Second, the limit extends to any employer that is part of a parent-subsidiary controlled group with a CHIP, treated under pension rules as part of an affiliated service group with a CHIP, or otherwise aggregated with the CHIP. Finally, even performance-based compensation is subject to the limit, and the limit continues to apply to compensation paid post-employment.

## CFOs more engaged in companies' health care strategies and cost containment

*Bob Adams, Partner, Washington National Tax*

According to a Towers Watson survey of benefit managers at 420 employers, CFOs of midsize and large companies have become much more involved in their companies' health care strategies since the enactment of the Affordable Care Act (ACA) in 2010. CFOs have increased engagement around the expected cost increases associated with the ACA that many expect will reduce

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earnings per share, as well as with respect to new health care strategies for their employees. One significant cost increase for 2014 will be the *transitional reinsurance fee* – a flat $63 annually for every employee and dependent covered by an employer-sponsored health benefit plan. An even more troublesome matter for many CFOs is an excise tax, called the *Cadillac tax*, that will be assessed beginning in 2018 on employers whose health care plans are valued at more than $10,200 for individual coverage and $27,500 for family coverage. Impacted employers will be required to pay an excise tax equal to 40 percent of the *excess benefit*. The 2013 Health Care Changes Ahead Survey by Towers Watson found that a majority of employers do anticipate making moderate to significant changes in their health benefit programs for all employees and retirees by the beginning of 2016.

## INTERNATIONAL

### IRS opens FATCA portal and releases draft FATCA Form 8966

*Mario de Castro, Director, Vienna, Va.*
*Ramon Camacho, Principal, Washington National Tax*

The IRS recently opened the online portal taxpayers must use to register with the IRS in order to comply with various aspects of the U.S. Foreign Account Taxpayer Compliance Act (FATCA). In addition, the IRS released a draft Form 8966 that taxpayers must submit to the IRS in order to comply with FATCA. Under FATCA, payments of U.S. investment income and gross proceeds made to certain non-U.S. entities are subject to a 30 percent gross basis withholding tax unless the payee enters into a foreign financial institution (FFI) agreement with the IRS under which it must report specific information relating to its U.S. account holders or is otherwise deemed to comply with FATCA under special rules. Withholding is set to begin as early as July 1, 2014, in certain cases. Non-U.S. entities that wish to avoid FATCA withholding may do so by entering into an FFI agreement through the online portal. Taxpayers that register through the portal before April 25, 2014, will be included on the list of FATCA-compliant entities the IRS will publish in early June. U.S. persons are required to withhold 30 percent of any U.S.-source investment income or gross proceeds paid to non-U.S. persons unless the payee submits appropriate documentation establishing compliance with FATCA. Failure to properly withhold will result in liability for the tax along with penalties and interest. To avoid these potentially significant liabilities, U.S. withholding agents and foreign payees should begin to assess their potential exposure under FATCA.

### Cayman Islands concludes information exchange agreements to comply with FATCA

*Mario de Castro, Director, Vienna, Va.*
*Ramon Camacho, Principal, Washington National Tax*

The government of the Cayman Islands (GCI) recently announced it had concluded a Model 1 intergovernmental agreement (IGA) and a new tax information exchange agreement (TIEA) with the U.S. Treasury Department. The IGA should greatly facilitate compliance with the Foreign Account Taxpayer Compliance Act (FATCA), which imposes a 30 percent withholding tax on Cayman-based entities unless such entities provide information to the IRS regarding their U.S. account holders. Under the IGA, such taxpayers must provide information directly to the GCI instead of the IRS, and the GCI will relay the information to the IRS automatically under the provisions of the TIEA. Cayman-based entities may now become FATCA compliant while also complying with Cayman Island privacy laws. Cayman-based entities will now be governed by the Cayman IGA and will not be required to enter into an agreement directly with the IRS to become FATCA compliant. Under the provisions of a recent IRS notice, taxpayers may generally rely on the

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Cayman IGA once it becomes public even though it may not be implemented by the GCI until a later time. In many cases, the Cayman IGA will provide significant benefits over an agreement with the IRS. For example, it is expected the IGA will exempt gross proceeds from FATCA withholding. Until the Cayman IGA is released to the public, taxpayers may review the provisions of the U.S. Treasury's standard Model 1 IGA since the Cayman IGA will likely be based almost entirely on these provisions.

## STATE & LOCAL

### Injunction lifted barring enforcement of Colorado out-of-state seller use tax notice and reporting obligations

*Steve Riddle, Principal, Denver, Colo.*

On Aug. 20, 2013, the U.S. Court of Appeals for the 10th Circuit issued its decision in *Direct Marketing Association v. Brohl*, holding that the U.S. District Court for the District of Colorado lacked jurisdiction to enjoin Colorado from enforcing a state law applicable to retailers (1) that do not collect Colorado sales tax, and (2) whose gross sales in Colorado exceed $100,000. The law requires such retailers to either (1) collect and remit sales tax voluntarily, or (2) provide notices to Colorado purchasers informing them of their duty to pay use tax, send annual purchase summaries to Colorado customers, and annually report Colorado purchaser information to the Colorado Department of Revenue. Because the Court of Appeals' decision was made on jurisdictional grounds, it did not evaluate the merits of the case, leaving open the question of whether the requirements imposed by Colo. Rev. Stat. Sec. 39-21-122 and associated administrative regulations violate the Commerce Clause of the U.S. Constitution. Direct Marketing Association may file a petition for rehearing with the Court of Appeals or a petition for certiorari with the U.S. Supreme Court to seek to vacate the Court of Appeals' decision and obtain a decision on the merits. Should a petition be filed, the Court of Appeals' order for the District Court to vacate its decision and lift its permanent injunction will be held in abeyance until a final decision on the jurisdictional issue is obtained. Remote sellers that do not collect and remit Colorado sales tax and exceed the $100,000 threshold should pay close attention to this case, as the Colorado Department of Revenue is likely to begin enforcing the provisions of Colo. Rev. Stat. Sec. 39-21-122 and associated administrative regulations as soon as the District Court's injunction is lifted.

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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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Printed in the U.S.A.

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