Year-end tax letter
2012

Candor. Insight. Results.

As we write this tax planning letter, uncertainty is the name of the game. Don't expect any last-minute tax legislation in the final days leading up to the election. If one party wins the presidency and both houses of Congress, it is possible they will delay tax legislation until they assume control in 2013. If the election results maintain the status quo, we would expect to see some action in the lame duck session—most likely a continuation of some, but not all, of the various extender provisions and a one-year alternative minimum tax (AMT) patch.

A divided government following the election could lead to a continued inability to compromise. If Congress does not act, the Bush-era tax cuts will expire. The resulting sharp income tax rate increase on Jan. 1 will hit most Americans, not just those earning more than $250,000. With the Supreme Court upholding the health care law, a 3.8 percent Medicare tax on net investment income will go into effect on top of the increase in income tax rates. In addition, the automatic sequestered budget cuts of $1.2 trillion will begin to take effect; the combination of all of these is commonly referred to as the "fiscal cliff." Many economists predict that the failure to address the fiscal cliff could throw the economy back into a recession.

What does this mean for you? Our advice is to proceed as if the 2001 tax cuts will expire at the end of 2012, but be ready to adjust your planning quickly depending upon the outcome of the November elections. With this background in mind, our planning letter focuses on the 3.8 percent Medicare tax, expiring tax provisions, the tax impact of the health care law, as well as other critical items. As always, we encourage you to contact your Baker Tilly advisor to discuss how these issues impact your tax position.

Planning for the 2013 rate increases

Effective Jan. 1, 2013 (barring any legislative action during the remainder of 2012), the "Bush tax cuts," among other tax provisions, are set to expire, which could mean:

- The highest income tax bracket for married taxpayers filing a joint return will increase to 39.6 percent from the current 35 percent for taxable income in excess $379,650. Note that the 39.6 percent rate does not include the 3.8 percent Medicare tax discussed above.
- The tax on long-term capital gains will increase to 20 percent from 15 percent.
- The tax on qualified dividends will increase to ordinary income rates (top rate of 39.6 percent) from 15 percent.
- The 2 percent payroll tax cut will expire (reducing take-home pay for employees and increasing self-employment tax for qualifying individuals). The employer payroll rate remains at 7.65 percent (both Social Security and Medicare).
- The Medicare rate for individuals with gross wages (or self-employment income) in excess of $200,000 will increase to 2.35 percent from 1.45 percent.
- The estate tax rate will revert to 55 percent and the exemption amount will decrease to $1 million from $5 million.
- The child tax credit will decrease to $500 from $1,000; phasing out when incomes exceed $110,000 (married, filing joint returns).
- The child and dependent care credit decreases to $2,400 per dependent (maximum $4,800) from $3,000 (maximum $6,000) per dependent.
- The personal exemption phase-out (PEP) and Pease (limitation on itemized deductions) provisions will be reinstated to their original levels, projected to be $174,750 for single taxpayers and $261,650 for married filing joint taxpayers. This means taxpayers with adjusted gross income (AGI) in excess of these amounts will lose the benefit of their personal exemptions and their itemized deductions will once again be limited.
- The current Internal Revenue Code (IRC) section 179 deduction will revert to $25,000, with a cap on qualified expenses of $200,000.
- Bonus depreciation will be eliminated.

These changes will have a significant impact on taxpayers in 2013. For example, a taxpayer with taxable income of $1 million, 50 percent of which is qualified dividends, will see their tax liability increase to $415,000 from $250,000.

Strategies to mitigate the impact of these tax increases

- Plan how much, if any, capital gains on appreciated securities you would want to recognize in 2012. Talk with your investment advisor now to prioritize what holdings should be sold dependent upon the outcome of the election. In addition, you may want to reevaluate including REITS and other investments in your portfolio as the tax implications of such holdings compared to common stocks may be changing. Consequently, working closely with your investment advisor in conjunction with your tax advisor is integral in your tax and investment planning.

Candor. Insight. Results.

- If you are planning to sell your business, try to close the sale in 2012 to take advantage of the lower capital gains tax rate.
  - Remember gain from installment sale payments is taxed in the year received; payments received in 2013 on a 2012 sale would be subject to the higher capital gains rate. However, if you opt out of the installment method, all the gain would be taxed in 2012 at the lower rate regardless of when the payments are received.
- If you plan on selling your home and the gain exceeds the $500,000 home exclusion, plan to close by year-end. The excess gain will still be taxable, but will avoid the 3.8 percent Medicare tax (see discussion below).
- Place in service capital improvements in 2012 to take advantage of 50 percent bonus depreciation and $139,000 IRC section 179 deductions.
- Distribute bonus payouts in 2012 to mitigate the employee payroll tax increase.
- Consider accelerating income to 2012 to take advantage of the lower rates. Likewise you may want to defer deductions until 2013 to offset the higher rates in that year.
- Qualified corporations should consider accelerating dividend payments to 2012 to take advantage of the last year for the lower tax rate.
- Contemplate adjusting your income tax withholding and/or estimated tax payments in early 2013 to account for any loss of itemized deductions, child and child care credits, and personal exemptions.
- Consider converting an IRA to a Roth IRA before income tax rates increase.

Conclusion: With a potential tax hike looming, the standard advice for deferral of income may no longer be appropriate. Planning to accelerate income so that it is taxed at the historically low current rates may be your best course of action.

Year-end tax letter table of contents

- 3.8 percent Medicare tax — page 3
- How the new health care law impacts you and your business — 4
- The new repair and maintenance regulations — 6
- Corporate planning — 8
- State and local tax developments — 9
- Estate and gift planning — 12
- International taxation — 13

3.8 percent Medicare tax

The Patient Protection and Affordable Care Act (health care law) added a 3.8 percent Medicare tax beginning in 2013. The tax applies to net investment income or the excess of a taxpayer's AGI above certain thresholds ($200,000 for individuals and $250,000 for joint filers), whichever is less. However, for estates and trusts, the threshold level is only $11,650 of net investment income before the 3.8 percent tax applies.

For purposes of this 3.8 percent tax, "net investment income" includes interest, dividends, royalties, rents, capital gains, and **passive income from trade or business activities**. As a result, the effective tax rate on passive activities will actually be higher than if an individual was active in the business, but not subject to self-employment tax on the same income, because passive income will be subject to the additional 3.8 percent unearned income tax.

As a result, the effective tax rate on passive activities will actually be higher than if an individual was active in the business.

Accordingly, we recommend preparing for the potential impact of this tax and evaluate the following important planning considerations.

- Examine your passive activities to see if you can establish material or active participation in any income-generating activities. If you also have passive losses, keep in mind that shifting passive income to active income could mean that those losses become suspended.
- If your company offers nonqualified deferred compensation plans, consider what income could be recognized for FICA purposes in 2012 before the 3.8 percent tax goes into effect. The regulations for these plans provide some latitude as to when the value of an employee's deferred compensation is recognized for FICA purposes.
- Since tax-exempt bonds and other similar tax-exempt investments are not subject to the new tax, compare the yields on such investments against the effective return on taxable investments after factoring in this additional tax and the other tax increases mentioned above. You should work with your investment advisor to select quality tax-exempt bonds due to the instability of many municipalities' finances.
- Estates and trusts should consider distributing income when beneficiaries' income is below the threshold levels.
- Estates and trusts should consider the Medicare tax when making investment decisions. Consideration should be given to tax-exempt income and growth versus income-oriented investments.

How the new health care law impacts you and your business

In addition to the 3.8 percent Medicare tax, a multitude of other tax changes are resulting from the health care law. While not an exhaustive list, contact your Baker Tilly advisor to discuss how the taxes and credits described below as well as the other provisions will impact your tax situation.

Individual coverage

All individuals are required to obtain health insurance for themselves and their dependents starting in 2014 or pay a penalty for lack of coverage. The federal government and many state governments are currently setting up health insurance market exchanges for individuals to purchase coverage. Confirm with your employer and your state the availability of coverage. If you fail to acquire insurance coverage, a penalty will be assessed which is payable with your income tax return. Penalties are calculated using a flat dollar amount or a specified percentage of household income divided by gross income. The IRS is required to send a notice to those who are not enrolled in an essential minimum coverage program.

You may be eligible for a refundable health insurance premium tax credit for insurance purchased through an exchange. Certain income and other requirements must be met (and are determined by the exchange) to determine whether you could qualify. Advance payments would be made on a monthly basis to the plan in which you enroll and are based on formulas using family size, household income, the federal poverty line and affordability, and minimum essential coverage requirements. You would be responsible for paying the difference between the premium assistance and the plan's premium cost.

Employer penalties

Large employers who do not offer health insurance to employees will be subject to an annual penalty of $2,000 per full-time equivalent (FTE). The penalty is assessed if minimum essential coverage is not offered or the coverage offered is believed to be too expensive. For this particular penalty, FTE means greater than 30 hours per week, with the first 30 full-time employees exempt from the penalty calculation, and a large employer is defined as one with more than 50 employees. Small employers are not subject to this penalty. If you are considered a large employer and do not pay at least 60 percent of covered health care expenses and require employees to contribute more than 9.5 percent of family household income for the year, the penalty increases to $3,000 per FTE less 30. Penalty payments are indexed by the premium adjustment percentage for each calendar year.

In some circumstances the penalty, rather than providing coverage, may be less expensive than incurring the costs of coverage. As part of their analysis, employers need to consider whether to offer plans, what their competitors are doing, how their employees will react if they no longer offer coverage, whether to continue to offer schedule flexibility, and evaluate the current cost of benefits against the penalty cost. Employers should also evaluate their current benefit cost per person between now and 2018 when the so-called "Cadillac tax" comes into effect. Current health care cost trends could make many benefit plans subject to this 40 percent excise tax on benefit values ($10,200 for single and $27,500 for family coverage).

Additional Medicare tax on self-employment income and wages

As noted above, an additional 0.9 percent Medicare tax on wages and self-employment income begins Jan. 1, 2013. The increased tax will apply to wages over $250,000 (for joint returns). The additional withholding applies regardless of the employee filing status. If the employee is over-withheld, the excess is considered a credit against total tax liability on the employee's personal income tax return. Self-employed individuals should review their estimated tax payments in the quarter when self-employment income reaches or exceeds $200,000 and determine if they need to adjust their payments.

> The additional tax is applied on a joint return basis. For example, each spouse's wages may be under the limit individually, but when combined, their income could be over the $250,000 limit for joint returns. In this fact pattern, they will likely be under-withheld for federal income tax purposes.

Medical device excise tax

Beginning in 2013, manufacturers, producers, or importers of taxable medical devices are subject to a 2.3 percent excise tax on the gross sales price of such devices, payable on a quarterly basis. Taxable medical devices include instruments, apparatus, machines, implants, components, parts, and accessories intended for use in the diagnosis, cure, mitigation, treatment, or prevention of disease.

Flexible spending accounts

Salary reduction contributions to health flexible spending arrangements under section 125 are limited to $2,500 in annual contributions beginning in 2013. The limits do not apply to employer non-elective contributions or to salary reduction contributions to cafeteria plans used to pay the employee share of health coverage premiums. Plans have through the end of 2014 to adopt required amendments; if the plan is not amended to restrict employee contributions to $2,500, it will not be considered a qualified benefit plan resulting in compensation income to the participating employee. The $2,500 will be indexed for cost-of-living adjustments beginning after Dec. 31, 2013.

Additional changes

Other changes in the health care legislation include an increase in the adjusted gross income threshold for the medical expense deduction on an individual Schedule A to 10 percent from 7.5 percent and a limit on the compensation deduction of health insurers capped at $500,000 for amounts paid to employees, officers, directors, or other workers or service providers/consultants.

Employers that provide coverage on or after Jan. 1, 2014, will have additional reporting requirements. The law requires employers to file information returns (with employees and the IRS) containing name, address, and taxpayer identification number of the primary insured individual and employer, the dates each individual was covered under minimum essential coverage during the calendar year, whether the coverage is a qualified plan through an exchange along with other required information. The IRS is currently developing additional guidance and the reporting format.

Employers are also required to supply employees a uniform summary report of health insurance benefits on the first day of the open enrollment period.

The new repair and maintenance regulations

In late 2011, the IRS issued new regulations on the deduction and capitalization of expenditures related to tangible property—the so-called "repair regulations." We expect that most, if not all, taxpayers will have to change their accounting methods to comply with these new rules. The regulations were released as temporary and proposed regulations and generally are effective for tax years beginning on or after Jan. 1, 2012. According to informal commentary from IRS officials, the regulations likely will be finalized by the end of this year. While public commentary has been critical of certain elements of the new regulations, we do not expect significant changes when the rules are finalized.

> The repair regulations offer significant opportunities and additional flexibility for taxpayers in accounting for fixed assets and repair expenditures. The trade-off, however, is increased complexity. Taxpayers in all industries with significant investments in fixed assets should pay close attention to these major new rules.

The new repair regulations are a framework for analyzing whether and when costs incurred in acquiring, maintaining, or improving tangible property must be capitalized. Taxpayers must apply the standards in the regulations to determine if expenditures are currently deductible as ordinary and necessary business expenses or must be treated as capital improvements and depreciated over a longer recovery period. The regulations contain several new and important concepts:

Building systems. The regulations adopt a new framework for determining the treatment of building improvement costs. The improvement tests (betterment, restoration/replacement, adaptation) are applied separately to specific building systems and components, rather than the building as a whole. If an expenditure results in an improvement to a specific building system or component, it is deemed to improve the building/unit of property as a whole, and therefore must be capitalized. The specific building systems listed in the regulations are HVAC, plumbing, electrical, escalators, elevators, fire protection and alarm, security, gas distribution, and any other system identified in published guidance.

Revised rule for retirements/dispositions of building components. A major benefit of the regulations is that they revise the definition of a disposition, so that a taxpayer may treat the replacement or retirement of a structural component of a building as a disposition of property. This new rule will mitigate the result that occurs when an original building component and any subsequent replacement are required to be capitalized and depreciated simultaneously.

> Prior to this change, component disposition was not permitted. For example, if a taxpayer replaced a roof, they would not be able to write off the cost of the original roof and would have to depreciate two roofs. The new disposition rule creates an opportunity for taxpayers with older buildings to review their fixed asset schedules and write off retired and/or disposed building components. The method change for dispositions of structural components requires an IRC section 481(a) adjustment. This means taxpayers that have capitalized multiple versions of building systems and components over the years will be able to write off the remaining adjusted basis of those assets in the year of the change.

General asset account (GAA) election. The GAA election is the mechanism that gives taxpayers the flexibility to deduct retired/disposed building components when they are replaced.

> If a taxpayer does not have a GAA election in place, they must always recognize a gain or loss upon the disposition of a retired or disposed building component. If the taxpayer does not recognize a loss, they will have to capitalize otherwise deductible repair expenses.

> Assume a taxpayer replaces the waterproof membrane on a warehouse building, the expenditure is a deductible repair, and a GAA election is in place. In this scenario, the taxpayer can choose whether to write off the undepreciated cost of the old membrane and capitalize the replacement cost or continue to depreciate the original component and deduct the replacement cost. However, if the taxpayer does not make the GAA election, they must write off the cost of the old component and capitalize the new membrane, even though it is a deductible repair. Further, if the taxpayer does not recognize the loss on the old component, they must stop depreciating the original component and the remaining basis will be lost.

Transition rules and IRS directive

In March 2012, the IRS published transition rules specifying the administrative procedures for taxpayers to obtain automatic consent to change their accounting methods to comply with the new regulations. The rules also provide a two-year window to make these method changes and allow taxpayers to make retroactive GAA elections for buildings and structural components.

The IRS also released an internal directive that instructs field agents to discontinue current exam activity for years beginning before Jan. 1, 2012, related to repair and maintenance costs and related issues involving the disposition of building structural components. Taxpayers will be allowed a two-year period to adopt the appropriate method of accounting, but if the taxpayer has not changed its method of accounting consistent with the transition rules, then repair expenses will be subject to possible examination for tax years ending on or after Jan. 1, 2012.

Section 481(a) adjustments

Most of the new automatic changes require an IRC section 481(a) adjustment, and taxpayers are permitted to use statistical sampling in certain situations to calculate the amount of the adjustment. Recent informal commentary from IRS officials suggests that taxpayers may be allowed to use extrapolation to compute their IRC section 481(a) adjustments if they do not have the data necessary for statistical sampling. Also, the transition rules continue to allow the default four-year recognition period for taxpayer unfavorable IRC section 481(a) adjustments.

Taking advantage of the new rules

The transition rules give taxpayers a two-year window to make method changes to comply with the new rules. We encourage you to contact your Baker Tilly advisor to analyze your fixed asset schedules and file any necessary accounting method change applications (Form 3115) in the first year; leaving the second year to add items that were not adopted or to make corrections. This decision must be made in the context of your overall tax planning objectives. Some things to consider:

- Make sure you understand the interaction between the rules for repair deductions, dispositions of building components, and the GAA election.
- Beginning with your 2012 tax return, we recommend that you make the retroactive GAA election for each existing building that you own, as well as for new buildings that you acquire or construct in subsequent years.
  There is no downside to making this election. It gives taxpayers the flexibility to recognize losses on retired/disposed building components or to continue to depreciate those components.
- If you filed accounting method changes for repair and maintenance costs within the past few years, review those changes and identify methods that may not be consistent with the new regulations. Revising methods and filing new Form 3115s is likely. You may have to give back a portion of a previous section 481(a) adjustment; however, the adjustment will be spread over four years and may be partially offset by losses on disposals of retired building components.
- If you have not filed an accounting method change for repair and maintenance costs, you have an opportunity to bring your methods into compliance with the new rules and likely obtain a current deduction for disposals of retired building components.
- If you are making an accounting method change to recognize gain or loss on retired/disposed structural components or building systems, consult with our cost segregation professionals to determine a reasonable method for estimating the historic costs and remaining basis of these components. Simply reviewing your fixed asset schedule may not provide the information necessary to identify all possible benefits.
- Consider refining prior cost segregation studies to break out the costs of the building structural components and systems. This will provide you with the data necessary to take deductions for future dispositions. Again, consult our cost segregation professionals.
- Consider deferring negative IRC section 481(a) adjustments (i.e., adjustments resulting in additional deductions) to 2013 if you believe rates will increase. You may also have good reasons to defer a positive adjustment (for example, if you are projecting a loss next year).
- Filing an automatic accounting method change provides protection if you are subsequently under an IRS examination for previous years so that a revenue agent cannot require a method change for those previous years. We encourage you to make any necessary method changes under these transition rules to take advantage of audit protection for treatment of the repair and maintenance expenses and other items.
- Finally, remember that while colloquially referred to as the "R&M regs," the regulations and revenue procedures address accounting methods for materials and supplies, spare parts, routine maintenance expenses, and other items. The issuance of these new rules provides an opportunity to review your accounting methods for all of these items.

Corporate planning

Given the current political climate on tax issues, corporations and their shareholders are faced with a difficult environment for planning. The following chart summarizes the highest tax rates on certain types of income being proposed by President Obama and Governor Romney. Also included are present rates for 2012 and rates that will be in effect for 2013 (absent legislation to change the rates). These rates do not reflect the additional 3.8 percent surtax that may be paid by higher-income individuals on certain types of income, including investment income such as dividends and capital gains.

	Obama	Romney	2012	2013
Corporate rates				
Individual rates				
Capital gains				
Dividends				

Romney's proposed rates assume an expanded tax base, meaning numerous deductions could be eliminated, reduced, or capped. However, no specifics have been given as to which deductions would be affected.

Putting aside what could happen in the future and looking at what we are facing under existing tax law, consider the following corporate strategies:

First, C corporations may want to pay taxable dividends in 2012 rather than waiting until 2013 or later. In 2012, the maximum rate on most dividends is 15 percent. Under existing law, this preferential rate will be eliminated for qualified dividends paid after 2012; dividends will be taxable at the marginal rate, which may be as high as 39.6 percent. If you are subject to the 3.8 percent surtax on investment income in years after 2012, payment of the dividend in 2012 may be even more important. The favorable rate in 2012 may offer a good opportunity to "clean out" some of the accumulated income that could pose problems in future years due to the accumulated earnings tax or personal holding company tax.

Second, C corporation shareholders should think about selling their stock (or have the corporation redeem their stock) in 2012 rather than in a later year. If the sale or redemption qualifies as a capital gain in 2012, the maximum rate is generally 15 percent, as opposed to the scheduled 23.8 percent maximum rate after 2012 (including the 3.8 percent surtax).

Third, certain S corporations that have accumulated earnings and profits from years in which the corporation operated as a C corporation may face a tax for having excessive passive income. If this situation continues for three consecutive years, the corporation may lose its S election. If the S corporation has no accumulated earnings and profits, the passive income issues do not apply. Electing to distribute the accumulated earnings and profits by paying a taxable dividend from the S corporation may be a viable option given the low dividend tax rate for 2012.

BAKER TILLY

Candor. Insight. Results.

State and local tax developments

The state and local tax landscape continues to change at a rapid rate. Driven by the need to fill a $55 billion budget gap in the current fiscal year, states continue to adopt aggressive new tax policies, some through legislation and others by administrative pronouncement.

Nexus, particularly as it applies to sales tax, occupies center stage. The "physical presence" requirement established by the *Quill* case 20 years ago has been circumvented by new forms of nexus such as "affiliate" and "click-through" nexus that hold that an indirect presence is sufficient to require an out-of-state retailer to collect sales tax.

Online sellers should be especially aware of state efforts to impose sales tax. Note that California and Pennsylvania click-through nexus standards took effect in September 2012. Internet retailers who obtain sales referrals through website links of third-party businesses under a commission arrangement are at risk. Both states have been actively contacting such retailers to inform them of their potential obligation to register for and collect sales tax. To forestall this threat, some retailers have terminated their contracts with Internet affiliates that have a presence in California or Pennsylvania.

Internet retailers who obtain sales referrals through website links of third-party businesses under a commission arrangement are at risk

The federal government has taken a greater interest in the online seller issue under pressure from states and localities that contend they are losing $20 billion or more annually in sales tax revenue to Internet purchases of taxable goods and services. The House Judiciary Committee recently held hearings on the Marketplace Equity Act (H.R. 3171) which mandates the collection of sales tax on remote sales. This would have a sweeping impact on online sellers—many of whom would face the prospect of implementing expensive multistate sales tax compliance systems. The Act provides a safe harbor such that registration is not required if a retailer has less than $100,000 of sales in a state or less than $1 million of total online sales. The odds for passage of legislation like the Main Street Fairness Act appear to be increasing as business groups including Amazon and the Retailers Industry Association have lined up in support of the legislation.

In the income, franchise, and business enterprise tax arena, states are actively pursuing the notion that "economic" presence in a state allows the imposition of a filing requirement. A number of states have adopted so-called "bright line" nexus tests. California, Colorado, and Connecticut enacted similar bright line tests such that a business with $500,000 or more of in-state sales are, under certain conditions, required to file a tax return.

Companies that sell services or derive income from intangibles are particularly exposed to these bright line nexus rules due to the lack of federal protection under Public Law 86-272. This federal enactment does not permit a state to assert nexus against companies that sell goods as long as their activities are confined to sales solicitation. Mere economic presence is insufficient to impose a tax on their net income.

The physical presence requirement for sales and income nexus and the constitutionality of these tests remain in question. While it is hoped by many businesses that the Supreme Court will rule again on the subject, some state and local tax experts believe that the court will remain on the sidelines. It has passed on numerous opportunities in recent years (such as the *Lanco* case out of New Jersey) and seemingly has tossed the ball to Congress pursuant to its decision in *Quill*.

Another state and local issue that has begun to pick up steam is the state tax treatment of "cloud computing." It can take many forms—e.g., Software as a Service (SaaS), Platform as a Service (PaaS)—and involves remote access to computer software, e-mail, servers, and other aspects of computer

technology. The purchaser of cloud computing pays for the use of SaaS, PaaS, or other applications through license fees, user charges, or other contractual payments. The sellers have custody of the software and/or hardware; set the terms of access and service; and assume many of the risks related to access, data security, and back-up capabilities.

During a Baker Tilly webinar on the tax implications of cloud computing, 38 percent of participants said determinging what is taxable is their greatest concern about adopting cloud computing solutions

The growth of cloud computing has been explosive and one source estimates that worldwide sales of related services and products will reach $150 billion by 2014. A recent poll by Baker Tilly during a webinar on the state and local tax implications of cloud computing found:

- 64 percent of the audience is considering whether to purchase or implement a cloud computing solution, 12 percent is in the process of adopting it, and 24 percent have deployed such a solution
- 38 percent of the participants said determining what is taxable is their greatest concern about cloud computing, while 21 percent answered "nexus issues"
- 14 percent of the webinar audience answered "Yes" to the question of whether tax uncertainties prevented their adoption of cloud computing while 86 percent said "No"

A myriad of sales/use and income/franchise tax issues surround cloud computing. As can be seen from our poll results, businesses are concerned. It is not clear whether cloud computing represents a service or can be broken down into the licensing of software and leasing of hardware (e.g., servers). The tax consequences of each outcome can be very different.

Many states charge sales and use tax on the license of prewritten software. Some like Michigan, New York, Pennsylvania, Utah, the District of Columbia, and Washington have determined that cloud computing falls into this category and impose taxes on in-state customers. Others like Maryland, Virginia, Missouri, Nebraska, and Wisconsin have ruled that when the customer does not obtain title to or have control of the software, SaaS and similar cloud offerings are a nontaxable service. Many states, such as Minnesota and Illinois, have not yet decided whether these services are taxable.

Aside from the problem of what, if anything, is taxable, the issue is where to source the cloud computing charges for sales/use tax purposes. Is it the location where the customer accesses the cloud solution or the billing address? What if the solution is used across many locations and by different business units of a multistate business?

On the income and franchise tax side of the ledger, the issue of whether cloud computing constitutes a service or the sale/license of property affects such key areas as apportionment. The rules for sourcing receipts from the sale of a service can be very different from the sales of property. In the first instance, many states allocate receipts based on where the costs related to rendering the services are performed. This is not necessarily the same location that a customer realizes the benefits of the services (e.g., remote access software). In the second instances, software that is classified as tangible personal property would be assigned to the state where the customer takes delivery of the "product."

Nexus also becomes problematic. Does the use of a third-party server to run software applications under a cloud computing contract constitute a lease of tangible personal property? If it does, a state could assert both income and sales tax nexus against the company purchasing the cloud solution.

Answers to these questions have been slow in coming from the states. Both sellers and buyers of cloud services must pay close attention to new developments in sales/use and income/franchise tax. Given the complexity and rapid evolution of tax rules affecting cloud solutions, businesses should consider consulting their tax advisor before making major deployments or sales related to them.

BAKER TILLY

Candor. Insight. Results.

Multistate apportionment and combined reporting stay in the news for businesses. The District of Columbia is retroactively implementing combined reporting effective for 2011. Combined groups are defined to include all persons subject to tax or would be subject to tax within DC; where the definition of "persons" includes, but is not limited to, any unincorporated business, financial institution, utility company, transportation company, S corporation, real estate investment trust (REIT), and regulated investment company (RIC). These regulations offer limited guidance on how the unincorporated businesses are treated within the combined group. They also stipulate the use of the Joyce rule of apportionment and define the use of net operating losses within the combined group. If you have multiple activities located in DC, you may be part of a DC combined group and should carefully evaluate these new requirements with your tax advisor.

Refund opportunities have arisen with respect to apportionment in California and Michigan. Both relate to use the Multistate Tax Compact's (MTC) standard three-factor apportionment formula versus the statutory scheme adopted that involves a heavily weighted sales factor. Most recently, the California Court of Appeals decided in the *Gillette* case that taxpayers may elect to apportion their income with a single-weighted sales factor rather than the double-weighted sales factor in place for tax years prior to 2011. California has attempted to short-circuit refund claims by repealing the state's MTC provisions and retroactively requiring the sales factor election to be made on an originally filed tax return. In response, the court has decided to re-hear the *Gillette* case. Taxpayers should consider filing protective refund claims to the extent that the MTC apportionment formula produces a material tax benefit. It should be noted that neither California nor Michigan will pay such refund claims until litigation on the issue is finalized, which is likely to take an extended period of time. You should consider whether you might benefit from filing a protective claim for refund versus the uncertainty of the claim being approved. We encourage you to discuss these matters with your Baker Tilly tax advisor.

While not a state and local tax matter per se abandoned and unclaimed property is taking a new urgency as states eye the vast amounts of such property as a potential source of revenue.

While not a state and local tax matter per se, abandoned and unclaimed property is taking a new urgency as states eye the vast amounts of such property as a potential source of revenue. Unclaimed payroll checks, credit account balances, and unused gift cards and certificates run into the billions of dollars annually. Many businesses are aware that these amounts must be reported and turned over to state authorities after a legally prescribed lapse of time, called a dormancy period, during which the owner of the property fails to take possession of it. In most states, abandoned and unclaimed property must be reported to the owner's state of residence. If this is unknown, it is often reportable to the state of the payer's incorporation or domicile.

States have taken aggressive steps to capturing unclaimed property by legislating shorter dormancy periods, engaging contingent auditors as bounty hunters to examine reporting and noncompliant holders of unclaimed property, and offering amnesty programs. Michigan closed such a program in January 2012 and is expected to follow it with a rigorous audit and enforcement program aimed at unclaimed property. Most recently, Minnesota adopted an amnesty program. Details are forthcoming.

Businesses should be aware of the abandoned and unclaimed property reporting requirements in the states where they operate. In addition, having an accurate system of compliance in place is important. Without such a system, a company can be at serious financial risk for unclaimed property assessments, interest, and penalties. Be aware that under many state unclaimed property statutes, businesses have few procedural or fairness protections similar to those enjoyed for income, franchise, and sales/use tax purposes. Large estimated assessments are not uncommon and appeal rights might be limited.

BAKER TILLY

Candor. Insight. Results.

Estate and gift planning

If you have not already taken advantage of the current historically generous lifetime gift exemption, now is the time to consider implementing a plan or risk losing what may be a short-lived opportunity as the current law is set to end Dec. 31, 2012. As we near year-end, you have additional urgency since executing and documenting many of the strategies requires the time and expertise of multiple advisors, including your tax advisor, attorney, and, in many situations, valuation professional.

Without some action from Congress, tax rates will increase as follows:

- A 57 percent increase in the highest estate, gift, and generation-skipping tax rate (back to the top rate of 55 percent from 35 percent)
- An 80 percent decrease in the estate and lifetime gift tax exemptions (to $1 million from $5.12 million)
- A 73 percent decrease in the generation-skipping tax exemption (to $1.36 million from $5.12 million)

Because congressional action in the transfer tax area has been difficult to predict over the last 10 years, prospects for the law remain unclear. The Obama administration proposes reinstating the 2009 rates and exemptions and includes provisions curbing the application of some popular planning strategies. The Romney proposal would repeal the estate tax. Despite lack of clarity, planning opportunities should be considered to minimize taxes and preserve wealth. Where making gifts is appropriate, you have immediate urgency.

Despite lack of clarity, planning opportunities should be considered to minimize taxes and preserve wealth; where making gifts is appropriate, you have immediate urgency.

Estate planning opportunities through year-end

- First, consider using the $5.12 million lifetime gift exemption through outright gifts or gifts to a trust, including:
  - *Establishing a spousal lifetime access trust, which allows your spouse to be a beneficiary of the trust*
  - *Forgiving loans to children or others (to use a portion of the gift tax exemption)*
  - *Giving assets subject to valuation discounts*
  - *Giving assets to a generation-skipping trust*
- Second, with the potential for legislation limiting some current advantageous planning strategies, implementation before year-end allows you to take advantage of what may be your last chance to utilize these strategies.

These opportunities will not apply to everyone, but we recommend preparing for the changing tax environment by discussing your situation with us, your attorney, and other advisors.

International taxation

Tax rates on capital gains/dividends

As noted above, the preferential 15 percent rate on qualified capital gains and dividends is scheduled to expire Dec. 31, 2012, and there is considerable uncertainty as to the rates thereafter. Given this indecision, it may be prudent for US individuals, S corporations, LLCs, and trusts to consider taking dividends of all earnings and profits from their foreign subsidiaries and IC-DISCs prior to year-end.

All such qualifying dividends would be eligible for the 15 percent rate if received before Dec. 31. Generally, dividends qualify for the 15 percent rate if they are received from corporations in countries with whom the US has an income tax treaty.

In a similar fashion, sales of foreign subsidiary shares in 2012 could take advantage of the 15 percent capital gains rate if such sales are being contemplated in the near future. In this case, it is also necessary to understand the foreign tax situation related to such transactions, since most foreign countries impose a withholding tax on dividends. This is often reduced by income tax treaties and is potentially creditable for US tax purposes following US foreign tax credit rules.

Foreign Account Tax Compliance Act (FATCA) requirements

The Treasury and the IRS have announced that implementation of the FATCA requirements will be effective Jan. 1, 2014. Final regulations are expected to be issued before year-end with the proposed agreement to be used by financial institutions released shortly thereafter. Under FATCA, payments made to foreign financial institutions and certain foreign nonfinancial institutions will be subject to a 30 percent tax withholding unless they keep records of, and disclose to the IRS, any direct or indirect US account holders. In addition, the IRS has issued a new draft Form W-8BEN to be used to certify the status of foreign beneficial owners under FATCA. It is good practice to ensure that W-8BEN forms are kept on file with respect to any foreign taxpayers to which payments are made to establish their foreign status.

Under FATCA, in effect for tax years beginning after March 2010, individual taxpayers are required to disclose certain foreign financial assets on Form 8938. This is a separate filing from the Foreign Bank Account Report (TD F 90-22.1); however, there is some overlap of reporting requirements such as account information. The forms also have some significant differences, notably the filing threshold. Form 8938 is typically used for a foreign financial asset whose value is greater than $50,000 at year-end or greater than $75,000 during the tax year. Foreign bank account reports are required for one or more foreign financial accounts whose value is greater than $10,000. The thresholds are higher for expatriate taxpayers. The definition of foreign financial asset is widely defined. For example, this year, during the 2011 tax compliance cycle, Baker Tilly worked through many challenges with clients in determining what assets are subject to this type of reporting and also in meeting the requirements concerning valuing such assets.

Form 8938 currently is applicable to individual taxpayers. However, once the IRS has finalized regulations it is likely that this form will be required for other types of entities, including partnerships, corporations, and trusts. Note that duplication of information when other types of informational returns are required to be filed, such as Forms 8865, 5471, 3520, and 8621, is avoided but the Form 8938 is still required to be filed with the relevant exception boxes being ticked.

The IRS is also continuing to focus on taxpayers with foreign accounts. For the last few years, the Offshore Voluntary Disclosure Initiative (OVDI) has allowed taxpayers who have not correctly disclosed foreign income on prior returns to correct their tax compliance. It should be noted that this is not an amnesty and, in many cases, taxpayers filing amended tax and information returns are still subject to penalties, albeit the penalty regime is less than if the taxpayers were discovered by the IRS. If you believe you have undisclosed foreign income or accounts, careful analysis of the situation is required and both accountant and legal advice should be sought concerning the situation.

Corporate tax proposals

Although US taxpayers are taxed on a worldwide basis, earnings of their foreign subsidiaries generally are deferred from US taxation until repatriated or the shares are sold. This deferral has resulted in more than $1 trillion of offshore earnings that remain untaxed in the US. Both presidential candidates have proposed making dramatic changes to the US taxation of the earnings of foreign subsidiaries of US taxpayers in

order to tax these earnings currently or move toward a territorial system of taxation. Several proposals to encourage repatriation of foreign earnings are being considered by Congress, but their fates remain unclear until after November elections.

Expiring provisions

Many tax provisions offering significant relief to taxpayers doing business overseas have expired or are expiring in 2012. Two of the most relevant are the beneficial "look-through" rule—related to payments of dividends, interest, rents, and royalties between related controlled foreign corporations—and the active financing income exception which allows businesses producing banking and financing income within controlled foreign corporations to exempt such income from current inclusion in the US as Subpart F income. In both cases, businesses taking advantage of these provisions may need to restructure or revise their underlying transactions. If this is not possible, such income may produce Subpart F income which results in US taxable income without the receipt of the corresponding cash from the underlying entities.

Transfer pricing

US businesses that have foreign operations are required to support any of their intercompany charges to ensure they are consistent with arms-length transactions following the transfer pricing rules set out by section 482. In particular, the IRS finalized regulations effective Dec. 16, 2011, with respect to controlled services transactions. Generally, the regulations require that high value-added services include a mark-up over cost when they are charged to affiliated companies within the overall group.

For more information or questions regarding any of the topics in this planning letter, please contact your Baker Tilly advisor or send an e-mail to tax@bakertilly.com.

Your 2012-2013 Tax Planning Guide is here.
Looking for additional ways to help minimize your tax liability? Reduce your taxable income by taking advantage of every tax break to which you are entitled. Visit bakertilly.com/tax-services for our 2012-2013 Tax Planning Guide.

Pursuant to the rules of professional conduct set forth in Circular 230, as promulgated by the United States Department of Treasury, nothing contained in this communication was intended or written to be used by any taxpayer for the purpose of avoiding penalties that may be imposed on the taxpayer by the Internal Revenue Service, and it cannot be used by any taxpayer for such purpose. No one, without our express prior written permission, may use or refer to any tax advice in this communication in promoting, marketing, or recommending a partnership or other entity, investment plan or arrangement to any other party.

Baker Tilly refers to Baker Tilly Virchow Krause, LLP, an independently owned and managed member of Baker Tilly International. The information provided here is of a general nature and is not intended to address the specific circumstances of any individual or entity. In specific circumstances, the services of a professional should be sought.

© 2012 Baker Tilly Virchow Krause, LLP