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In focus

All that planning and developing, well it just doesn't count. IRS says no to publisher's preproduction activities in our first article this quarter. Take a deeper look at remote sales tax collection and the Marketplace Fairness Act of 2013 in our second article. What will it mean to EMC companies? Finally, provisions affecting EMC companies from Medicare to W-2 reporting, how the Affordable Care Act may affect you.

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IRS rules publisher's pre-production activities do not qualify for section 199 deduction

The IRS national office recently released Chief Counsel Advice (CCA) 201313020, which concluded that planning and development activities undertaken by a publisher of books and other printed materials (collectively, "books") did not constitute a qualifying manufacture, production, growth, or extraction (MPGE) activity for purposes of the section 199 deduction.

In the situation analyzed in the CCA, a publisher performed market research, resource planning, content and layout development, and editing activities that led to the creation of an electronic version of a book.

The publishing company contracted out the mass production of the hard copy of the book, which was the item sold by the publisher to customers, with the publisher providing only the electronic version of the book and its print specifications to the contract manufacturer. The publisher claimed its design, development, creation, content and layout developments, material analysis and selection, and editing and packaging activities collectively constituted a qualified MPGE activity for the purposes of computing the section 199 deduction. The IRS appeals division asked the IRS national office to provide guidance on the publisher's position.

The IRS national office concluded that these activities did not qualify as MPGE activities, as the production of an electronic book is not considered tangible personal property under section 199 and does not fall within the types of intangible property that do qualify for section 199. The IRS stated that because no qualified production property (QPP) existed prior to the mass production of the book by the third-party contractor, the pre-production activities performed by the publisher could not be considered qualifying MPGE activities under section 199. The CCA stated that the activities performed by the third-party contractor qualified as eligible MPGE activities that resulted in QPP. The CCA notes, however, that if the publisher had the benefits and burdens of ownership during the period in which the contractor manufacturer printed the books, then the IRS would conclude that the publisher's activities would be MPGE activities.

Observation

The section 199 regulations require that domestic production gross receipts (DPGR) be determined on an item-by-item basis. The term "item" means the property offered for sale in the normal course of the taxpayer's business, if the gross receipts for the disposition of such property qualify as DPGR. The item that was offered for sale by the publisher was the finished, tangible, printed book and not the electronic book. Accordingly, it is unclear why the IRS concluded that the publisher's activities gave rise to intangible property, i.e., an electronic book, when the publisher did not offer an electronic book for sale in the normal course of its business. Rather, the publisher offered tangible books for sale, which are QPP.

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The publisher argued that because it was treated as a manufacturer under section 263A, it also should be treated as a manufacturer for purposes of section 199. The IRS countered that, in some cases, a taxpayer treated as a producer under section 263A should not be considered a manufacturer for purposes of section 199, and that the section 263A consistency requirement set forth in the section 199 regulations should not be read to require that a taxpayer that is a producer under section 263A also is a producer for section 199 purposes in all cases.

In addition, the CCA concluded that the publisher's activities related to the development of the print specifications were also non-MPGE activities, as they did not result in the production of QPP. As the publisher did not engage in any other MPGE activity with respect to the qualified property, the IRS also determined that any packaging activities would not qualify as MPGE activities. Finally, the IRS national office rejected IRS exam's position that a taxpayer must show that it applied some "physical force" to the QPP in order for the activity to qualify as MPGE for section 199 purposes, noting that the term "physical force" was not defined or established as a standard that was required in order for an activity to be a qualifying MPGE activity.

The takeaway

The issues raised in the CCA and the arguments made by the IRS national office are similar to the arguments the IRS has made in *Advo, Inc. & Subsidiaries vs. Commissioner*, Docket No. 17247-10, pending before the Tax Court. According to the Tax Court filings in that case, Advo, Inc. is a direct-mail media company that is engaged in soliciting and processing advertising from retailers, manufacturers, and service companies for targeted distribution to consumer households and that uses third-party printers to print its advertisements. The Tax Court case deals with issues similar to those raised in the CCA, e.g., whether Advo's activities prior to the third-party printing activities are MPGE activities for section 199 purposes, as well as what factors are taken into account in determining whether Advo or its third-party printers have the benefits and burdens of ownership during the printing process. A decision in *Advo* is expected from the Tax Court in the coming months.

Senate passes Marketplace Fairness Act — what EMC companies will need to consider

In brief

The US Senate on May 6 passed, by a vote of 69-27, the Marketplace Fairness Act of 2013, which provides that full member states of the Streamlined Sales and Use Tax Agreement (SSUTA) and non-member states that meet certain minimum simplification requirements may require remote sales tax collection. The Senate also passed a perfecting amendment by a vote of 70-24. [S 743 and SA 741].

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In order to confront the challenges of the potential new law, companies that may be affected will need to both understand how the new online sales and use tax model is changing and pay close attention to the new obligations that may be imposed on them under the legislation.

If enacted, this legislation will have a substantial impact on many companies, and the effects may well reach beyond traditional retailers and impact many unsuspecting EMC companies making sales over the Internet. In addition to the potential obligation to collect and remit sales taxes on goods sold to customers in states where they previously did not have a taxable presence, EMC companies making online sales may need to track business registration requirements in new tax jurisdictions, monitor state and local tax rates for changes, and maintain compliance records in the event of a state audit.

In detail

S 743 is identical to the original version of the bill, S 336, introduced on February 2. The legislation grants remote seller collection authority to states that are full members of the Streamlined Sales and Use Tax Agreement. States that are not SSUTA members must enact minimum simplification requirements to receive remote seller collection authority, including the provision of a single entity within the state for administration, a single audit of a remote seller for all state and local jurisdictions, and a single sales and use tax return for remote sellers to file. Additional simplification requirements include the provision of: a uniform sales and use tax base among the state and the local taxing jurisdictions; taxability, exemption, and rates and boundaries information for products and services; and free software to calculate sales taxes due and file returns, among other items. The legislation contains a small seller exception for remote sellers with gross annual receipts in nationwide total remote sales of less than $1 million.

Senate Amendment 741 contains the following additional provisions:

- Streamlined Sales and Use Tax Agreement Member States are authorized to collect remote sales and use tax from sellers not qualifying for the small seller exception only if any changes to the SSUTA made after the date of enactment of S 743 are not in conflict with the bill's minimum simplification requirements.

- The effective date for SSUTA Member States to exercise remote seller collection authority is increased from 90 to 180 days after the state publishes notice of intent to exercise the authority, and no earlier than the first day of the calendar quarter that is at least 180 days after the date of enactment of S 743 (Please note, the language of S 743 provides the effective date for a state that is not a member of the SSUTA shall commence beginning no earlier than the first day of the calendar quarter that is at least six months after the date that the state enacts and implements the minimum simplification requirements).

- A state may not impose requirements on remote sellers that the state does not impose on non-remote sellers with respect to the collection of sales and use taxes under S 743.

- The bill does not alter the current standards for determining nexus between a person and a state or locality.

- The legislation does not deny the ability of a remote seller to deploy and utilize a certified software provider of the seller's choice.

- The definition of "State," as applied in the bill, includes any tribal organization (as defined in section 4 of the Indian Self-Determination and Education Assistance Act [25 USC 450b]).

The takeaway

The Marketplace Fairness Act of 2013, its current form, received significant bipartisan support before passing the Senate by a large margin. In the Senate, 56 amendments were submitted regarding various topics, including the moratorium on the taxation of Internet access and the taxation of digital products. However, the Senate agreed to vote only on a perfecting amendment, Senate Amendment 741.

SA 741's conditional provision requiring that no additional SSUTA amendments be in conflict with minimum simplification requirements appears to ensure the SSUTA cannot be amended in the future to remove simplification provisions that would otherwise be required under the bill and still allow the collection authority.

Other provisional changes in SA 741 address concerns regarding the time frame, fairness, and utilization of software. The increased time period in which to grant collection authority gives state legislatures and state tax departments some relief with the task of preparing their collection systems and processes. The conditional provision, that no additional requirements be placed on remote sellers that are not placed on non-remote sellers, attempts to provide some reassurance that burdensome, discriminatory practices will not take place. Finally, the option of using a remote seller's preferred software provider may also ease the seller's compliance burden.

As Congress has considered remote seller collection authority through the introduction of several bills over the last few years, the option to include tribal organizations has been debated. The inclusion adds additional complexity to tribal organizations' compliance requirements and will require implementation of the same simplification requirements as non-SSUTA states to receive collection authority.

With the Senate passage, S 743 now faces opposition in the US House of Representatives, with further amendments expected.

Overview of key tax provisions under the Affordable Care Act affecting EMC employers

"The ACA made broad changes with respect to health care for individuals, employers and insurers. Beginning in 2014, an employer with at least 50 full-time employees must offer minimum essential health coverage to at least 95% of its full-time employees."

The Affordable Care Act (ACA) made broad changes with respect to healthcare for individuals, employers, and insurers. The ACA also imposed new taxes and industry fees. Many of the provisions under the ACA are now in effect, and the individual mandate, health insurance exchanges, and employer shared responsibility penalties will become effective in 2014. This article provides a summary of certain tax-related provisions under the ACA that will impact EMC companies. These provisions were the subject of a recent hearing in the House Ways and Means Committee.

Provisions affecting employers as of 2013

Requirements for group health plans: The ACA expanded the types of coverage required for group health plans, insurance issued in connection with group health plans, and individual health insurance policies. The new benefits must be provided for plan years beginning after September 23, 2010. The new requirements include, among other things, the following:

- Required coverage of adult children up to age 26
- No pre-existing condition exclusions for children under age 19
- Coverage for certain preventive health services with no cost sharing (deductibles, coinsurance, or co-pays)
- No lifetime limits or annual dollar limits on essential health benefits (in full effect after 2013)
- A standardized summary of benefits and coverage (SBC)

If a group health plan does not provide these benefits, excise taxes of $100 per person per day may be imposed if a failure is not corrected within 30 days. For example, if annual dollar limits are not properly removed, an excise tax of $100 per affected individual per day would apply. Additional penalties apply for a failure to provide an SBC of up to $1,000 for each failure.

Observations

The excise tax will increase if the error is not corrected and will also increase if the failure to provide the benefit is due to wilful neglect. Employers are encouraged to review group health plans to ensure the required benefits and SBCs are provided and to correct any errors quickly.

"Grandfathered" group health plans that were in effect on March 23, 2010 are not subject to certain of these requirements (e.g., covering certain preventive services with no cost sharing). However, a future increase in the cost of coverage borne by participants may cause the plan to lose grandfathered treatment and these new requirements would apply at that time.

Limitation on tax-free subsidy for Medicare Part D drug benefits:
Beginning in 2013, employers can no longer claim a tax deduction for the portion of the cost of Medicare Part D drug benefits that is reimbursed through the government subsidy program. Before 2013, to encourage employers to provide retiree drug benefits, employers were allowed to both deduct that cost and receive a tax-free reimbursement of part of those costs.

Observation

Employer contributions to voluntary employees' beneficiary associations (VEBAs) before 2012 that were segregated for Medicare Part D drug claims may be used to pay claims after 2012 and the employer is still entitled to receive the subsidy for those expenses.

Medical loss ratio rebates: Beginning in 2011, insurance companies are required to spend a specific percentage of health care premiums on medical care and quality improvement costs. This percentage is expressed as the medical loss ratio (MLR). Insurance companies that do not meet the MLR standard must send premium rebates to employers and other customers beginning in 2012. The tax treatment of the MLR for employers and plan participants depends on the terms of the plan for allocating the rebate and whether employee premiums are paid on a pre-tax or after-tax basis.

Reporting cost of employer health coverage on employee's Form W-2:
Employers must report the cost of employer-sponsored health coverage on each employee's Form W-2, even though the amount is not taxable to the employee. The employer can calculate the cost based on the rules for determining premiums for COBRA coverage. If this information is not reported on the W-2, the employer may be liable for penalties of up to $200 per incorrect W-2. The IRS has temporarily exempted employers filing fewer than 250 Forms W-2 from this requirement for the prior year.

Changes to flexible spending accounts and health savings accounts:
Beginning in 2011, the cost of over-the-counter (OTC) medications cannot be reimbursed through a flexible spending account (FSA) or from a health reimbursement account (HRA) or health savings account (HSA), unless the OTC medication is purchased with a prescription. Beginning in 2013, the ACA limits the amount that can be withheld from an employee's salary on a pre-tax basis for health expenses to $2,500 per plan year.

Although this is not a tax on the employer, employers must monitor payroll systems to make sure the new limit is applied to FSA contributions, and employers may see a rise in payroll taxes due to decreased FSA contributions. Finally, under the ACA, the penalty for a nonqualifying distribution from a HSA was increased from 10% to 20% of the amount of the distribution.

Increased Medicare tax on high-earners: Beginning in 2013, employers must withhold an additional 0.9% Medicare tax from employees who earn over $200,000. The tax applies only to the employee; the employer is not subject to the tax, unlike the 1.45% Medicare tax that applies to both employees and employers. If the employer fails to withhold the additional Medicare tax, it may be liable for the tax as well as interest and penalties.

New PCORI and transitional reinsurance fees: The ACA imposes new fees directly on health insurers and on employers sponsoring self-insured health plans. These fees will be based on the average number of individuals covered under a plan or policy, which includes an employee's covered family members.

One fee will help fund the Patient-Centered Outcomes Research Institute (PCORI), which was established by the ACA to research comparative clinical effectiveness aimed at advancing the quality and relevance of evidence-based medicine and improving the value of health care. The PCORI fee will be payable annually for seven years, beginning with the first plan year ending on and after October 1, 2012.

For the first plan or policy year ending on or after October 1, 2012, the PCORI fee is $1 multiplied by the average number of lives covered under the plan or policy during the year.

This fee is due by July 31, 2013 for plans or policies with years ending in October, November and December 2012. Fees for plans or policies with years ending in January through September 2013 will first be due by July 31, 2014. The PCORI fees will be paid on Form 720, filed by July 31 following the applicable plan year.

Insurers will pay and file returns with the IRS for insured health policies; employers (or other plan sponsors) will file the returns and pay the fees for self-insured plans.

The other fee will fund temporary reinsurance to help stabilize premiums in the individual market once the exchanges are up and running and the ACA's insurance market reforms take effect. The transitional reinsurance premium (TRP) fee will be assessed for three years beginning with the 2014 calendar year, although states may choose to extend these fees for insured plans.

The first TRP fee will be due in late 2014 or early 2015, and will be $63 per enrollee. This fee will be paid after the plan notifies HHS of the average number of covered lives for the first nine months of 2014 and receives a statement from HHS of the amount owed. The fees for 2015 and 2016 will be smaller, as the overall amount to be collected is less.

Observation
Most medical plans, including those covering only retired employees, are subject to the fees. However, stand-alone dental or vision benefits, and most health FSAs, are exempt, as are most employee assistance programs and disease management or wellness programs.

Provision affecting employers as of 2014 and thereafter

Employer shared responsibility: Beginning in 2014, an employer with at least 50 full-time employees (employees working 30 hours or more a week on average during the year) must offer minimum essential health coverage to at least 95% of its full-time employees (and their dependent children). If an employer fails to do so and one or more employees secures assistance for coverage purchased through an exchange, there is an annual penalty of $2,000 multiplied by the total number of full-time employees less 30.

The penalty is applied monthly, so the employer is responsible for 1/12 of the total annual penalty for each month that it does not offer minimum essential health coverage. For this purpose, minimum essential health coverage is an ACA-compliant group health plan, but it need not meet a specific minimum value of coverage.

In addition, beginning in 2014, a large employer that offers minimum essential health coverage will have a penalty of $3,000 for each employee who receives assistance for buying insurance on the exchange. This penalty will not exceed $2,000 per full-time employee (over 30).

If the employee's share of the cost of single coverage offered by the employer exceeds 9.5% of the employee's household income, the employee may be eligible to receive premium assistance to purchase insurance through the exchanges.

Similarly, if the plan's share of total allowed cost of provided benefits is less than 60% of such costs, so that under the ACA the employer's coverage does not meet the required “minimum value,” the employee may also be eligible to receive premium assistance to buy insurance through the exchanges. An individual must have household income below 400% of the federal poverty level to be eligible for premium assistance.

Observation
These are commonly known as the “pay or play” provisions for employers. The penalties are excise taxes and are not deductible.

Reporting of health insurance coverage: Beginning for 2014 coverage periods, insurers and employers or unions with self-insured plans must report information to the IRS for each individual covered under a health insurance plan that provides minimum essential coverage. This information will be used by the government to determine whether individuals who purchase insurance on the exchanges will be eligible for a premium tax credit. Separate information must be given to full-time employees with the terms and conditions of the coverage.

Excise tax on high-cost employer-provided health coverage: Beginning in 2018, the ACA imposes an excise tax on the provider of employer-sponsored healthcare coverage if the aggregate cost for an employee exceeds a threshold amount. The tax is 40% of the amount by which the aggregate cost exceeds the threshold. For 2018, the annual threshold amount is $10,200 for self-only coverage and $27,500 for other coverage. Higher thresholds apply to retirees under age 65 and individuals in certain high-risk professions. The threshold amount is adjusted by the health cost adjustment percentage, which will increase if healthcare costs exceed certain predictions, and by an age- and gender-adjusted excess premium amount, which will increase the threshold if the employer's workforce based on age and gender results in higher premiums than the national workforce.

Observation
While the excise tax (often called the “Cadillac tax”) is imposed on the insurer for insured plans, it is likely to be passed on to employers through higher premiums, which will likely increase the amount of premiums subject to the tax. The excise tax is not deductible by the insurance company; however, the insurance premiums paid by the employer are generally deductible. For self-insured plans, the excise tax is imposed on plan administrators but is expected to be passed along to plan sponsors.

The takeaway

The tax provisions under the ACA are extremely broad and have varying effective dates. Employers must be able to address each of these provisions as they become effective in order to make the best business decisions regarding benefits and to avoid excise taxes and penalties.

Let’s talk

For a deeper discussion of how this issue might affect your business, please contact:

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