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January 11, 2011

To: Friends and clients of Donner & Company, CPA, PA

Re: Tax updates and a couple Firm updates

Dear Friends,

I for one am Happy to see 2010 out the rear view mirror and look forward to a Great 2011!!!

2010 was fraught with many complex and confusing tax issues. We as tax preparers could not count on whether various tax issues were here to stay, would be repealed, or changed and modified. Then on December 17, 2010 the final tax bill was passed.

I have attached a "Free Special Report" for you that hi-lights 2010 tax rules and also future tax issues so you are aware of issues that may impact you.

I recently e-mailed 2010 "Personal" tax preparation organizers to you if I had your e-mail address. If you did not receive an organizer please let me know. If you have e-mail I can e-mail it to you or I can send you a printed version. If you have an e-mail address and I do not have it please let me know.

Also, Donner & Company is growing. This year we are striving to add more Individual, LLC, Corporate and Partnership business clients, bookkeeping and Quickbooks consulting. Also, because my wife Lisa and I are active in real estate investing I have been receiving a lot of foreign, non-resident client referrals. Some of these foreigners have sold property here and need taxes prepared. Some are buying property to rent out. Depending on the situation these folks need tax help. We can handle those situations.

Lastly, because of our passion for real estate investing, Lisa's and my friend, mentor, and international real estate investor trainer and Guru "Ron LeGrand" asked us to co-author a book with him. After months of writing and re-writing, in October 2010, "***The New Masters of Real Estate – Getting Deals DONE in the new Economy***" was released. For a guy that never did much in English or writing composition I even won a "**Golden Quill Award**". The book was published by Celebrity Press, is available at all major book-stores and on Amazon. As a client of Donner & Company, CPA, PA I would like to give you a Free copy. I will give you the book at the completion of your tax return. See the attached copy of our new book.

Thank you for your business,

Rick Donner, CPA

# 2010 TAX YEAR-IN-REVIEW

December 28, 2010

*Special Report*

## HIGHLIGHTS

- Individual Tax Rates
- Capital Gains And Dividends
- Payroll Tax Cut
- Federal Estate Tax
- Bonus Depreciation
- Health Care Reform Mandates
- Reporting Of Uncertain Tax Positions
- Expanded Information Reporting
- New Foreign Tax Compliance Rules
- Retirement Funding Relief
- Tax Reform Proposals
- And More

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## Major Tax Law Changes In 2010 Require Immediate Action, Long-Term Strategies

2010 was a year in which a still-recovering economy generated a great number of major tax developments impacting taxpayers of all types: individuals, businesses, exempt organizations and more. Many of the developments were triggered by the passage of federal tax legislation; others by IRS rules and regulations; still others by important court cases. Some developments provide taxpayers with much-needed relief; others are aimed at helping the government collect needed revenues. This Tax Briefing provides a review of the key tax law developments of 2010 and their impact on taxpayers.

### OVERVIEW

From start to finish, 2010 was an important year for tax law changes. The year ended with an extension of the Bush-era tax cuts, an alternative minimum tax (AMT) patch, extenders relief and reinstatement of a modified estate tax. Even without such a dramatic closing, however, 2010 is notable for the tremendous impact of its other developments on a broad cross-section of taxpayers.

A series of tax stimulus measures, first in the Hiring Incentives to Restore Employment Act of 2010 (the HIRE Act, enacted March 18, 2010), then in the Small Business Jobs Act of 2010 (the 2010 Jobs Act, enacted September 27, 2010), and finally in the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the 2010 Tax Relief Act, enacted December 17, 2010) provide substantial, but temporary, opportunities that,

in many cases, must be acted upon quickly to maximize savings. To offset the cost of many of the tax breaks, Congress enacted “revenue raisers” with a special focus on tightening international tax rules, extending information reporting, adding anti-abuse provisions, and more. On the other hand, the \$800 billion-plus of incentives in the 2010 Tax Relief Act was off-budget, exempt from the “pay-go” rules requiring offsetting tax increases.

Additionally, historic health care legislation, with its many tax components, is reason alone to single out 2010 as notable both for its initial impact and its reach into the future. This sweeping legislation impacts all taxpayers - individuals and employers - immediately and for years to come.

Overlaid on 2010’s tax legislation is an equally significant output of guidance, procedures and initiatives from the IRS. The IRS used its powers to explain new laws, provide some relief to taxpayers experiencing economic hard times, strengthen heightened disclosure rules, and generally expand and refine its audit and collection toolkits. Court decisions pushed back on certain IRS positions, while reinforcing others.

### LEGISLATIVE CHANGES – IMPACT ON INDIVIDUALS

#### *Individual Income Tax Rates*

On December 17, 2010, President Obama signed into law a two-year extension of the reduced individual income tax rates put in

place by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and subsequent legislation. Under the 2010 Tax Relief Act, the individual rates remain at 10, 15, 25, 28, 33, and 35 percent for all taxpayers through the end of 2012.

**IMPACT.** *The extension significantly benefits taxpayers in the top two income brackets who, without the extension, would have seen top rates of 36 and 39.6 percent, respectively, after 2010. However, the extension is temporary for all taxpayers. A 15, 28, 31, 36 and 39.6 rate structure will start after 2012 without further Congressional action. Also looming after 2012, higher income taxpayers will be hit with an additional 0.9 percent Medicare tax and a 3.8 percent Medicare contribution tax (both discussed in connection with recent health care legislation, below).*

**IMPACT.** *Higher-income taxpayers also benefit immediately from a two-year extension of the elimination of the limitation on itemized deductions and the personal exemption phase-out (discussed below).*

**Marriage penalty relief, child tax credit and more.** Along with extending the individual rate cuts for two years, the 2010 Tax Relief Act extends marriage penalty relief that was linked to the EGTRRA rate reductions, as well as enhancements to the popular child tax credit. The child tax credit remains at \$1,000 for the 2011 and 2012 tax years. The 2010 Tax Relief Act also extends some enhancements to the earned income tax credit, the adoption credit and the dependent care credit for two years.

**Limitation on itemized deductions/personal exemption phase-out.** Full repeal of the limitation on itemized deductions and the personal exemption phase-out was scheduled to expire after 2010. The 2010 Tax Relief Act extends full repeal of the limitation on itemized deductions and the personal exemption phase-out for two years, through December 31, 2012.

### Capital Gains and Dividends

The Tax Relief Act of 2010 extends reduced capital gains and dividend tax rates

beginning after December 31, 2010 and ending before January 1, 2013. Qualified capital gains and dividends will continue to be taxed at a maximum rate of 15 percent (zero percent for taxpayers in the 10 and 15 percent brackets). After 2012, however, the EGTRRA-sunset provisions under the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) will kick the maximum capital gains rate up to 20 percent and align the dividends rate with the higher ordinary income tax brackets unless Congress acts in the meantime.

**PLANNING NOTE.** *The 28 percent rate for collectibles and the 25 percent rate for recaptured 1250 gain remain unchanged after 2010.*

### Alternative Minimum Tax

Passage of the 2010 Tax Relief Act also prevents the AMT from encroaching on middle income taxpayers. The legislation creates an AMT “patch” for 2010 and 2011. Congress increased the exemption amounts for 2010 to \$47,450 for single individuals, \$72,450 for married couples and surviving spouses, and \$36,225 for married individuals filing a separate return. The exemption amounts for 2011 are \$48,450 for single individuals, \$74,450 for married couples and surviving spouses, and \$37,225 for married individuals filing a separate return.

**IMPACT.** *Without the retroactive patch, the exemption amounts for 2010 would have been \$33,750 for single individuals, \$45,000 for married couples filing a joint return and surviving spouses, and \$22,500 for married individuals filing a separate return.*

The patch also allows taxpayers to offset their AMT liability by the full amount of their nonrefundable personal tax credits in 2010 and 2011.

### Payroll Tax Cut

The 2010 Tax Relief Act reduces the employee-share of OASDI tax from 6.2 percent to 4.2 percent for wages paid in calendar

## TAX RATES FOR 2011 UNDER THE 2010 TAX RELIEF ACT

### Single Individuals

If taxable income is:	The tax will be:
Not over \$8,500	10% of taxable income
Over \$8,500 but not over \$34,500	\$850.00 plus 15% of the excess over \$8,500
Over \$34,500 but not over \$83,600	\$4,750.00 plus 25% of the excess over \$34,500
Over \$83,600 but not over \$174,400	\$17,025.00 plus 28% of the excess over \$83,600
Over \$174,400 but not over \$379,150	\$42,449.00 plus 33% of the excess over \$174,400
Over \$379,150	\$110,016.50 plus 35% of the excess over \$379,150

### Married Couples Filing Jointly

If taxable income is:	The tax will be:
Not over \$17,000	10% of taxable income
Over \$17,000 but not over \$69,000	\$1,700.00 plus 15% of the excess over \$17,000
Over \$69,000 but not over \$139,350	\$9,500.00 plus 25% of the excess over \$69,000
Over \$139,350 but not over \$212,300	\$27,087.50 plus 28% of the excess over \$139,350
Over \$212,300 but not over \$379,150	\$47,513.50 plus 33% of the excess over \$212,300
Over \$379,150	\$102,574.00 plus 35% of the excess over \$379,150

AMT exemption amounts for	2010	2011
Individuals	\$47,450	\$48,450
Married couples filing jointly	\$72,450	\$74,450
Married individuals filing separately	\$36,225	\$37,225

year 2011 up to the taxable maximum of \$106,800. The one-year payroll tax cut replaces the Making Work Pay credit, which is scheduled to expire after 2010.

**IMPACT.** Like the Making Work Pay credit, the payroll tax cut is designed to deliver tax benefits incrementally. Wage earners will see an increase in their take-home pay. Most individuals will see a much greater benefit under the 2011 payroll tax holiday, with a maximum \$2,136 benefit per wage earner as compared to \$400 (\$800 for joint filers) under the Making Work Pay credit. However, individuals who do not pay into Social Security, such as federal government workers, will not see a benefit.

**IMPACT.** Employers have a short window in which to implement the payroll tax cut. The IRS has issued revised withholding tables, which must be used as soon as possible after January 1, 2011 and no later than January 31, 2011.

## Federal Estate Tax

EGTRRA generally reduced the federal estate tax until completely abolishing it for decedents dying in 2010. After 2010, the pre-EGTRRA estate tax (with a maximum tax rate of 55 percent and a \$1 million applicable exclusion amount) was scheduled to be revived. Additional EGTRRA changes affected the gift and generation-skipping transfer (GST) tax.

The 2010 Tax Relief Act reinstates the estate tax at a maximum rate of 35 percent with a \$5 million exclusion amount for decedents dying after December 31, 2009 and before January 1, 2013.

**COMMENT.** The new law also allows “portability” between spouses of the estate tax applicable exclusion amount and

*extends some other taxpayer-friendly provisions originally enacted in 2001.*

The 2010 Tax Relief Act gives estates of decedents dying after December 31, 2009 and before January 1, 2011, the option to elect to apply (1) the estate tax based on the new 35 percent top rate and \$5 million applicable exclusion amount, with stepped-up basis or (2) no estate tax and modified carryover basis rules under EGTRRA. An election is revocable only with the consent of the IRS.

“The Health Care and Education Reconciliation Act, enacted in early 2010, imposes two additional Medicare taxes on higher-income individuals effective for tax years beginning after December 31, 2012.”

**Gift tax.** The 2010 Tax Relief Act continues the EGTRRA gift tax rate of 35 percent and maximum exclusion amount of \$1 million for gifts made in 2010. For gifts made after 2010, the gift tax is reunified with the estate tax with a top gift tax rate of 35 percent and an applicable exclusion amount of \$5 million.

**Generation-skipping transfer (GST) tax.** The GST tax acts in tandem with the estate tax to ensure that the transfer of wealth is taxed on a generation-by-generation basis. Under the 2010 Tax Relief Act, the GST exemption amount is \$5 million with a GST rate of zero for GSTs made in 2010. For transfers made after 2010 and before 2013, the exemption amount is \$5 million with a GST tax rate of

35 percent. Other changes made to the GST tax under EGTRRA are also extended for two years under the 2010 Tax Relief Act.

## Medicare Tax Changes

The Health Care and Education Reconciliation Act, enacted in early 2010, imposes two additional Medicare taxes on higher-income individuals effective for tax years beginning after December 31, 2012.

**0.9 percent tax.** A 0.9 percent additional Medicare tax is imposed on single individuals who receive wages with respect to employment during any tax year beginning after December 31, 2012, in excess of \$200,000. The threshold is \$250,000 for a married couple filing a joint return (\$125,000 for a married taxpayer filing separately).

**3.8 percent tax.** Also imposed for tax years beginning after December 31, 2012 is a 3.8 percent Medicare contribution tax on qualified unearned income of higher-income individuals. The 3.8 percent Medicare tax is imposed on the lesser of an individual’s net investment income for the tax year or any excess of modified adjusted gross income (MAGI) in excess of \$200,000 for an individual. The threshold for married couples filing a joint return and surviving spouses is \$250,000 (\$125,000 in the case of a married taxpayer filing separately).

## Other Legislative Changes Affecting Individuals

**Tax extenders.** Certain temporary tax incentives for individuals had expired at the end of 2009. The 2010 Tax Relief Act extends most of them retroactively for two years: 2010 and 2011.

Renewed extenders for individuals include (not an exhaustive list):

- State and local sales tax deduction;
- Teacher’s classroom expense deduction;
- Tax-free distributions from IRAs for charity; and
- Higher education tuition deduction.

**COMMENT.** One provision not extended is the \$500 real property deduction (\$1,000 for joint filers) available to homeowners who do not itemize their deductions.

**American Opportunity Tax Credit.** The American Recovery and Reinvestment Act of 2009 (2009 Recovery Act) significantly expanded the HOPE education credit and renamed the credit the American Opportunity Tax Credit (AOTC). The 2010 Tax Relief Act extends the AOTC to apply to tax years 2011 and 2012.

**IMPACT.** Qualified taxpayers will continue to be eligible for the AOTC based on 100 percent of the first \$2,000 of tuition, fees and course materials paid during the tax year, plus 25 percent of the next \$2,000 of tuition, fees and course materials paid during the tax year. The full credit is available to single individuals with modified AGI (MAGI) of \$80,000 or less (\$160,000 or less for married taxpayers filing a joint return). The credit is reduced ratably until a single individual's MAGI is greater than \$90,000 (\$180,000 for married taxpayers filing a joint return).

**Self-employed individuals.** Self-employed individuals may claim a deduction for qualified health insurance costs for income tax purposes. For self-employment taxes, however, the self-employed individual cannot deduct any health insurance costs. The 2010 Small Business Jobs Act temporarily allows the income tax deduction for the cost of health insurance in calculating net earnings from self-employment for purposes of self-employment (SECA) taxes. This tax break is temporary and only applies to the self-employed taxpayer's first tax year beginning after December 31, 2009 which, for most individuals, is the 2010 calendar year.

**COMMENT.** Under the payroll tax cut in the 2010 Tax Relief Act, self-employed individuals pay 10.4 percent OASDI on self-employment income in

calendar 2011 up to the maximum taxable amount.

**First-time homebuyer credit.** The first-time homebuyer credit rewarded qualified taxpayers with a tax incentive worth 10 percent of the purchase price, up to a maximum of \$8,000. The credit has expired for most taxpayers.

**PLANNING NOTE.** Some taxpayers have additional time to take advantage of the first-time homebuyer credit. Eligible individuals on extended active military duty outside of the U.S. for more than 90 days may claim the first-time homebuyer credit by purchasing a principal residence before May 1, 2011, or entering into a binding contract before May 1, 2011, and closing on the home before July 1, 2011.

**Unemployment benefits exclusion.** The 2009 Recovery Act allows individuals to exclude the first \$2,400 in unemployment benefits from income for 2009. Congress did not renew this exclusion for either 2010 or 2011.

**Energy incentives.** A popular energy tax incentive for individuals renewed at the end of 2010 is the Code Sec. 25C residential energy property credit. However, the 2010 Tax Relief Act extends the credit as it existed before the 2009 Recovery Act, with less generous provisions.

**Local disaster relief.** Previous legislation provided for a variety of temporary provisions to assist taxpayers recovering from a qualified disaster. Some of these local disaster incentives, which expired at the end of 2009, are renewed for one or two years.

## LEGISLATIVE CHANGES – IMPACT ON BUSINESS

### Bonus Depreciation

Congress used the 2010 Tax Relief Act to double and extend bonus depreciation

from 50 percent to 100 percent for qualified property acquired after September 8, 2010 and before January 1, 2012, and placed in service before January 1, 2012. A limited category of property with a longer production period qualifies for 100 percent bonus depreciation for an extended period through December 31, 2012.

The 2010 Tax Relief Act also provides for 50-percent bonus depreciation for 2012 (through 2013 for longer production period assets).

**IMPACT.** Because bonus depreciation has no dollar caps, taxpayers may prefer 100 percent bonus depreciation put into place by the 2010 Tax Relief Act over Code Sec. 179 expensing.

**Refundable credits in lieu of bonus depreciation.** Under the 2009 Recovery Act, a corporation otherwise eligible for first year bonus depreciation may elect to claim minimum tax credits in lieu of claiming depreciation for qualified property placed in service after March 31, 2008 and before December 31, 2008. The 2010 Tax Relief Act includes an election to accelerate AMT credits in lieu of bonus depreciation provided for “round 2 extension property.”

### Expensing

The HIRE Act extends enhanced Code Sec. 179 expensing through December 31, 2010. The 2010 Small Business Jobs Act extends the incentive through December 31, 2011, and raises the limit retroactively for all purchases in 2010. Finally, the 2010 Tax Relief Act extends the incentive further, through December 31, 2012, but at a reduced “enhanced” level.

The 2010 Tax Relief Act also extends the allowance of expensing for off-the-shelf computer software for software placed in service before 2013.

**IMPACT.** Congress also tweaked Code Sec. 179 expensing by allowing taxpayers

to expense qualified leasehold investment property, qualified restaurant property and qualified retail improvement property for 2010 and 2011. The maximum amount with respect to real property that may be expensed, however, is capped at \$250,000. Other restrictions apply.

### Qualified Small Business Stock

The 2010 Small Business Jobs Act enhances the exclusion of gain from qualified small business stock to noncorporate taxpayers. For stock acquired after September 27, 2010 and before January 1, 2011, and held for at least five years, the 2010 Small Business Jobs Act provides an exclusion of 100 percent. The 2010 Tax Relief Act extends the 100 percent exclusion for one more year, for stock acquired before January 1, 2012.

**IMPACT.** *With the 100-percent exclusion, none of the gain on qualifying sales or exchanges of small business stock is subject to federal income tax. In addition, the excluded gain is not treated as a tax preference item for AMT purposes, so the gain will not be subject to AMT. Investors, however, must be patient to realize this benefit because they must hold the qualified shares for at least five years (or roll over proceeds to other qualified shares). Stock issued after December 31, 2011 reverts to the standard 50-percent exclusion.*

### General Business Credit

The 2010 Small Business Jobs Act extends the carryback period for eligible small business credits from one to five years. Eligible small business credits are defined for purposes of the 2010 Small Business Jobs Act as the sum of the general business credits determined for the tax year with respect to an eligible small business. An eligible small business is a corporation whose stock is not publicly traded, a partnership or a sole proprietorship. Average annual gross receipts cannot exceed \$50 million.

**IMPACT.** *The extended carryback provision is effective for credits determined in the business's first tax year beginning after December 31, 2009.*

### Employer-Side Payroll Tax Forgiveness

The HIRE Act provides a qualified employer with an exemption from having to pay its share of OASDI taxes for a covered employee's employment from the day after March 18, 2010 through December 31, 2010. A covered employee, generally an individual who has been unemployed for a specified period of time, must begin work for a qualified employer after February 3, 2010 and before January 1, 2011. Payroll tax forgiveness applies to wages paid to qualified employees from the day after March 18, 2010 through December 31, 2010.

**IMPACT.** *This "employer-side" tax break is not available for 2011. However, a two percent reduction in OASDI taxes is available under the Tax Relief Act of 2010 as an "employee-side" tax break, available to virtually all employees at all income levels, up to the \$106,800 OASDI wage cap.*

### Worker Retention Credit

Under the HIRE Act, employers that have hired new workers who qualify for payroll tax forgiveness may also be eligible for a tax credit for each qualified employee who is retained on the employer's payroll for 52 consecutive weeks. The business credit under Code Sec. 38 is increased, with respect to each qualified retained worker, by the lesser of \$1,000 or 6.2 percent of wages paid by the taxpayer to the qualified retained worker during the 52 week period. A qualified retained worker must be paid an amount equal to at least 80 percent of his first 26 weeks of wages during the last 26 weeks of the 52 week qualifying period.

**IMPACT.** *The new hire retention credit cannot be used to offset the business alternative minimum tax (AMT).*

### Other Legislative Changes Affecting Businesses

**Business extenders.** Renewed extenders for businesses in the 2010 Tax Relief Act include (not an exhaustive list):

- Research tax credit;
- Differential wage payments to activated military reservists;
- Indian employment credit;
- Film and television production costs;
- Environmental remediation;
- Active financing income/look-through treatment;
- New Markets Tax Credit;
- Railroad track maintenance credit;
- Motorsports entertainment complex accelerated recovery;
- Tax Incentives for Empowerment Zones; and
- Tax Incentives for the District of Columbia.

**Start-Up Expenses.** The 2010 Small Business Jobs Act increases the amount of deductible start-up expenses from \$5,000 to \$10,000. The threshold amount before reducing this deduction increases from \$50,000 to \$60,000 in expenses. The increases are temporary and are effective only for tax years beginning in 2010.

**IMPACT.** *Start-up expenses that are not currently deductible must continue to be amortized ratably over a 180-month period (15 years) beginning with the month in which the active trade or business begins.*

**Cell phones.** No deduction is allowed for property that is "listed property" under Code Sec. 280F unless a taxpayer adequately substantiates the expense and business usage of the property. The 2010 Small Business Jobs Act removes cell phones from the definition of listed property for tax years beginning after December 31, 2009.

**COMMENT.** *The 2010 Small Business Jobs Act also removes "similar telecommunications equipment" from their*

*classification as listed property under Code Sec. 280F. This would appear to encompass smartphones and other personal communications devices.*

**Charitable incentives.** A number of incentives to encourage charitable giving are renewed for 2010 and 2011. They include, but are not limited to enhanced deductions for contributions of food inventory; deductions for corporate contributions of books to public schools; and corporate contributions of computer inventory.

**Energy incentives.** Several energy-related tax incentives that expired at the end of 2009 are renewed for two years under the 2010 Tax Relief Act. They include the credits for biodiesel and renewable diesel fuel; the Code Sec. 45 renewable electricity production tax credit to a refined coal production facility producing steel industry fuel; the credit for electricity produced at qualified open-loop biomass facilities; and the new energy efficient home credit (not an exhaustive list).

**Rejected revenue raisers.** A number of revenue raising proposals initially had great momentum at the start of 2010, only to lose steam as intense lobbying efforts slowed their progress. Modified proposals may reappear in 2011.

- **Carried interest.** In its search for revenue raisers, Congress turned to carried interest. The House approved a bill (H.R. 4213) intended to raise nearly \$18 billion over 10 years by a change in the taxation of carried interest. The bill generally treated net income from an investment services partnership interest as ordinary income except to the extent it is attributable to the partner's qualified capital interest. A portion of recharacterized income would be taxed at ordinary income rates and would be subject to self-employment tax. The Senate rejected the proposal.
- **S corp self-employment tax.** A House-passed bill (H.R. 4213) included a provision imposing self-employment payroll taxes on S corporation

passthrough income where an S corporation is engaged in a professional service business and its principal asset is the reputation and skill of three or fewer employees or where the S corporation is a partner in a professional service business. The S corporation proposal, like the proposed change in tax treatment of carried interest, was rejected by the Senate.

## HEALTH CARE REFORM

Passage of the Patient Protection and Affordable Care Act (PPACA) and the Health Care and Education Reconciliation Act (HCERA) in early 2010 generated extensive guidance from the IRS. Some provisions of the PPACA were effective immediately, such as the Code Sec. 45R small employer health insurance tax credit, while others carry later effective dates.

**Code Sec. 45R credit.** The PPACA rewards qualified small employers that provide health care coverage with a tax credit. In Notice 2010-44 and Notice 2010-82, the IRS explained that the small employer (for-profit and tax-exempt employers) must have fewer than 25 full-time equivalent (FTE) employees for the tax year, the average annual wages of its employees for the year must be less than \$50,000 per FTE, and the employer must pay the premiums under a qualifying arrangement. If the number of FTEs exceeds 10 or average annual wages exceed \$25,000, the amount of the credit is reduced using a formula.

The maximum credit for tax years beginning in 2010 through 2013 for a for-profit employer is 35 percent of the employer's premium expenses. For tax years beginning in 2010 through 2013, the maximum credit for a tax-exempt employer is 25 percent of the employer's premium expenses.

**Health FSAs.** Under the PPACA, purchases of over-the-counter (OTC) medicines and drugs made after December 31, 2010 without a prescription cannot be reimbursed by health flexible spending accounts (FSAs) or health reimbursement accounts

(HRAs). The IRS issued guidance describing the new limitations (Notice 2010-59, Rev. Rul. 2010-23).

**IMPACT.** *Individuals may continue to use health FSA dollars to purchase OTC medical supplies, equipment, (for example, crutches, bandages, blood-sugar test kits, glasses, and contact lenses) and insulin without a prescription.*

**Grandfathered health plans.** Health plans in existence on the date of enactment of the PPACA (March 23, 2010) are generally treated as grandfathered plans, exempting them from some of the PPACA's mandatory provisions. The IRS issued interim final rules explaining how a plan may maintain its grandfathered status (T.D. 9489).

**Adult children.** The PPACA requires plans and issuers offering dependent coverage to make the coverage available until an adult child reaches the age of 26. The IRS issued interim final rules (T.D. 9482) explaining that the PPACA applies to all plans in the individual market, new employer plans and existing employer plans unless the adult child has another offer of employer-based coverage. Beginning in 2014, children up to age 26 can stay on their parent's employer plan even if they have another offer of coverage through an employer.

**COMMENT.** *The IRS also issued guidance explaining that, as a result of the PPACA, health coverage provided for an employee's children under age 27 is generally tax-free to the employee (Notice 2010-38).*

**Preventive services.** The IRS issued interim final rules (T.D. 9493) requiring new plans and issuers to cover certain preventive services. The preventive services must be provided without cost-sharing when delivered by an in-network provider in plan years beginning on or after September 23, 2010. Preventive services include adult screenings for depression, diabetes and HIV, and screenings for children.

**Internal and external appeals.** The IRS issued interim final rules (T.D. 9494)

describing the expanded rights of individuals under the PPACA to appeal adverse determinations made by their health plans. New health plans beginning on or after September 23, 2010 must have an internal appeals process that allows individuals to appeal denials or reductions for covered services and rescissions of coverage.

**Lifetime and annual coverage limits.** The PPACA generally prohibits group health plans from placing any lifetime or annual dollar limits on the amount of essential health benefits that individual participants may receive under the health insurance plan. IRS interim final rules (T.D. 9491) prohibit the use of lifetime limits in all health plans and insurance policies issued or renewed on or after September 23, 2010.

## DOMESTIC COMPLIANCE MEASURES

In a revenue-challenged economy, Congress during 2010 put considerably more emphasis on compliance measures to enhance tax collection. Congressional leaders believed that fraud, innocent errors and incomplete data have left billions of dollars unreported. In 2010, Congress focused its compliance measures on two levels: (1) new legislation to impose new transparency requirements and (2) pressure on the IRS to use its existing authority and tools to capture more revenue.

### Uncertain Tax Positions

In one of the most significant developments of 2010, the IRS announced that it will require corporations to report uncertain tax positions on their tax returns (Ann. 2010-75, Ann. 2010-76). Qualified corporations must file Schedule UTP, Uncertain Tax Position Statement, for the 2010 tax year if they have assets that equal or exceed \$100 million. The asset threshold for reporting is reduced to \$50 million starting with the 2012 tax year and to \$10 million starting with the 2014 tax year. Taxpayers must provide a concise description of the tax position, including a description of the relevant facts affecting the tax treatment of the position and

information that reasonably can be expected to apprise the IRS of the identity of the tax position and the nature of the issue.

**IMPACT.** *The requirement to report uncertain tax positions covers corporations that file certain Form 1120 series returns (specifically, C corporations, foreign corporations, and property, casualty and life insurance companies). The IRS has indicated it may extend the requirement to report uncertain tax positions to pass-throughs and other entities for 2011 or later tax years.*

“In one of the most significant developments of 2010, the IRS announced that it will require corporations to report uncertain tax positions on their tax returns...”

**IMPACT.** *Many taxpayers questioned if UTP reporting signaled a change in the IRS's policy of restraint concerning tax workpapers. The IRS indicated that it will forgo seeking particular documents relating to uncertain tax positions and the workpapers that document completion of Schedule UTP. Taxpayers may redact certain information, such as working drafts of the concise description of tax positions, from copies of workpapers.*

### Information Reporting

New laws significantly expand information reporting. Many of the new information reporting requirements apply to tax years beginning after 2010, on a phased-in basis.

**IMPACT.** *Computer technology over the past few years has increased exponentially the IRS's ability to cross match literally millions of e-filed information documents against filed tax returns. The IRS and*

*Congress view this as a win-win opportunity to raise revenue.*

**Broker basis reporting.** The Emergency Economic Stabilization Act of 2008 (EESA) requires a broker, already required to file an information return to report gross proceeds from the sale of a covered security, to report the adjusted basis and type of gain for most stock acquired on or after January 1, 2011. The EESA also requires reporting for stock in a mutual fund (regulated investment company) or a dividend reinvestment plan (DRP) acquired on or after January 1, 2012 and for other securities and options acquired on or after January 1, 2013. The IRS issued guidance (Notice 2010-67, T.D. 9504) and provided transition relief for certain broker transfer transactions.

**Payment card reporting.** The Housing Assistance Tax Act of 2008 requires a payment settlement entity to report payments made to merchants for goods and services in settlement of payment card and third-party payment network transactions on payment card transactions occurring after December 31, 2010. The IRS issued final regulations (T.D. 9496) describing the mechanics of payment card reporting.

**W-2 reporting.** The PPACA requires employers, starting in the 2011 tax year, to report the value of the health insurance coverage they provide employees on each employee's annual Form W-2. The IRS, however, is phasing-in the new information reporting mandate.

**Rental property expense reporting.** The Small Business Jobs Act of 2010 imposes information reporting on qualified rental expense payments made after December 31, 2010. If a person receiving rental income from real estate makes payments totaling \$600 or more in any tax year to a person or corporation, the payor must file an information return reporting those payments.

Covered payments include payments for rent, salaries, wages, amounts in consideration for property, premiums, and other payments.

**IMPACT.** *Individuals who can show that reporting is a hardship, individuals who receive a minimal amount of rental income and certain military personnel are excluded from this new reporting requirement. The IRS is expected to issue guidance on the exceptions.*

**Business reporting.** Under the PPACA, all businesses, charities and state and local governments will file an information return for all payments aggregating \$600 or more in a calendar year to a single provider of goods or services (other than a payee that is a tax-exempt corporation). The PPACA also repeals the longstanding reporting exception for payments to a corporation. The PPACA's expanded information reporting requirements apply to payments made after December 31, 2011.

**IMPACT.** *The PPACA expands business information reporting in two ways. First, the types of payments that can trigger reporting are expanded to include amounts paid in consideration of goods as well as services. Second, payments to corporations will no longer be exempt from reporting because of the payee's status as a corporation.*

**COMMENT.** *If the payee does not provide a taxpayer identification number (TIN), the PPACA generally requires the payor to withhold 28 percent from all subsequent payments due to the payee. The payee is subject to a penalty of \$50 for each failure to provide the correct TIN to a payor that has requested it.*

**Information return penalties.** Penalties for non-compliance with information re-

turn reporting will jump after 2010, not only giving added force to the new information requirements but also raising existing rules to a new level of importance. Penalty amounts vary across three tiers, depending upon how far after the due date the taxpayer files:

- Returns filed up to 30 days after the due date: \$30 per return, with a maximum of \$250,000 per calendar year (\$75,000 for small businesses);
- Returns filed after 30 days following the due date, but on or before August 1: \$60 per return, with a maximum of \$500,000 per calendar year (\$200,000 for small businesses); and
- Returns filed after August 1: \$100 per return, with a maximum of \$1.5 million per calendar year (\$500,000 for small businesses).

"In 2010, the IRS announced that the new electronic filing mandate for specified tax return preparers will be phased-in over two years..."

**IMPACT.** *The increased penalties are effective for information returns filed with the IRS on or after January 1, 2011.*

**COMMENT.** *A small business is one that has gross receipts of less than \$5 million for purposes of the penalty structure.*

## Electronic Filing

The IRS continues to push for greater use of electronic filing by individuals and businesses. In the business area, the IRS can mandate e-filing; it cannot for individuals.

**Preparer e-file.** In 2010, the IRS announced that the new electronic filing mandate for specified tax return preparers will be phased-in over two years (Notice 2010-85). Beginning January 1, 2011, preparers who reasonably expect to file 100 or more individual, estate or trust returns in calendar year 2011 generally must e-file those returns. The threshold for mandatory e-filing falls to 11 or more covered returns reasonably expected to be filed in calendar year 2012.

**Tax Court filings.** The Tax Court announced that beginning with petitions filed on or after July 1, 2010 taxpayers represented by counsel must file all documents with the U.S. Tax Court using the court's electronic filing system. The Tax Court is now conforming its e-filing policies with other federal courts. However, the court made some exceptions, including one for taxpayers representing themselves.

## Economic Substance Doctrine

**IRS court victories.** The U.S. Court of Appeals for the Federal Circuit found that contributions of a foreign currency option spread to a partnership lacked economic substance (Jade Trading, CA-FC, 2010-1 USTC ¶50,304). The court found that purported losses generated by the transaction were fictional and the transactions were "virtually guaranteed to be unprofitable." The IRS also won an important victory in the Federal Circuit when the court found that a series of Son of BOSS transactions lacked economic substance (Stobie Creek Investments LLC, CA-FC, Dec. 50,455).

**Codification.** The HCERA codified the economic substance doctrine. The IRS issued guidance in Notice 2010-62.

Expanded Information Reporting	
Payment Card Reporting:	Transactions after December 31, 2010
Rental Expense Reporting:	Rental expense payments made after December 31, 2010
Basis Reporting by Brokers:	Certain transactions on or after January 1, 2011
W-2 Reporting Health Insurance Reporting:	Optional for 2011; Required for 2012
Enhanced Business Reporting:	Payments made after December 31, 2011

## Code Sec. 6707A Penalties

The 2010 Small Business Jobs Act provides taxpayers with much anticipated relief from harsh penalties under Code Sec. 6707A for failing to disclose participation in reportable and listed transactions. Under the new law, the penalty generally equals 75 percent of the reduction in tax reported on the participant's return as a result of the transaction or that would result if the transaction was respected for federal tax purposes. The 2010 Small Business Jobs Act also sets maximum and minimum penalty amounts.

*IMPACT. Penalty relief is retroactive to penalties assessed since January 1, 2007.*

## Work Product Doctrine

Developments concerning the work product doctrine were a mixed bag of taxpayer victories and IRS wins in 2010.

**Textron case.** In a highly watched case, the Supreme Court declined to review the decision of the Court of Appeals for the First Circuit that allowed the IRS access to a corporation's tax accrual workpapers (Textron Inc., 2009-2 USTC ¶50,574). The First Circuit narrowly defined the scope of those documents protected because they were prepared "in anticipation of litigation" and distinguished them from those that had to be prepared because they were needed to fulfill financial reporting requirements.

**Taxpayer win.** The Court of Appeals for the District of Columbia Circuit upheld work product protection despite auditor disclosures (Deloitte, LLP, CA-DC, 2010-1 USTC ¶50,487). The court found that the taxpayer did not waive the work product privilege for certain documents by disclosing them to its independent auditor.

### Mandatory E-filing for Practitioners

2011:	100 or more individual returns
2012:	11 or more covered returns

## Whistleblowers

The Tax Relief and Health Care Act of 2006 (TRHCA) increases the amount of the award a whistleblower could claim, allowed a whistleblower to appeal award determinations to the Tax Court and established the IRS Whistleblower Office. In 2010, the IRS posted descriptions on its web site of various scenarios when a whistleblower may receive an award. The IRS also reported that it has yet to pay any claims under the revised rules in the TRHCA.

## FOREIGN COMPLIANCE MEASURES

The focus of both the Congressional use of legislation and increased pressure on the IRS has been most apparent in connection with foreign-related transactions and financial dealings.

### Foreign Account Tax Compliance

The Treasury Department and the IRS are stepping up their oversight of foreign account tax compliance, particularly after passage of a set of compliance measures in the HIRE Act. The IRS issued preliminary HIRE Act guidance, defining foreign financial institution (FFI), describing obligations exempt from withholding, and identifying the information that FFIs must report to the IRS under their FFI agreement in Notice 2010-60. Further details and restrictions are expected in 2011. Additionally, the IRS provided certain taxpayers some temporary relief from the filing requirements for TD F 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR).

**FBAR.** Persons subject to U.S. jurisdiction (including citizens, residents and domestic entities) must file an FBAR if they have financial interests in, or signature or other authority over, a bank, securities, or other financial account in a foreign country exceeding \$10,000. Reports must be filed by June 30 of the succeeding year.

**FinCEN.** The Treasury Department's Financial Crimes Enforcement Network

(FinCEN) proposed new rules to update the reporting requirements imposed on U.S. persons with foreign bank accounts. The proposed FinCEN rules would clarify who (or what entity) must file a report and which accounts must be reported.

**HIRE Act.** The HIRE Act reaches individuals with interests in "specified foreign financial assets." New Code Sec. 6038D, which implements the HIRE Act's reporting requirements, requires qualified individuals to attach to their income tax returns certain information with respect to each asset if the aggregate value of all the assets exceeds \$50,000.

*IMPACT. The HIRE Act's information report, unlike the FBAR, must be filed with the taxpayer's federal income tax return. Persons required to file an FBAR will generally also be required to file a HIRE Act report, but under a different set of deadlines.*

*IMPACT. New Code Sec. 6038D applies to assets held during tax years beginning after March 18, 2010. Calendar-year individuals would first file their HIRE Act information report with their 2011 tax returns filed in 2012.*

## Voluntary Disclosures, Joint Audits And More

In 2009 and 2010, more than 15,000 individuals participated in an IRS voluntary disclosure program. The IRS also is reportedly launching investigations into other foreign financial institutions as well as preparing for joint audits with other jurisdictions.

**Voluntary disclosures.** The IRS voluntary disclosure program offered a reduced penalty framework in exchange for voluntary disclosure of unreported accounts. In December 2010, IRS Commissioner Douglas Shulman indicated that the agency is considering another voluntary disclosure program, possibly in 2011.

**COMMENT.** *The voluntary disclosure program has been criticized for failing to distinguish between willful noncompliance and nonwillful violations of U.S. tax laws. In some cases, the IRS appears to have targeted individuals who were refugees and had to place assets in overseas banks. In other cases, individuals may have deposited funds in overseas banks long ago and forgotten their existence.*

**Switzerland.** In November 2010, the IRS reported that Switzerland had supplied information on approximately 4,000 accounts at Swiss banking giant UBS AG. The IRS predicted that the final count of UBS accounts would exceed 7,500.

**Joint audits.** The IRS is developing a protocol for joint audits with other countries. A joint audit is not the same as a simultaneous audit where two countries are conducting audits at the same time using exclusively their own resources. Rather, a joint audit is a coordinated action combining the resources of other countries.

**Large Business and International Division.** The IRS's heightened focus on international activities is reflected in the 2010 change of the name of the Large and Mid-Size Business (LMSB) Division to the Large Business and International (LB&I) Division.

**IMPACT.** *The change is more than rebranding. The IRS reported that it is adding significant numbers of personnel who are specialists in international issues. The realigned LB&I will continue to serve the same population of taxpayers (corporations, subchapter S corporations and partnerships with assets greater than \$10 million as well as certain high wealth individuals). LB&I will also oversee implementation of the provisions in the HIRE Act.*

### Other Foreign-Focused Initiatives

**Transfer pricing.** Code Sec. 482 authorizes the IRS to adjust the income, de-

ductions, credits, or allowances of commonly controlled taxpayers to prevent evasion of taxes or to clearly reflect their income. IRS regulations generally require that prices charged by one affiliate to another, in an intercompany transaction involving the transfer of goods, services, or intangibles, yield results consistent with those realized where uncontrolled taxpayers had engaged in the same transaction under the same circumstances. The IRS had several important developments concerning transfer pricing in 2010.

The IRS announced its nonacquiescence to a major transfer pricing decision on buy-in payments by the Tax Court, Veritas Software Corp, 133 T.C. No. 14 (2009), Dec. ¶58,016. The IRS disputed the factual findings and disagreed with

“The IRS is developing a protocol for joint audits with other countries.”

the Tax Court's conclusion that the discussion of preexisting intangibles in the governing regulations excluded consideration of subsequently developed intangibles for valuation.

The IRS also announced its acquiescence in result only to another transfer pricing decision, this one by the Court of Appeals for the Ninth Circuit, Xilinx, March 22, 2010, 2010-1 USTC ¶50,302. The Ninth Circuit found a qualified cost sharing arrangement did not apply to a taxpayer's allocation of employee stock option compensation costs. While the agency acquiesced to the decision's result (and dismissed it as moot), the IRS disagreed with the Ninth Circuit's interpretation of the Code Sec. 482 regs that reached that result.

**Foreign tax credits.** In Notice 2010-65, the IRS provided additional intellectual property

exceptions to the foreign tax credit disallowance rules under Code Sec. 901(1) for taking a credit on withholding taxes. The IRS will exempt certain licensing and copyright transactions from the application of Code Sec. 901(1). Regulations to be issued reflecting this guidance will apply to amounts paid or accrued after September 23, 2010.

**IMPACT.** *The IRS's treatment may impact situations where a foreign jurisdiction requires a foreign entity to have more than one member and an accommodating party is used. In that case, questions may arise as to whether the accommodating party should be respected as an owner for U.S. taxation.*

## EVOLVING ENTITIES FOR TAX PURPOSES

### Limited Liability Companies

Limited liability companies (LLCs) have grown exponentially in popularity over the last several years as state jurisdictions have relaxed qualifications and the IRS has extended its rules to permit their greater and more varied use.

**Partnership participation.** In a victory for members of LLCs, the Tax Court has declined to treat a member of an LLC holding an ownership interest in a limited partnership as a limited partner for federal tax purposes (Newell, TC Memo. 2010-23, Dec. 58,127(M)). The LLC in this case was classified as a partnership for federal tax purposes. The court found that an LLC is a hybrid entity and, in light of California business law, the member fell within the general partner exception under temporary regulations.

**Series LLCs.** The IRS issued proposed regulations (NPRM REG-119921-09) on domestic series limited liability companies (LLCs). The proposed regulations treat each series unit established by the LLC as a local law entity that may be a separate entity for federal tax purposes.

**COMMENT.** Several states allow LLCs to establish series LLCs, consisting of the LLC and several units or a series. Under state law, the series units established by an LLC generally are not treated as separate entities.

**IRS acquiescence.** The IRS in 2010 acquiesced in result only to the Court of Federal Claims' decision in Thompson (FedCl, 2009-2 USTC ¶50,501), which held that a member's interest in a limited liability company (LLC) taxed as a partnership is not a limited partnership (LP) interest for passive activity loss (PAL) purposes under Code Sec. 469. The court found that an LLC member's material participation is evaluated using the more generous criteria that normally applies to anyone who is not a limited partner.

### Partnerships

The IRS issued final regulations (T.D. 9485) intended to strengthen the anti-abuse rules for contributions of property to a partnership where the property's value has appreciated or depreciated in the hands of the contributor. The IRS will use the anti-abuse rule in Reg. §1.701-2(b) to recast a transaction that has a principal purpose of substantially reducing the present value of the partners' tax liabilities in a manner inconsistent with the partnership provisions.

**COMMENT.** The IRS indicated that it may recast a transaction, including an allocation for contributed property, even though it literally satisfies the Tax Code or regulations.

### Exempt Organizations

**Exempt status.** Under the Pension Protection Act of 2006, exempt organizations failing to satisfy annual filing requirements for three consecutive years automatically lose their tax-exempt status. In 2010, the IRS provided temporary relief to help small exempt organizations remain in compliance. The relief was targeted to Form 990-N (e-Postcard) and Form 990-EZ filers.

**COMMENT.** Organizations required to file Form 990 or Form 990-PF were not eligible for the relief program and their exemptions were automatically revoked if they failed to file for three consecutive years.

**Tax shelter transactions.** Tax exempt organizations may be sanctioned for participation in certain tax shelter transactions. The IRS issued final regulations (T.D. 9492) describing who is a party to an exempt entity prohibited tax shelter transaction.

**IMPACT.** The final regulations reach entities described in Code Sections 501(c) and 501(d), tax-qualified pension plans, individual retirement arrangements, and similar tax-favored savings arrangements.

## RETIREMENT-RELATED ISSUES

The economic environment continued to raise issues in 2010 related to properly funding retirement savings. Some individuals preparing for retirement have become more fearful that they may outlive their savings, and employers that sponsor retirement plans are no longer entirely confident that they can meet their funding obligations. Certain stop-gap measures and other solutions to address those concerns were tried in 2010. The nature of the problem assures continued activity in the area.

### Roth IRA Conversions

Effective for 2010 and beyond, taxpayer-friendly rules for Roth IRA conversions apply. Individuals may convert funds from a traditional IRA, 401(k) plan or certain other qualified plans to Roth IRAs, regardless of income. The traditional IRA or plan can make the distribution directly to a new or existing Roth IRA (a trustee-to-trustee transfer) or to the taxpayer to deposit into a Roth IRA within 60 days.

**PLANNING NOTE.** If a taxpayer receives a distribution on December 31, 2010

and the distribution is deposited into a Roth IRA by March 1, 2011, the taxpayer is treated as having made the rollover or conversion in 2010.

**IMPACT.** Taxes paid from conversion should come from nonretirement assets. If a taxpayer intends on using funds from the amount rolled over, the withdrawal is subject to a 10-percent penalty, in addition to the tax, if the taxpayer is under age 59½ and not disabled.

**COMMENT.** Taxpayers with 2010 conversions to a Roth IRA have a choice either to recognize the income on the conversion in 2010 or, under a default provision, allow it to be recognized evenly over 2011 and 2012.

### In-Plan Roth Rollovers

The 2010 Small Business Jobs Act allows plan participants to roll over eligible in-plan distributions from a non-Roth account into a designated Roth account in the same plan. The provision applies to rollovers made after September 27, 2010 for 401(k) and 403(b) plans. The IRS issued guidance (Notice 2010-84) describing the types of in-plan Roth rollovers.

**COMMENT.** A 457(b) government plan may allow these rollovers after December 31, 2010.

**IMPACT.** In-plan Roth rollovers on 2010 distributions are eligible for deferral of income recognition into 2011 and 2012, in lieu of recognizing the income in 2010. Plans may, but are not required to, allow in-plan rollovers. To expedite rollovers in 2010, however, plan amendments do not need to be made formally until the later of the end of calendar year 2011 or the end of the plan's year. The rules for distributions under the Tax Code must also be satisfied. For 401(k) plans, the taxpayer must have severed employment, reached age 59½, died, become disabled, or received a qualified reservist distribution.

### Pension COLAs And Other Inflation Adjustments

The Tax Code includes a number of amounts that are adjusted annually for inflation. Inflation was very low in 2010 and, consequently, many of these amounts reflect no change for 2011.

**Pension COLAs for 2011.** The IRS announced that most retirement plan contribution and benefit limits for 2011 will be unchanged from 2010 (IR-2010-108). There are some exceptions for slight increases in several adjusted gross income (AGI) phase out amounts for traditional and Roth individual retirement account (IRA) contributions and in the AGI cutoffs for the saver's credit.

**Social Security wage base.** The maximum amount of earnings subject to the Social Security tax (taxable maximum) for 2011 is \$106,800. This was the same Social Security wage base for 2010. Additionally, the so-called "nanny tax" remains unchanged for 2011 from 2010. Cash amounts paid for domestic services in the employer's private home are not subject to FICA taxes if less than \$1,700 during 2011.

### 409A Plans

The IRS provided a document correction program for Code Sec. 409A nonqualified deferred compensation plans in Notice 2010-80. Threshold requirements mandate that all plans with substantially similar failures be corrected. Relief is not available for participants and service recipients under examination, intentional failures, listed transactions, plans linked with qualified plans, and stock rights. Corrections made by December 31, 2010 are treated as effective on January 1, 2009.

### Pension Funding Relief

In 2010, Congress passed the Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010. The pension funding relief measures are intended to give sponsors of defined benefit plans additional time to amortize pension

funding shortfalls. Single employer plans may take advantage of an extended period to amortize certain funding shortfalls. Multiemployer plans may elect a 30-year period for certain losses incurred in either of the first two plan years ending on or after August 31, 2008.

### Funding Notices

The Department of Labor's Employee Benefits Security Administration (EBSA) issued proposed rules in 2010 (RIN 1210-AB18) requiring defined benefit plans to provide funding notices to every plan participant and beneficiary, the Pension Benefit Guaranty Corporation (PBGC), each labor organization representing plan participants and beneficiaries, and, for multiemployer plans, each contributing employer. The notices must describe, among other things, the plan's funding health, how the plan's assets are invested and the number of participants.

## OTHER ECONOMY-DRIVEN CHANGES

### Accounting Method Changes

Businesses strapped for cash in 2010 turned increasingly to accounting method changes

on various assets and conventions to maximize tax savings as well as assure compliance with current rules. IRS notably has both encouraged accounting method changes but nevertheless has pushed back on certain strategies.

**Form 3115.** The IRS issued a revised version of Form 3115, Application for Change in Accounting Method, and its instructions, in 2010 (Ann. 2010-32). For automatic consent applications, the taxpayer must satisfy Rev. Proc. 2008-52 as modified by Rev. Proc. 2009-39. The revised instructions to Form 3115 list almost 150 accounting changes for which the IRS provides automatic consent. Taxpayers requesting one of those changes must use the automatic consent procedures, unless they come within one of the six scope limitations.

Accounting method changes eligible for automatic consent include, but are not limited to, certain:

- Changes in the method of accounting for certain trade or business expenses under Code Sec. 162;
- Changes in the method of accounting for bad debts from a reserve method to a specific charge-off method under Code Sec. 166;

## 2010 and 2011 Dollar Limits

	2010	2011
<b>IRAs</b>		
IRA Contribution Limit	\$5,000	\$5,000
IRA Catch-Up Contributions	1,000	1,000
<b>IRA AGI Deduction Phase-out Starting at</b>		
Joint Return	89,000	90,000
Single or Head of Household	56,000	56,000
<b>401(k), 403(b), Profit-Sharing Plans, etc.</b>		
Annual Compensation - 401(a)(17)/404(l)	245,000	245,000
Elective Deferrals - 402(g)(1)	16,500	16,500
Catch-up Contributions - 414(v)(2)(B)(i)	5,500	5,500
Defined Contribution Limits - 415(c)(1)(A)	49,000	49,000
Taxable Wage Base	106,800	106,800

- Changes in the method of accounting for depreciation or amortization;
- Changes in the method of accounting for capital expenditures under Code Sec. 263;
- Changes in uniform capitalization (UNICAP) methods under Code Sec. 263A; and
- Changes in the method of accounting for last-in, first-out (LIFO) inventories under Code Sec. 472.

**COMMENT.** *If an accounting method change is not identified as an automatic change, it is a non-automatic change that requires IRS consent.*

**PLANNING NOTE.** *Taxpayers seeking advance consent should submit Form 3115 as early as possible during the tax year for which the change is requested. Taxpayers requesting an automatic change in accounting method must file an original Form 3115 with their income tax return for the year of the change. Taxpayers may be able to obtain a six-month extension of the automatic application deadline.*

**Passive activities.** IRS Chief Counsel in 2010 determined that a recharacterization of a taxpayer's activities from nonpassive to passive under the passive activity loss rules is not a change in a method of accounting (TAM 201035016). According to Chief Counsel, whether a taxpayer materially participates in an activity does not concern a method of accounting. Determining whether an activity is passive does not involve deciding the tax period for an item of income or deduction or the timing of a material item.

**Motor vehicle dealerships.** In Rev. Proc. 2010-44, the IRS issued two safe harbor accounting methods for motor vehicle dealerships under Code Sec. 263A, regarding the capitalization and inclusion of certain costs in inventory. The safe harbor methods allow dealers to deduct certain handling and storage costs incurred at a retail sales facility and certain handling costs incurred on dealer- and customer-owned vehicles.

## Loss Corporations

The IRS issued Notice 2010-50 to help loss corporations more easily measure ownership changes that can jeopardize use of net operating losses (NOLs) under Code Sec. 382. The guidance reduces the impact of fluctuating stock values. The IRS will now accept "any reasonable attempt" to measure an increase in ownership under designated methodologies.

**IMPACT.** *Code Sec. 382 was put in place to deter one corporation from acquiring another corporation with accumulated NOLs (the loss corporation) and using the NOLs to offset unrelated income earned by the acquiring corporation.*

**COMMENT.** *At the same time, the IRS issued Notice 2010-49, announcing that it intends to liberalize the rules under Code Sec. 382 by requesting comments on changing the regs on stock transfers to "small shareholders," that is, shareholders who own less than five percent of a corporation's stock.*

## Deferred COI Income

The IRS released guidance on the acceleration of cancellation of indebtedness (COI) income that has been deferred under Code Sec. 108(i) (T.D. 9497, NPRM REG-142800-09). Code Sec. 108(i) allows taxpayers to defer COI income realized on the reacquisition of a debt instrument in 2009 or 2010. A taxpayer can elect to defer the income until 2014 and then recognize it ratably over five years. Code Sec. 108(i)(5) (D) requires the taxpayer to accelerate and recognize the deferred income on the occurrence of certain events.

## Offers-In-Compromise

Early in 2010, the IRS announced what it called more flexible offer-in-compromise (OIC) evaluation procedures for taxpayers who are unemployed or underemployed. Under the new guidelines, if a taxpayer is unemployed and is not expected to return to his or her previous occupation or level

of earnings, IRS personnel are instructed to contact the taxpayer to discuss the expected future level of income. Special consideration should be given if a taxpayer is long-term unemployed.

**COMMENT.** *Despite calls from lawmakers and the National Taxpayer Advocate, the IRS has not shown any flexibility on the requirement that a taxpayer generally include a nonrefundable 20 percent payment (in a lump sum offer) when submitting his or her offer.*

## Worker Classification

As businesses look to classifying more workers as independent contractors to save on payroll taxes and qualified benefits, the line drawn between classification of a worker as an employee or an independent contractor has become more important. The IRS launched a national research program study of employment taxes to assess the impact of worker classification and related employment tax issues. The White House has urged Congress to revise the rules governing worker classification and to give the IRS more tools to reclassify independent contractors as employees when the circumstances warrant.

## Debt Modification

Proposed reliance regulations from the IRS are intended to clarify when a change in a debt issuer's financial condition gives rise to a modification of the debt instrument sufficiently significant to trigger a taxable event (NPRM REG-106750-10). The IRS determined that deterioration in the issuer's financial condition generally will not be taken into account.

## Like-Kind Exchanges

The economic slowdown has negatively impacted some like-kind exchanges under Code Sec. 1031 because of the default of qualified intermediaries (QIs). The IRS announced, in 2010, a safe harbor for failed like-kind exchanges (Rev. Proc. 2010-14). The safe harbor for reporting gain or loss is available to taxpayers that initiated deferred

like-kind exchanges but failed to complete the exchange due to a QI's default on its obligation to timely acquire and transfer replacement property when its assets are suddenly frozen in bankruptcy or receiverships.

**IMPACT.** *If a taxpayer satisfies Rev. Proc. 2010-14, the taxpayer will not be deemed to be in actual or constructive receipt of any of the exchange proceeds until the QI emerges from bankruptcy or receivership and, then, will recognize gain only as required under the safe harbor gross profit ratio method.*

### Flash Crash

On May 6, 2010, the U.S. financial markets experienced a brief but severe drop in prices. The event has become known as the "flash crash." Many investors had their holdings sold that day because of automatic stop-loss orders. Many of these investors realized gains subject to tax. In an information letter issued after the flash crash, the IRS determined that it has no authority to provide for the nonrecognition of gain for stop-loss orders executed during the flash crash. Any relief for investors must come from Congress, the IRS explained.

### Low Inflation/Interest Rates

The low rate of inflation and the resulting low interest rates during 2010 helped, hindered, or remained impartial to certain tax planning, depending upon the particular situation.

**Individuals.** Tax bracket amounts, standard deductions and other figures that the Tax Code now requires to be inflation-adjusted each year rose very little between 2009 and 2010 and, again, between 2010 and 2011. Generally, such adjustments take inflation-forecasting out of the equation for predicting taxable income from one year to the next but regional differences and variations in personal expenses should always be considered.

**Businesses.** A number of inflation adjustments are built into allowed business ex-

pense deductions related to travel and vehicle expense:

- **Per diem amounts.** Simplified per diem rates for business travel after September 30, 2010 also reflect low inflation. The IRS-approved per diem rate for "high-cost" areas is \$233 (\$168 for lodging and \$65 for meals and incidental expenses) (Rev. Proc. 2010-39). The IRS-approved per diem rate for all other areas is \$160 (\$108 for lodging and \$52 for meals and incidental expenses). The high-cost per diem for the previous year was \$258 and the per diem for all other areas was \$163.
- **Business mileage rate.** The business standard mileage reimbursement rate for 2011 will be 51 cents-per-mile, a one cent increase from 50 cents-per-mile for 2010 (IR-2010-119).

**COMMENT.** *The IRS also announced that it reversed its position and will allow taxpayers to use the standard mileage rate in determining the deductible costs of operating an automobile for hire.*

**COMMENT.** *Beginning on January 1, 2011, the mileage rate for medical or moving purposes will be 19 cents-per-mile and the rate for miles driven in service of charitable organizations will be 14 cents-per-mile.*

### Applicable Federal Rates

Whether a debt instrument provides adequate stated interest is determined under both the stated interest rate and present value testing amount methods of determining adequate stated interest by reference to a test rate of interest. In determining whether adequate stated interest is provided in a debt instrument issued in the sale or exchange of property the test rate of interest is generally equal to the applicable federal rate (AFR), which changes each month under IRS tables. Likewise, the value of an annuity for estate planning and charitable giving purposes hinges on interest rates keyed to the AFR monthly figures.

**COMMENT.** *The short-, mid- and long-term rates for December 2010 are 0.32%, 1.53%, and 3.53%, respectively. In December 2009, they were 0.69%, 2.64%, and 4.17%, respectively. The key "7520" rate for December 2010, was at its historic low point of 1.83 percent.*

**IMPACT.** *The AFR levels over the past year have been at historic lows, creating unprecedented opportunities ... and pitfalls for income and estate tax planning. For example, in the case of a charitable lead annuity trust, the lower the interest rate, the larger the charitable deduction. Likewise, in the case of private annuities used in family estate planning to shift assets from an older to a younger generation, the lower the interest rate, generally the lower the amount that the younger family member needs to pay out.*

## DEFICIT REDUCTION COMMISSION

On December 1, 2010, President Obama's National Commission on Fiscal Responsibility released a blueprint for reducing the \$13 trillion national debt. The Commission recommended eliminating nearly all individual tax incentives, including the mortgage interest deduction. In exchange, individuals would benefit from reduced income tax rates (a proposed rate range of 8, 14 and 23 percent). The Commission also proposed to reduce the top corporate tax rate to between 23 and 29 percent.

**IMPACT.** *The Commission's specific proposals are highly unlikely to be enacted before 2012. Nevertheless, President Obama's reintroduction of tax reform as an agenda item when discussing the temporary compromise struck in the 2010 Tax Relief Act, together with the stark warnings by the Commission over the nation's current economic course, makes a possible sea-change in the federal Tax Code a not so unrealistic possibility in the not-too-distant future.*

## LOOKING AHEAD

Many of the developments in 2010 will generate additional guidance, rules and regulations from the IRS in 2011 and

beyond. Areas of special emphasis for the IRS are expected to continue to be in the international arena, health care, business entities, and accounting methods. The new Congress, which meets in January

2011, may revisit some of the laws enacted in 2010. The White House has proposed to look at tax reform, both for individuals and businesses, with a possible overhaul of the Tax Code.

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