Washington National Tax Quarterly Update

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Assurance ▪ Tax ▪ Consulting

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Today's Presenters

Capitol Hill Update

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Agenda

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Capitol Hill update

Rick Bailine, Principal-in-Charge, Washington National Tax

Overview

- Tone of national politics
- The next multi-billion dollar stimulus
- Parties' budget proposals
- The real issue: Top tax expenditures for 2010-2014

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Tone of national politics

Have our national politics gone to the dogs?

- Rover Rides on the roof
- Fido-flavored food

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The next multi-billion dollar stimulus

- Obama campaign chest
- Romney campaign chest

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Parties' budget proposals

- Ryan budget
  - Social Darwinism
- Obama budget
  - 97-to-0 Senate vote last year

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Recent congressional actions

- The Buffet Tax
  - Death by non-filibuster

- Republican tax cut for small business
  - Passed House; Senate fate - see above!

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Top five corporate tax expenditures, 2010-2014

	Cost ($ billions)
Deferral of active income of controlled foreign corporations	$71
Exclusion of interest on state and local government bonds	$45
Deduction for income attributable to domestic production activities	$43
Inventory property sales source rule exception	$38
Depreciation of equipment in excess of alternative depreciation system	$37

From Tom Barthold's Sept. 22, 2011 testimony before the Joint Select Committee on Deficit Reduction

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Top five individual tax expenditures, 2010-2014

	Cost ($ billions)
Exclusion of employer-provided contributions for health care, health insurance premiums and long-term care premiums	$659
Deduction for mortgage interest on owner-occupied residences	$484
Reduced rate of tax on dividends and long-term capital gains	$403
Net exclusion of pension contributions and earnings	$303
Earned income tax credit	$269

From Tom Barthold's Sept. 22, 2011 testimony before the Joint Select Committee on Deficit Reduction.

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M&A update

Nick Gruidl, Partner, Washington National Tax

Topics of discussion

- Update on the rescission doctrine
- Transaction costs: Update and traps

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Rescission doctrine

- What is it?
- When can it be applied?
- Treasury and IRS reassessment of rescission
- How to proceed from here?

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What is the rescission doctrine: A tax "do-over"?

- Abrogation, cancellation or voiding of a contract
- Releases contracting parties from further obligations to each other
- Restoration of the parties to status quo
- Rescission must occur within the same tax year as the original transaction
- *Penn v. Robertson,* 115 F.2d 167 (4th Cir. 1940)
- Rev. Rul. 80-58

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Rescission doctrine

Rev. Rul. 80-58

- Anthony sells land to Isabella
- Isabella is unable to obtain rezoning and returns land to Anthony under the terms of the contract
- Anthony returns proceeds to Isabella
- As long as transactions occur within the same tax year, the original sale is treated as if it never occurred

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Rescission doctrine (cont.)

How is rescission effectuated?

- Mutual agreement of the parties
- Declaration of one party without consent of the other if sufficient grounds exist (e.g., fraud)
- Court for a decree of rescission
- State law rescission of the contract is not required
  - i.e., the transaction does not have to be legally rescinded

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Rescission doctrine: Examples

- PLR 201211009 – Rescission to allow a QSP
- PLR 201016048 – Rescission of share issuance to avoid cancellation of debt and allow section108(e)(6) capital contribution treatment – only partial rescission
- PLR 200701019 – Stock purchase followed by liquidation rescinded to allow retention of basis in Sub that was then sold – hindsight?
  - Decision to liquidate was not "prudent"
- PLR 20095206 – Partnership rescinds incorporation and reforms as LLC due to inability to attract investors
- PLR 200843001 – Sale of a portion of foreign hybrid rescinded to retain DRE status

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Rescission doctrine: IRS ruling history

- Beginning in 2005, IRS corporate began issuing a number of private letter rulings on rescission
  - 15 rulings between 2005-2011
- In general, rulings have taken a broad interpretation of Rev. Rul. 80-58
  - How far should a ruling be applied beyond the specific facts?
- Treasury became concerned over IRS ruling policies and added rescission to the 2011 guidance plan
  - Concern over application of ruling, as well as establishment of “secret law” and disparate treatment of taxpayers based on contacts inside the Beltway

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Rescission doctrine

Current IRS policy:

- IRS added rescission doctrine to the “no rule” policy in 2012
- Guidance project in process
- Issues to address include:
  - Use of hindsight for retroactive tax planning
  - Application within the related party context
  - Areas of inapplicability (e.g., investment in U.S. property tested quarterly)

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Rescission doctrine (cont.)

How to proceed from here?

- Despite the no rule policy, taxpayers may continue to rely on case law and Rev. Rul. 80-58 in applying rescission doctrine
- How broadly can a taxpayer safely apply rescission doctrine without a ruling?
  - Will a taxpayer apply rescission where it could be argued hindsight is being used for retroactive tax planning?

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Transaction costs

Transaction costs

The majority of costs surrounding an M&A transaction fall into one of two categories:

- Compensatory costs
- Professional advisory fees, including investment banking success-based fees

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Transaction costs: Compensatory costs

- Compensation to employees related to an M&A transaction is not subject to capitalization
- Special timing rules under section 404 often create difficulty in timing of transaction-related deductions
  - Deferred compensation is deductible in the year in which the compensation is included in the employees' income
    - Includes standard deferred compensation plans, accrued vacation, stock appreciation rights and restricted stock (generally not applied to stock options)
- Example
  - Transaction closes 9/30/2011 and results in short tax year return for the Target
  - Deferred compensation deductions are deferred until the 12/31/2011 tax year-end

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Transaction costs: Success-based fees

- Success-based fee is any fee due only upon the successful completion of a transaction
- Notice 2011-29 was issued in an effort to eliminate controversy between the IRS and taxpayers surrounding deductibility of success-based fees
  - Only applicable to success-based fees
- Rather than satisfying stringent documentation standards, taxpayers are able to elect to treat 70 percent of success-based fees paid in an acquisitive transaction as non-facilitative
  - Taxable years ending after 4/8/2011

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Success-based fees

- Safe harbor election – Rev. Proc. 2011-29
  - Irrevocable election
    - Attach statement to **original** return for year in which success-based fee is paid or incurred
    - Made on transaction-by-transaction basis
- Transactions ineligible for the safe harbor:
  - Target costs in an asset sale
  - Target costs in a section 338(h)(10) transaction
  - Acquisitions of less than 50 percent of an entity
  - Certain leveraged buy-outs (LBOs and MBOs)

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Directive on success-based fees

- LB&I Directive 04-0511-012 (7/28/2011)
  - Exam should not challenge taxpayer's treatment of success-based fees paid or incurred in taxable years ended before 4/8/2011
    - Only with respect to covered transactions, AND
    - If taxpayer capitalized at least 30 percent of total success-based fees incurred with respect to transaction
  - Applies only to original timely filed returns
    - Not applicable for amended returns and claims
- Action: analyze benefit of safe harbor for fiscal and short years ended pre-4/8/2011

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Disregard of section 409A

Deferred compensation distribution rules may be hazardous to your wealth

Steve Levin, Director, Washington National Tax

Distributions under section 409A deferred compensation plans

- Restricted to permitted distribution events
  - Separation from service, death, disability, CIC event, objectively identified payment date, unforeseeable emergency
  - No discretion permitted – by either the service recipient or service provider
- Timing and form of payments must be specified at time of deferral
- Distribution events, timing and form of payment are generally “etched in stone” and cannot be accelerated or deferred – however …

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Certain amendments to the distribution provisions are acceptable

- Can add death, disability or unforeseeable emergency as an acceleration trigger, but not to defer distributions
- Can add a "subsequent deferral election" feature However, it:
  - May not take effect for 12 months from date the election is made
  - Must defer the originally scheduled distribution for a period of not less than five years (except as to distributions triggered by death, disability or unforeseeable emergency)
  - May not be elected within 12 months of the originally scheduled payment date

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Certain amendments to the distribution provisions are acceptable (cont.)

- There are certain permitted exceptions that are not considered "accelerations" under Regs. section 1.409A-3(j)(4)

  - e.g., small cash-outs; certain permitted distributions on plan termination; distribution of section 457(f) taxed amounts; distributions upon income inclusion under section 409A; payments to cover employment taxes

- Payment can be deferred in limited instances

  - e.g., if payment will jeopardize company's ability to continue as a going concern or where calculation of the benefit is not practicable due to events beyond the control of the service provider

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Certain amendments to the distribution provisions are acceptable (cont.)

- Rules of administrative convenience are available
- Payments are considered timely if paid no earlier than 30 days prior to the scheduled payment date or subsequent to the payment date but in the same calendar year (or, if later, by the 15th day of the 3rd calendar month following the scheduled payment date and the service provider cannot designate the date for payment)
  - Example 1: Scheduled payment date is 6/30/12: payment can be made as early as 5/31/12 or as late as 12/31/12 and be treated as a timely payment
  - Example 2: Scheduled payment date is 12/31/12: payment can be made as early as 12/1/12 or as late as 3/15/13 as long as service provider cannot designate the payment date

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Failure to comply with section 409A - consequences

- Other changes to the timing/form of distributions will result in a section 409A failure
- Consequences to service provider of a section 409A failure:
  - Inclusion of income occurs at time of vesting - not when payment is received
  - Additional 20 percent federal income tax on section 409A income
  - Possible additional state income tax on section 409A income
  - Premium interest-based tax at 1 percent over the IRS underpayment rate measured from when the tax should have been paid to when it is actually paid
  - The additional taxes will result in interest charges and may result in underpayment penalties

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Failure to comply with section 409A - consequences (cont.)

- Consequences to service recipient of a section 409A failure:
  - Exposure for uncollected income and payroll withholding taxes
  - Penalties for failing to correctly report and withhold on Form W-2, Form1099 or Form 941
  - Possible penalty for negligent or intentional disregard of federal tax withholding obligations
  - Potential claims from plan participants looking to be made "whole" against additional amounts incurred by reason of employer's negligence in causing a section 409A failure

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Possible relief – IRS corrections procedures

- IRS Notice 2008-113 provides some relief for correction of section 409A operational failures, including distribution failures
- Relief depends on i.) how quickly the failure was identified and corrected, and ii.) whether the affected individual was an "insider" or a "non-insider"
  - The sooner the failure is identified and corrected, the better
  - Relief is more generously allowed for non-insiders versus insiders
  - Insiders include officers, directors and 10 percent owners
  - Correction requires the service recipient and all affected service providers to attach a "section 409A compliance statement" to their timely-filed tax returns in the year of correction identifying the failure, correction and eligibility for relief under the notice

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Compensation & benefits update

Bill O'Malley, Director, Washington National Tax

Topics

- Health care reform
  - Actions to consider now
- 401(k) plans
  - U.S. Department of Labor initiatives
  - Fiduciary litigation
- Adding annuity options to employer plans

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Health care reform

- ACA references the combination of:
  - Patient Protection and Affordable Care Act
  - Health Care and Education Reconciliation Act of 2010
- The Supreme Court has heard the arguments and now has to decide whether to:
  - Uphold the ACA
  - Overturn the ACA
  - Overturn the individual mandate, but keep other parts of the ACA intact

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Affordable Care Act 2012 action dates

- Maximum health flexible spending account (FSA) elections
  - As early as 2/1/2012
- Medical loss ratio (MLR) rebates
  - 8/1/2012
- Summary of benefits and coverage (SBC)
  - 9/23/2012
- Form W-2 reporting
  - 12/31/2012

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Flexible spending accounts (health)

- Effective 1/1/2013, regardless of the plan year, the limit on employee salary reductions to a health FSA will be $2,500
  - This is a per-participant, per-employer limit
    - For example, if someone works for two companies, the employee contribution limit is $5,000 for the year
  - This change in the law does not limit the ability of an employer to contribute the plan
    - For example, if an employer matches 20 percent of the employee's deferral, then the employee would have a $3,000 spending limit

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Health FSA plan documents

- Action items
  - Calendar year plans
    - Amend the plan before 1/1/2013
  - Fiscal year plans
    - Consider switching to the calendar year as of 1/1/2013
    - Adopt the new limit early - e.g., on 7/1/2012 for a plan with a June year-end (tracking issue)
    - Stay the course (tracking issue)
  - All plans
    - Communicate the changes to employees

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Medical loss ratio (MLR) rebates

- Applicable to insured plans
- An insurer must provide rebates to enrollees when their spending for the benefit of policyholders on reimbursement for clinical services and health care quality improving activities, in relation to the premiums charged (as adjusted for taxes), is less than the MLR standards established pursuant to the statute
  - Rebates are based upon aggregated market data in each state and not upon a particular group health plan's experience
  - Rebates must be paid by August 1st each year

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MLR fiduciary issue

- What if your company receives an MLR rebate?
- You need to determine if the rebate is a plan asset under U.S. Department of Labor regulations
  - If the plan or its trust is the policyholder, the plan's trust should receive the rebate
  - However, most insured plans do not have a trust. In this case, the items to consider are:
    - Review the applicable plan documents
      - Did the employer pay the entire cost of the premiums? (that would be unusual)
      - What percentage did the employer pay compared to participants?

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Allocating the MLR rebate

- If you determine that the rebate is at least in part a plan asset, the use of the asset is a fiduciary decision. Possible uses are:
  - Distribute in cash to plan participants (taxable)
  - Reduce future premium costs for participant
- Based on prior history with the demutualization of the insurance industry (e.g., Principal Life, Prudential, Equitable, etc.) the U.S. Department of Labor is likely to initiate some form of investigation process to determine the proper use of plan assets

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Summary of benefits and coverage

- The summary of benefits and coverage (SBC) is a new requirement, and in addition to (not in lieu of) the requirement under ERISA to provide a summary plan description
  - The SBC document is a description of a health plan's provisions regarding eligibility, covered services, excluded services, cost-sharing percentages, etc.
  - The regulations provide that employers must issue the SBC in connection with the first open enrollment period that starts after 9/23/2012

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Form W-2 reporting changes

- Staring with the 2012 Forms W-2, the ACA requires that employers report on Form W-2 the value of employer-sponsored coverage
- IRS guidance is in Notice 2012-9
  - IRS has exempted:
    - Small issuers, for now (less than 250 Forms W-2 in 2011 = small)
    - Indian tribal governments
  - An employer does not have to report to employees who receive their Forms W-2 during the course of the year

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401(k) plans

- U.S. Department of Labor initiatives
  - Service provider disclosures (to employers)
    - Due by 7/1/2012
  - Plan sponsor disclosures (to participants)
    - Initial disclosure date for most plans is 8/30/2012
- Fiduciary litigation

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Service provider disclosures

- Plan sponsors have a fiduciary obligation to understand the fees paid from plan assets
  - Ignoring this requirement can constitute participation in a prohibited transaction
- Service providers have many methods of charging fees
  - Percentage of assets
  - Base plus per-head fee
  - Combination of both

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Service provider evaluation process

- Start with developing an understanding of all of the fees that a service provider charges
  - Not always easy to comprehend because of the indirect compensation received by recordkeeping firms
- After understanding the fees, an employer needs to make a qualitative decision as to whether the fees are reasonable for the services provided
  - This is not a requirement to only select the lowest cost provider
- Document

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Participant disclosures

- Applies to participant directed plans (401(k), etc.)
- Types of disclosures:
  - Initial
    - General plan and investment fee information, including options and restrictions on the right to invest
  - Annual
    - Updated information on plan and investment fees (estimated)
  - Quarterly (participant statement focused)
    - Actual amounts deducted from participant accounts
  - Updated information
    - As necessitated by plan changes

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401(k) plan fee litigation

- In addition to the potential for incurring a prohibited transaction tax and Department of Labor fiduciary penalties, plan sponsors that ignore the fundamental requirement to know what they are doing risk participant litigation
  - Many of the country's largest employers, such as John Deere, Caterpillar, Boeing, Wal-Mart, etc., have been involved in expensive litigation defending the prudence of their respective 401(k) plans

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Tussey v. ABB, Inc.

- This recently decided case led to a finding that the fiduciaries breached their duties by:
  - Failing to monitor plan recordkeeping costs
  - Not following their own stated policies for negotiating recordkeeping fees and for changing the investments made available to plan participants
  - Choosing fee structures and investment options that had the effect of benefiting the company to the detriment of plan participants
- Approximately $35,000,000 in damages awarded to the plaintiffs

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Plan provided annuities

- For a variety of administrative reasons, most defined contribution plans do not offer annuity payout options
- The Treasury Department would like to change that and has undertaken a project to examine ways to encourage the use of annuities as a part of a participant's retirement payout
  - This resulted in the Treasury and IRS issuing proposed regulations regarding longevity annuity contracts in retirement plans

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Longevity annuity contracts

- Longevity annuity contracts are deferred annuity contracts that begin payments well after a plan's normal retirement age
  - For example, a participant with an account balance of $500,000 retires at age 65:
    - Uses $50,000 to purchase a longevity annuity contract that is to commence at age 85
    - Leaves the remaining $450,000 in the plan
  - The problem that the regulations address is how the plan can provide for the deferred payout and still meet the age 70½ minimum distribution requirements under section 401(a)(9)

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Proposed regulation

- Applies to qualified plans, 403(b) plans, governmental 457(b) plans, Roth IRA and traditional IRA-based plans
- Maximum purchase amount of $100,000
- Maximum percentage of assets for traditional IRA-based plans
- Deferred start date cannot be later than 85
- Restrictions on survivor benefit percentages

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