Where Are We Now?
Fallout From 2010 Legislation

Introduction

Seven pieces of federal legislation with significant tax implications for were enacted in 2010: The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, The Small Business Jobs Act of 2010, the Hiring Incentives to Restore Employment Act, the Patient Protection and Affordable Care Act, the Health Care and Education Reconciliation Act of 2010 (collectively referred to as Health Care Legislation), the Homebuyer Assistance and Improvement Act of 2010 and HR 1586.

Since then, the 1099 Taxpayer Protection and Repayment of Subsidy Overpayments Act of 2011 has repealed some new Form 1099 reporting requirements in 2010 legislation.

Most of these changes will have some effect on compliance and planning for 2011 and later.

The 1099 Taxpayer Protection and Repayment of Subsidy Overpayments Act of 2011

The Taxpayer Protection Act (enacted April 14, 2011) repealed some expanded Form 1099 reporting requirements on businesses and owners of rental property, and increased the amount of excess advance section 36B payments (scheduled to begin in 2014) subject to recapture.

Code sections 6041(i), and 6041(j), added by the Patient Protection Act of 2010, expanded Form 1099 reporting requirements to include annual purchases of $600 or more from a single vendor in calendar years after 2011, repealed the exception for payments to corporations and gave the IRS regulatory authority to enforce the new rules.

Section 6041(h), added by the Small Business Jobs Act of 2010, extended the expanded reporting requirements to cover landlords, even if their rental activities did not rise to the level of trade or business.

The Taxpayer Protection Act repealed sections 6041(i), (j) and (h) as they had never been enacted.

The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010

President Obama signed the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 on December 17, 2010. It extended 2001 Act rate reductions (the so-called "Bush tax cuts") through December 31, 2012. In addition, it extended most of the expiring provisions of the 2003 Act and some benefits created or enhanced by subsequent legislation through 2011.

Provisions Generally Affecting Individuals

Extensions through 2012 generally affecting individuals include:

- The nominal income tax rates on individuals, and estates and trusts,

- The 15% maximum rate on qualified capital gains and qualified dividends (the 28% and 25% rates for gains on collectibles and unrecaptured section 1250 gain are still in place)

    - Including the zero rate on capital gains and qualifying dividends of taxpayers in the 15% bracket (i.e., taxable income of $34,500; $69,000 on a joint return),

Notes: Absent legislation, individual rates will revert to pre-2001-Act levels. Taxpayers who believe rates will go up after 2012 should consider accelerating recognition of income and delaying recognition of deductions to the extent possible. Possibilities include the election out of installment reporting and foregoing the election to treat qualified dividends and/or capital gains as investment income for purposes of the investment interest deduction. Along the same lines, foregoing the direct deduction under section 179 and electing out of bonus depreciation (covered below) by sole proprietors and passthrough entities will preserve basis and allow higher depreciation deductions in future years.

- The elimination of the phaseouts of unprotected itemized deductions and personal exemptions,

- The standard deduction and the 15% rate bracket on a joint return at twice the amount applicable to taxpayers filing as single,

- The enhanced earned income and child credits (but not the advance payment election for the EIC),

- The enhancements to the adoption credit and exclusion from income for employer-provided adoption assistance plans,

- The dependent care credit,

- Enhancements to the Coverdell Education Savings Accounts,

- The suspension of the 60-month rule and increased phaseout range for the student loan interest deduction,

- The income exclusion for the National Health Service and Armed Services Scholarship programs,

- The American Opportunity Credit (originally scheduled to expire after 2010),

Individual provisions extended through 2011 include:

- The itemized deduction for mortgage insurance premiums,

- Most of the "individual extenders" that had expired after 2009:

    - The election to deduct state and local sales taxes in lieu of income taxes (but not the addition to the standard deduction for real property taxes),

    - The deduction to AGI for higher education expenses,

    - The deduction to AGI for teachers' classroom supplies,

    - The qualified charitable distribution from IRAs and

    - The 50%-of-contribution-base limitation for contributions of real property for conservation purposes.

The AMT Patch

The AMT exemption amounts are $47,450, $72,450 and $36,225 for 2010; and $48,450, $74,450 and $37,225 for 2011, for single taxpayers and heads of households, married taxpayers filing jointly and married taxpayers filing separate returns, respectively. In addition, the nonrefundable individual credits are allowed against the AMT for 2010 and 2011.

Payroll Tax Reduction

The employee's share of the 6.2% social security tax (but not the 1.45% Medicare tax) is reduced to 4.2%, for 2011 only.

Notes: This reduction applies to self-employed taxpayers as well, reducing the SE tax rate to 10.4%.

Energy Credits

The "old" section 25C (i.e., 10%/$500) nonbusiness energy credit is extended through 2011; however, new, slightly more stringent eligible property requirements apply, and the dollar limits are reduced by amounts claimed in 2006 and 2007.

Provisions Generally Affecting Businesses

The Tax Relief Act also extended (sometimes with some modifications) a number of provisions generally affecting business:

- The credit for military differential pay, through 2011,

- The 25% credit for qualified child care expenses and the 10% credit for resource and referral services, through 2012,

- The exclusion for employer-provided education assistance under section 127, through 2012,

- The election to treat long-term research and/or AMT credits as refundable in lieu of claiming bonus depreciation (originally expired after 2009), for property in service after 2010 and before 2013,

- The R&D credit, through 2011,

- The Tax Relief Act extended the 100% exclusion of gain and elimination of the AMT preference on the sale or exchange of section 1202 stock issued after September 27, 2010 and before January 1, 2012.

    - The Small Business Jobs Act of 2010 had increased the exclusion of gain to 100% and eliminated the AMT preference for section 1202 stock issued after September 27, 2010 and before January 1, 2011. The American Recovery and Reinvestment Act of 2009 increased the 50% exclusion for 1202 stock acquired after February 17, 2009 and before January 1, 2011 to 75%, but did not eliminate the 7% AMT preference.

- Some charitable contribution incentives that had expired in 2009 were extended through 2011:

    - The deduction at FMV for certain contributions of food inventory,

    - C corporation contributions of books and computer equipment for educational purposes and

    - The application for partnership rules to contributions of capital gain property by S corporations,

- The Work Opportunity Credit (originally set to expire after August 31, 2011), through 2011 (but note that the inclusion of unemployed veterans and disconnected youth as target group members was not extended),

- The 15-year recovery period for qualified real estate (i.e., qualified leasehold improvement, restaurant, and retail improvement property); also the five-year recovery period for most farm equipment and machinery, for property in service before January 1, 2012,

- The New Markets credit, through 2011 and

- Most of the "energy extenders", generally through 2011.

The Section 179 Deduction

The direct deduction under section 179 is set at $125,000 with a $500,000 phaseout threshold for property in service in years beginning after 2011. The current ($500,000 / $2 million) limitations and the $250,000 deduction for qualified real estate are scheduled to expire after 2011.

Bonus Depreciation

The Tax Relief Act increases the 50% bonus depreciation to 100% for qualified property in service after September 8, 2010 and before January 1, 2012 (2013 for long-lived property and transportation property). It also extends the current 50% bonus depreciation rules through 2012.

- The Jobs Act had extended the 50% bonus depreciation rules through 2010 and 2011, respectively.

Transfer Taxes

Estate Tax

The estate tax is reinstated with an equivalent exemption of $5 million and a top rate of 35% for decedents dying after 2009 and before 2013.

The estates of decedents dying in 2010 can elect to apply the estate tax and carryover basis rules in effect for 2010 (i.e., no estate tax coupled with the modified carryover basis rules at section 1022). Once made, the election is revocable only with IRS consent.

    - Property acquired from a decedent dying in 2010 is treated as transferred by gift, subject to a modified carryover basis rule; generally, the lesser of basis in the hands of the decedent or FMV as of the date of death.

    - A step-up in basis of up to $1.3 million, plus the decedent's NOLs, capital loss carryovers and built-in losses that would have been allowable under section 165 if the decedent had realized them, is allowed for property passing to any heir or legatee. The step-up is limited to $60,000, with no additions if the decedent was a nonresident alien.

    - An additional step-up in basis of up to $3 million is allowed for *qualified spousal property* (i.e., property passing outright to the surviving spouse and qualified terminal interest property). The $3 million step-up is not allowed if the decedent was a nonresident alien.

    - In no event will the basis of property acquired from a decedent exceed its FMV as of the date of death.

- If the heir or legatee determines his or her basis in whole or part by reference to the decedent's basis, the decedent's holding period tacks on. If not, the holding period starts fresh as of the date of death.

Effective for decedents dying after 2010, a portability provision generally allows an election that permits the surviving spouse to use the unused part of the deceased spouse's estate tax (but not GST) exemption. This allows a married couple to transfer up to $10 million without requiring intervivos transfers to equalize their estates.

The 40% exclusion for land subject to a qualified conservation easement and the election to pay estate taxes attributable to closely held businesses over up to 10 years is extended through 2012

The GST

The GST exemption amount is the same as that for the estate and gift taxes (i.e., $5 million) for decedents dying or transfers made after 2009 and before 2013. Effective for transfers after 2010, the GST rate will equal the highest estate and gift tax rate in effect for the year (i.e., 35% for 2011 and 2012). The rate for GST transfers during 2010 is zero.

Gift Tax

The gift tax is reunited with the estate tax and GST (i.e., with a maximum unified transfer tax exclusion of $5 million and a top rate of 35%), for gifts made after 2010 and before 2013. The exemption amount for 2010 was $1 million, with a maximum rate of 35%.

Notes: Absent legislation, the transfer tax rules will revert to those in place prior to the 2001 Act for decedents dying and transfers made after 2012 (i.e., a $1 million lifetime exclusion and a 55% top rate). High net worth individuals who think the exclusion will be reduced and/or transfer tax rates increased after 2012 may want to consider making gifts in 2011 and 2012 to use the $5 million gift and GST exclusions and 35% gift tax rate.

Filing Requirements

The personal representatives and beneficiaries of decedents who died after 2009 but before December 17, 2010 (date of enactment) generally have until September 17, 2011 (nine months after date of enactment) to file returns, make any elections required to be made on a return, pay any taxes due or make disclaimers.

The Small Business Jobs Act of 2010

The Small Business Jobs Act of 2010 was signed into law on September 27, 2010. It contains a number of provisions favorable to small businesses, some of which were effective for 2010 only, or were superseded by subsequent legislation. However, there are some provisions that are effective in years after 2010.

Temporary Reduction in the Built-in Gain Tax Recognition Period

The built-in gain tax does not apply for years beginning in 2011 if the fifth year in an S corporation's recognition period precedes its tax year beginning in 2011. The recognition period reverts to the original ten years for years beginning after 2011.

Notes: What constitutes a year for purposes of the five-year test is not entirely clear. Section 1374(d)(7)(B)(ii) (added by the Small Business Job Act), simply refers to "…the 5th year in the recognition period…"'. Committee Reports indicate that "year" in section 1374(d)(7)(B)(ii) means calendar year. Section 1374(d)(7)(B)(i), added by the Recovery and Reinvestment Act of 2009, eliminated the built in gains tax for years beginning in 2009 and 2010 for any corporation whose seventh *taxable* year in the recognition period was 2008 or earlier; and for its year beginning in 2010 if the seventh year was 2009. A taxable year would include, for example, a short year when a fiscal year C corporation changed to a calendar year in connection with an S election. A calendar year would not.

Example 1: X Corp changed from a June 30 to a calendar year in connection with an S election effective July 1, 2006. If X's recognition period includes its short July 1 – December 31, 2006 year, the fifth year in X's recognition period is 2010, so X has no built in gains tax problem in 2011. If not (note that the first *calendar* year in X's recognition period is 2007), X does not qualify for relief under section 1374(d)(7)(B)(ii).

The regular 10-year recognition period is actually 120 months, (see regs. at 1.1374-1(d)), and can end during, rather than at the end of, a tax year.

Example 2: Y Corp changed from a June 30 to a calendar year in connection with an S election effective July 1, 2002. Its seventh taxable year ends 12/31/2008, so the built in gains tax does not apply for 2009, 2010 or, on account of the Small Business Jobs Act (see above), 2011. However, absent more legislation, Y Corp will be subject to the built in gains tax from January 1, 2012 through June 30, 2012.

Increased Section 179 Deduction

The bill increases the direct writeoff under section 179 to $500,000 and the threshold for the phaseout to $2 million.

It also expands the definition of eligible property to include qualified real estate (i.e., qualified leasehold property, qualified restaurant property and qualified retail improvement property), but with the direct deduction limited to $250,000.

Carryovers on account of the taxable income limit will be allowed only in years beginning in 2010 or 2011. Amounts disallowed in 2011 on account of the taxable income limitation are deemed placed in service in 2011 for depreciation purposes. This has the effect of restoring basis in cases where the taxpayer is unable to use the direct writeoff on account of the taxable income limit.

Examples (verbatim from Committee Reports):

For example, assume that during 2010, a company's only asset purchases are section 179-eligible equipment costing $100,000 and qualifying leasehold improvements costing $350,000. Assuming the company has no other asset purchases during 2010, and is not subject to the taxable income limitation, the maximum section 179 deduction the company can claim for 2010 is $350,000 ($100,000 with respect to the equipment and $250,000 with respect to the qualifying leasehold improvements).

For example, assume that during 2010, a company's only asset purchases are section 179-eligible equipment costing $100,000 and qualifying leasehold improvements costing $200,000. Assume the company has no other asset purchases during 2010, and has a taxable income limitation of $150,000. The maximum section 179 deduction the company can claim for 2010 is $150,000, which is allocated pro rata between the properties, such that the carryover to 2011 is allocated $100,000 to the qualified leasehold improvements and $50,000 to the equipment.

Assume further that in 2011, the company had no asset purchases and had taxable income of $-0-. The $100,000 carryover from 2010 attributable to qualified leasehold improvements is treated as placed in service as of the first day of the company's 2011 taxable year. The $50,000 carryover allocated to equipment is carried over to 2012 under section 179(b)(3)(B).

Amendments to sections 179(b), (d) and (f), effective for property placed in service in tax years beginning in 2010 and 2011

Notes: Qualified leasehold, restaurant and retail improvement property have the same meanings as when used for purposes of defining 15-year straight-line recovery property at section 168(e).

Bonus Depreciation

The 50% bonus depreciation was extended for one year through 2010 (2011 for certain long-lived and transportation property). The Tax Relief Act subsequently increased the percentage to 100% and extended the 50% bonus rules through 2012.

Amendments to section 168(k), effective for property placed in service in years ending after 2009

In addition, solely for purposes of determining the percentage of completion under section 460, the depreciation deduction with respect to bonus property is computed as if bonus depreciation had not been enacted.

Amendments to section 460(c), effective for property placed in service in 2010 (2010 or 2011 for certain long-lived and transportation property).

Listed Transactions

The penalty under section 6707A for failure to disclose a reportable transaction is set at 75% of the decrease in the tax on the taxpayer’s return as a result of the transaction or what the reduction would have been had the transaction been respected for tax purposes.

The minimum penalty is $5,000 for individuals and $10,000 for other taxpayers. The maximum annual penalty is set at $100,000 and $200,000, respectively.

Amendments to section 6707A(b), effective for penalties assessed after 2006.

Listed Property

Cell phones and similar telecommunications equipment are no longer included in the definition of listed property.

Amendments to section 280F(d)(4)(A), effective for years ending after 2009.

Levies

The IRS is allowed to issue levies on government payments to federal contractors with outstanding tax liabilities before the collections due process (CDP) hearing takes place.

Amendments to sections 6330(f) and (h), effective for levies issued after September 27, 2010 (the date of enactment).

Notes: The due process hearing must take place within 30 days of the levy.

Section 457 Roth Accounts

The bill amends the definition of applicable retirement plan and elective deferral to include employees' deferrals under governmental section 457 plans. The effect is to allow participants in governmental section 457 plans to elect to treat elective deferrals as Roth contributions.

It also allows participants in section 401(k), 403(b) and 457(b) plans with qualified designated Roth programs to roll amounts from non-Roth accounts under the same plan to designated Roth accounts.

Amendments to sections 402A(c) and (e), effective for years beginning after 2010 as to the definition of applicable retirement plan and distributions after the date of enactment as to the new rollover rules

Annuity Contracts

The owner of an annuity is allowed to treat any amount of a policy taken down by way of annuity payments over a life, joint lives or a term certain of at least 10 years as a separate contract. Basis in the contract is allocated based on relative amounts in each part of the contract (i.e., the annuity and non-annuity amounts). The tax on income the non-annuity amount accumulates after the contract is split up continues to be deferred.

Amendments to section 72(a), effective for amounts withdrawn in years beginning after 2010

The Cellulosic Biofuel Producer Credit

The bill excludes tall crude oil (a byproduct of paper manufacturing similar to black liquor) and other corrosive fuels with an acid number greater than 25 from the definition of biofuels eligible for the biofuel producer tax credit.

Amendments to section 40(b), effective for fuel sold or used after 2009

Income Source Rules for Loan Guarantees

Amounts received for loan guarantees are treated as effectively connected income if they are paid (directly or indirectly) by a U.S. person or a foreign person with respect to U.S.-source income.

Amendments to sections 861(a) and 862(a), effective for guarantees issued after the date of enactment (September 27, 2010).

Notes: These provisions are intended to override the decision in *Container Corp.* 134 T.C. No. 5, currently on appeal to the 9th Circuit.

Corporate Estimated Taxes

Estimated tax payments due in July, August and September, 2015 of corporations with over $1 billion in assets would be in creased by 36 percentage points over the amounts currently scheduled.

Act section 561, in effect amending section 6655, effective as of the date of enactment

The Homebuyer Assistance and Improvement Act of 2010

The homebuyer credits have expired for most taxpayers. However, members of the armed services or Foreign Service on extended active duty outside the United States are eligible for the credit if they enter into a binding contract to purchase a qualified residence by April 30, and close before October 1, 2011.

The Hiring Incentives to Restore Employment Act

The Hiring Incentives to Restore Employment Act of 2010, somewhat overshadowed by the health care debate, was signed into law on March 18, 2010. In addition to providing tax incentives for private sector businesses to hire and retain employees, it extended the increased section 179 deduction limits and introduced some increased reporting requirements for foreign accounts.

Retained Worker Business Credit

The payroll tax forgiveness for wages paid to a qualified individual expired at the end of 2010. However, the retained worker credit will be allowed on returns for years ending in 2011.

Employers that hire qualified individuals and keep them on the payroll for at least 52 consecutive weeks are eligible for a general business credit equal to the lesser of:

1. 6.2% of wages paid to a retained worker during the 52-consecutive-week period beginning on the start date or

2. $1,000

A retained worker is a qualified individual who remains on the employer's payroll for 52 consecutive weeks, provided that the worker's compensation during the last 26 weeks of the 52-consecutive-week period is at least 80% of his or her compensation for the first 26 weeks.

A qualified individual is one whose wages through the end of 2010 qualified for payroll tax forgiveness; i.e., an individual who:

- Started work after February 3, 2010 and before 2011,

- Certifies in writing under penalty of perjury that he or she was employed for no more than 40 hours during the 60-day period ending on his or her start date,

- Does not replace another employee unless the other employee was terminated voluntarily, or for cause, and is not:

    - After the application of the indirect ownership rules at section 267(c), an over-50% owner, or related to the employer or to an over-50% owner of the employer,

    - If the employer is an estate or trust, a grantor, beneficiary or fiduciary, or a relative of a grantor, beneficiary or fiduciary, of the estate or trust, or

    - A dependent of: the employer, an over-50% owner of the employer or of a grantor, beneficiary or fiduciary of the employer.

Wages paid to domestic workers and individuals eligible for the foreign earned income exclusion do not qualify for the credit.

Act sections 2012 and 2013, effective as of the date of enactment (see the legislative history of section 38)

Notes: The credit, like all general business credits under section 38, is nonrefundable, and section 39(d) generally prohibits carrybacks to years before the date of enactment of the legislation creating the credit. The retained worker credit is not the list of credits eligible for the five-year carryback or use against the AMT under section 39(a)(4) as amended by the Small Business Act. Consequently, any unused part of the credit may only be carried over, and the credit is not allowed against the AMT.

Foreign Account Reporting and Compliance

Subject to an exception for small accounts held by individuals, U.S. withholding agents are required to withhold 30% of any withholdable payment to a foreign financial institution that does not agree to comply with expanded reporting and compliance requirements.

- A withholding agent is any person that has the control, receipt, custody, disposal or payment of any withholdable payment.

- A withholdable payment is virtually any potentially taxable payment from a source in the United States, including the gross proceeds from the sale of interest-or-dividend-producing property.

In order to avoid the 30% withholding, the foreign institution must agree:

- If any foreign secrecy laws would prevent compliance with the expanded reporting requirements, to attempt to get a valid waiver of those laws from the account holder, and, unless it has the waiver within a reasonable period of time, to close the account,

- To report the names, addresses and taxpayer ID numbers of account holders that are U.S. persons, and account numbers, balances of, and deposits and withdrawals to and from the accounts of U.S. persons, and

- To withhold 30% of passthrough payments (i.e., a withholdable payment or one attributable to a withholdable payment) to recalcitrant account holders (i.e., that refuse to provide the information and/or waiver listed above) or to foreign entities that do not meet the reporting and compliance requirements.

The same requirements apply to account holders that are foreign entities in which U.S. persons own substantial (generally at least 10%) interests.

The expanded reporting and compliance rules do not apply to accounts held by an individual if the aggregate value of all of his or her accounts at the same financial institution is no more than $50,000.

New Chapter 4, Taxes to Enforce Reporting on Certain Foreign Accounts, consisting of new sections 1471 through 1474, generally effective for payments made after 2012

Expanded Individual Reporting Requirements

Individuals holding interests in specified foreign financial assets with an aggregate value of more than $50,000 are required to attach a statement to their income tax returns with the information necessary to identify the location, account number, issuer, class of security, any other information the IRS may require, and the maximum value of the asset during the year.

A specified foreign asset is virtually any foreign account, stock, security, contract, partnership interest or other financial instrument not held by a foreign financial institution.

Subject to abatement for reasonable cause, the penalty for failure to make adequate disclosure is $10,000. If the taxpayer fails to furnish the required information within 90 days of a notice from the IRS, an additional penalty of $10,000 applies for each 30-day period or fraction thereof after the expiration of the 90-day period, up to a maximum of $50,000.

New section 6038D, cross referenced to sections 1471(d) and 1473,effective for years beginning after the date of enactment (i.e., March 18, 2010)

Increased Penalties on Unreported Foreign Income

The penalty for an income tax underpayment attributable to an undisclosed foreign financial asset is 40% of the tax due. A foreign financial asset is virtually any foreign account, partnership, corporation, trust or other financial instrument owned or controlled by a U.S. person.

New section 6662(j), cross referenced to sections 6038, 6038B, 6038D, 6046A and 6048, effective for years beginning after the date of enactment

Extended Assessments Statute

The statute of limitations is extended from the normal three years to six if a taxpayer omits income from foreign assets of more than the lesser of:

- $5,000 of gross income from foreign assets or
- 25% of gross income from all sources.

Amendments to section 6501(e)(1), effective for returns filed after the date of enactment

Notes: HR 1586 added a reasonable basis exception

Shareholders of Foreign Passive Investment Companies

The shareholders of foreign passive investment companies are required to file annual reports containing information to be specified by the IRS.

New section 1298(f), (old 1298(f) redesignated as 1298(g)), effective as of the date of enactment

Foreign Trusts

The Act clarifies that a foreign trust generally is treated as having a U.S. beneficiary even if he or she has only a contingent interest in the trust, and increases the initial civil penalty for failure to report the formation and funding of a foreign trust as required by section 6048 to the greater of $10,000 or 35% of the reportable amount.

Amendments to section 679(c)(1) as to the existence of a U.S. beneficiary; amendments to 6677(a), effective for notices and returns required to be filed after 2009 as to reporting penalties

<u>Notes:</u> The last sentence of old section 6677(a) limited the penalty to the gross reportable amount.

Dividend Equivalents

Dividend equivalent payments (i.e., payments made under a securities lending or sale/repurchase transaction) that are contingent on, or determined by reference to a U.S.-source dividend, are treated U.S.-source dividends

New section 871(l); old 871(l) redesignated as 871(m) , effective for payments made 180 days after enactment

Other Provisions

The bill delays the availability worldwide interest allocation election under section 864 until years beginning after 2020, and makes some adjustments to the estimated tax requirements for corporations with over $1 billion.

Amendments to section 864 and Act section 561

Health Care Legislation

President Obama signed the Health Care and Education Reconciliation Act of 2010 on March 30, 2010. It amends the Patient Protection and Affordable Care Act, which was signed into law on March 23, 2010. The two bills contain a number of tax provisions.

Codification of the Economic Substance Doctrine

Under long-standing judicial doctrine, transactions entered into solely to obtain tax benefits (i.e., without economic substance) have on occasion been disregarded for tax purposes, even if they meet the literal requirements of Code or regulations The Reconciliation Act added a statutory definition and imposes some penalties for underpayments involving transactions that lack economic substance.

Notes: Individuals are subject to the new rules only in the case of transactions entered into in connection with a trade or business or an activity entered into for profit.

Statutory Definition

Effective for transactions entered into after the date of enactment (March 30, 2010), a transaction is deemed to have economic substance only if it:

1. Changes the taxpayer's economic position in a meaningful way, independent of federal, and, if they are related to a federal tax effect, state or local income tax results and

2. The taxpayer has a substantial nontax purpose for entering into the transaction.

    - Profit potential is treated as a substantial purpose only if the present value of the reasonably expected pre-tax profits (net of fees and other transaction expenses, including, subject to regulations, foreign taxes) are substantial when compared to the present value of the expected tax benefits.

    - Financial accounting benefits are disregarded if they result from a reduction in federal income taxes.

New section 7701(o)

Penalties for Underpayments

The Act applies a strict liability penalty (i.e., not subject to reasonable basis/good faith exceptions) of 20% to any underpayment attributable to the disallowance of a claimed tax benefit on account of lack of economic substance. The same penalty applies to refund claims found to be excessive on economic substance grounds.

The penalty is increased to 40% (however, the additional 20% is subject to reasonable basis/good faith exceptions) unless the taxpayer makes adequate disclosure of the facts affecting the tax treatment of the transaction at issue.

New sections 6662(b)(6), 6662(i) and 6676(c) (old 6676(c) redesignated as 6676(d)).

Notes: Section 7701(o) does not spell out when or whether the economic substance doctrine applies. Committee Reports include a list of "basic" business transactions that have been allowed under longstanding judicial and/or administrative practice that the new rules are not intended to apply merely because the choice between economic alternatives is based in whole or substantial part on tax results. The list includes the choice of debt vs. equity financing, a U.S. person's use of a foreign vs. a domestic corporation to hold a foreign investment, the use of corporate organization or reorganization transactions and the use of a related party in a transaction. In addition, the Committee Reports indicate that section 7701(o) is not intended to alter or replace any other rule (including judicial doctrine?) and is not intended to disallow tax benefits that are consistent with congressional intent (e.g., the low income housing, rehabilitation and some other investment-specific credits).

The IRS has issued Notice 2010-62, providing interim guidance on the codification of the economic substance doctrine. Among other things, the Notice:

- States that the Service will challenge taxpayer positions based on existing case law where the taxpayer satisfied only one of the two statutory requirements for economic substance,

- Generally requires the use of Form 8275 or 8275R to satisfy the adequate disclosure requirements of section 6662(d) to avoid the enhanced 40% penalty at section 6662(i), and

- States that the IRS does not intend to publish guidance as to types of transactions to which the economic substance doctrine does or does not apply, or issue letter rulings as to the application (or lack thereof) of the economic substance doctrine.

Expanded Health Insurance Coverage for Children Under Age 27, Preventative Services, Etc.

The Reconciliation Act expanded the exclusion from income for employer-provided payments or reimbursements for medical care of the employee, and his or her spouse and dependents to cover children of the employee who have not attained age 27 by the end of the year.

- The child need not be a dependent.

- The employee's year is the one used to determine when the child has attained age 27.

Amendments to section 105(b), effective March 30, 2010

The Service provided interim guidance on the implementation of the expanded exclusion in April of 2010 (Notice 2010-38), then followed with interim final regulations, to apply to plan years beginning after September 22, 2010 (TD 9482):

- Amendments to regulations retroactive to March 30, 2010 will provide that the exclusion under section 106 (dealing with employer contributions to heath and accident plans) also applies to children who have not attained age 27.

- Similar amendments will allow the extended coverage for VEBAs, section 401(h) accounts and the deduction to AGI for self-employed taxpayers at section 162(l).

- The expanded exclusion also applies to cafeteria plans, flex accounts and health reimbursement accounts.

- Retroactive amendments to cafeteria plans to provide the expanded coverage may be made through December 31, 2010.

- Employers may allow employees to make salary reduction contributions for health and accident benefits for children under age 27 under a cafeteria plan, including health flex plans, even though the plan has not been amended.

- As to the expanded coverage, the only relevant factors are age and relationship to the taxpayer. However, grandfathered plans can, for plan years beginning before 2014, exclude an adult child if he or she is eligible to enroll in another employer-sponsored plan

- Regulations require the plan to or issuer to allow at least 30 days for the child to be enrolled in the plan, beginning no later that the first day of the first plan year beginning after September 22, 2010. Once the child has enrolled coverage must begin by the first day of the first plan year beginning after September 22, 2010, even if the child requests a later coverage date.

See also TD 9489, 9491 and 9483 containing interim final regs., dealing with expanded coverage requirements for preventative health services, pre-existing conditions and limitations on benefits.

Plans generally (subject to some exceptions for certain grandfathered plans) may not impose:

- Cost-sharing requirements for certain routine preventative care measures

- Exclusions from coverage for pre-existing conditions, or

- Annual or lifetime limits on the dollar value of health benefits.

In addition, the Act extended the non-discrimination rules at section 105(h) to cover large non-grandfathered insured plans. The status of small non-grandfathered plans is not clear.

- New section 2716 of the Public Health Service Act (PHSA) requires insured plans to satisfy the nondiscrimination rules at Code section 105(h). New Code section 9815 incorporates PHSA section 2716 into Subchapter B, Chapter 100 of Subtitle K of the Internal Revenue Code, generally effective for plan years beginning after September 23, 2010.

- Grandfathered plans are not subject to the new rules.

    - A grandfathered plan is, generally, a plan that was in existence on March 23, 2010 and has not been substantially amended since that date; however,

    - If an employer enters into an entirely new policy or contract after March 23, 2010, the new policy or contract is not a grandfathered plan, even if the same health insurance product was offered before then.

- Code section 4980D generally imposes a $100-per-failure-per-day penalty on an employer whose group health plan fails to comply with the requirements of Chapter 100 of Subtitle K (which includes section 9815 but not section 105).

Section 9815 verbatim:

9815(a) GENERAL RULE. **—**Except as provided in subsection (b)

9815(a)(1) the provisions of part A of title XXVII of the Public Health Service Act (as amended by the Patient Protection and Affordable Care Act) shall apply to group health plans, and health insurance issuers providing health insurance coverage in connection with group health plans, as if included in this subchapter; and

9815(a)(2) to the extent that any provision of this subchapter conflicts with a provision of such part A with respect to group health plans, or health insurance issuers providing health insurance coverage in connection with group health plans, the provisions of such part A shall apply.

Notes: PHSA section 2716 did not amend Code section 105(h), and section 4980D does not apply to small employers that provide health insurance coverage solely through a contract with a health insurance issuer. A small employer is, generally, one that had an average of at least 2 but fewer than 50 employees during the preceding calendar year and at least 2 employees on the first day of the plan year (see section 4980D(d)(1)).

Consequently, although small employers with insured plans are technically covered by the new prohibition against discrimination in favor of highly compensated employees, there is, at least for now, no penalty for noncompliance, either under section 105 or section 4980D (note that section 105 is in Subtitle A, not Subtitle K, of the Code). That said, new ERISA section 715 incorporates PHSA section 2716 by reference. This raises the possibility of enforcement by Labor under ERISA, or a civil action by a non-highly-compensated employee.

Small Business Tax Credit

Effective for years beginning after 2009, certain small employers are allowed a general business tax credit of up to 35% of the cost of health care insurance premiums the business pays for its employees. Section 501(c) exempt organizations that qualify as small employers are allowed a maximum credit of 25% against taxes on any unrelated business taxable income and certain payroll taxes.

Notes: Section 1311 of the Act requires each state to establish an American Health Benefit Exchange no later than January 1, 2014. These exchanges will be designed to facilitate the purchase of qualified health care insurance policies and plans by individuals and employers. The 35% and 25% credits are increased to 50% and 35% in years after 2013, at which time employers must provide the health care insurance through an exchange in order to qualify for the credit.

The credit for tax-exempt employers is limited to the sum of their tax on unrelated business taxable income, the income and Medicare taxes the employer is required to withhold from employees, and the employer's share of the Medicare tax.

Employers must reduce their deduction for health insurance premiums by the amount of the credit.

Small Employer Defined

A small employer is defined as one:

1. With less than 25 full-time equivalent employees

2. With average annual wages of less that $50,000 per full-time equivalent employee and

3. That pays all or part of its employees' the health care premiums under a qualified arrangement.

Only amounts the employer pays on a non-elective basis count for purposes of computing the credit. Consequently, amounts paid under a section 125 flex plan are not eligible for the credit.

Premiums for purposes of computing the credit are capped at the average premium for health care coverage in the employer's state or area within a state. The IRS has issued Rev. Rul. 2010-13, listing initial average premiums for single and family coverage by state.

Full-Time Equivalent Employees

The number of full-time equivalent employees (FTEs) is determined by dividing total hours (not in excess of 2080 per employee) during the year for which the employer pays wages by 2080, rounded down to the next whole number.

Average Annual Wages

Average annual wages are total wages paid to FTEs during the year divided by the number of full-time equivalent employees, rounded down the next $1,000.

Required Aggregation

Members of a controlled group or an affiliated service group (see sections 414(b),(c),(m) and (o)) are treated as a single employer for purposes of determining the number of full-time equivalent employees and average annual wages.

Excluded Employees

Seasonal workers (as defined by the Department of Labor) who work for no more than 120 days during the year, owners and owners' family members, are disregarded for purposes of determining the number of full-time equivalent employees and average annual wages.

The term "owner" includes self-employed taxpayers (including partners), over-2% S corporation shareholders and over-5% owners of other businesses. Ancestors, step-parents, descendants, siblings, step-siblings, aunts, uncles, nieces, nephews and in-laws are all treated as family members for this purpose.

Qualified Arrangement

A qualified arrangement is, generally, one that requires the employer to pay a uniform percentage (not less than 50%) of the premiums for each employee enrolled in a health care plan offered by the employer.

However, for 2010 only, if the employer pays at least 50% of the premium (based on single coverage amounts, even if the employee has family coverage) for each enrolled employee, the arrangement will not fail to qualify, even if the employer does not meet the uniform percentage requirement.

Phaseout

The credit is phased out as the number of full-time equivalent employees exceeds 10 and/or average annual wages exceed $25,000.

- If the number of FTEs exceeds 10, the amount of the reduction is computed by multiplying the otherwise allowable credit by a fraction, the numerator of which is the number of FTEs in excess of 10 and the denominator of which is 15.

- If average annual wages exceed $25,000, the reduction is determined by multiplying the otherwise allowable credit by the excess of average annual wages over $25,000 divided by $25,000.

The $25,000 and $50,000 dollar amounts are indexed for inflation in calendar years beginning after 2113.

If an employer has over 10 FTEs and average annual wages above the $25,000 (adjusted after 2013) dollar amount, the tentative credit is reduced by the sum of the two reductions. This can reduce the credit to nothing even though the employer has fewer than 25 FTEs and average annual wages of less than $50,000.

The health care credit is non-refundable (i.e., it is allowed only against the employer's income tax and AMT). Excess credits, like all general business credits, generally carry back for one year and over for twenty, subject to the prohibition at section 39(d) on carrybacks to years before the effective date of the legislation creating the credit. However, the five-year carryback for credits of small businesses arising in years beginning in 2010 is allowed. See section 39(a)(4) as amended(covered above).

New section 45R

Notes: The IRS has mailed notices to small businesses advising them of the availability of the new tax credit and has posted a considerable amount of information about the credit, mostly in Q & A format, on its website. See IR 2011-38, April 1, 2010. In addition, the Service has issued guidance on eligibility, premiums, coverage and the effect of state tax credits. See Notice 2010-44.

Excise Tax on Indoor Tanning Services

A 10% excise tax applies on indoor tanning services performed after June 30, 2010.

New section 5000B

Notes: The Service issued interim final, temporary and proposed regulations on June 14, 2010:

- If the provider sells other products or services, the costs of the other goods and services are not subject to the excise tax, if they are separately charged, are reasonable in amount and are shown in exact amounts in the provider's books and records.

- If tanning is part of a bundle of services, reasonable allocations are required.

- Most bona fide medical procedures are exempt.

- If tanning is included in the membership fee of a qualified physical fitness facility, the tanning services are treated as incidental to the facility's predominate business, and are exempt. A qualified physical fitness facility is one:

    - Whose primary business is to serve as a physical fitness facility,

    - That does not offer tanning services to the general public and

    - Does not make a separate charge (directly or indirectly) for tanning services.

- Special rules apply to gift cards. The tax is due when it can reasonably be determined that a payment is for tanning services.

Reg. 1.5000B, generally effective for services provided after June 30, 2010

Notes: The IRS added a new line in Part II of Form 720 to provide a place to report and pay the tax. The first return is due November 1, 2010.

Increase and Extension of the Adoption Credit and Exclusion

The Patient Protection Act increased and extended the adoption expense credit and the fringe benefit exclusion through 2011, and made the credit refundable.

The statutory maximum for the credit and exclusion is increased to $13,170 for years beginning after 2009. In addition, effective in 2011, the base period for cost-of-living adjustments and the phaseout threshold from is changed from 2001 to 2009.

Section 23 redesignated as section 36C; also amendments to section 137

On September 29, 2010, the IRS issued Notice 2010-66, Rev Proc 2010-35, Rev Proc 2010-31, and a draft of revised Form 8839.

- Notice 2010-66 states that carryovers from years before 2010 (when the credit was nonrefundable) become refundable, beginning in 2010 and are not subject to the phaseout based on modified AGI.

- Rev Proc 2010-35 updated Rev Proc 2009-50 for the increased maximum credit or exclusion, and the statutory change making the credit refundable.

- Rev Proc 2010-31 updates Rev Proc 2005-31 to provide safe harbors for determining the finality of foreign adoptions to conform with the provisions of the Hague Convention on Protection of Children, effective in the United States as of April 1, 2008. It also contains guidance for taxpayers filing amended returns to claim the credit or exclusion for adoptions final under the new rules in 2008 or 2009.

Elimination of the Deduction for Medicare Part D Subsidies

Section 1860D-22 of the Social Security Act provides a federal subsidy for employers that sponsor a qualified prescription drug plan for retired employees. Code section 139A, originally enacted in 2003, excludes the subsidy from income and allows a deduction for all plan expenses, including those reimbursed by way of the subsidy.

The Patient Protection Act eliminates the deduction for amounts reimbursed by the subsidy.

Amendments to section 139A, effective for years beginning after 2010.

HSAs MSAs and FSAs

The penalty for nonqualified distributions from HSAs, MSAs and flex arrangements is increased from 10% to 20%, effective for distributions after 2010. The exceptions for death, disability and attainment of the age for Medicare eligibility are still available.

Amendments to section 223(f)(4)(A)

Distributions from HSAs, Archer MSAs and FSAs for over-the-counter medicines are not qualified medical expenses, unless they are insulin, or prescribed by a medical professional.

Amendments to sections 223(d)(2), 220(d)(2); also new section 106(f), effective for amounts paid from HSAs and MSAs after 2010 and expenses incurred in FSA plan years beginning after 2010

<u>Notes:</u> The IRS has issued interim guidance on the definition of qualified medical expenses and obsoleted Rev. Rul. 2003-103, which allowed distributions and reimbursements for nonprescription medicines. See Notice 2010-59; also Rev. Rul. 2010-23, both effective as of the effective dates of the amendments to the related regulations (presumably for amounts paid from HSAs or MSAs after 2010 or incurred in flex plan years beginning after 2010).

SIMPLE Cafeteria Plans for Small Business

An eligible employer that meets minimum contribution, eligibility and participation requirements is automatically treated as satisfying the nondiscrimination requirements for cafeteria plans generally and for any qualified benefits offered under the plan. The SIMPLE cafeteria plan rules are similar to those for SIMPLE IRAs.

Eligible Employer

An eligible employer is one that employed an average of no more than 100 employees during either of its two most recent preceding years.

- A predecessor is treated as the employer for this purpose.
- Controlled groups and businesses under common control are treated as one employer.
- Leased employees are treated as employees of the service recipient, subject to the safe harbor exception at section 414(n)(5).

If the employer was not in existence during a preceding year, eligibility is determined using reasonable expectations for the current year.

Once an eligible employer has adopted a plan, it remains eligible as long as the average number of employees in any subsequent year is less than 200.

Plan Requirements

The plan must require the employer to contribute:

1. A uniform percentage (at least 2%) of each qualified employee's compensation to provide qualified benefits to that employee, regardless of whether he or she makes a salary reduction contribution; or
2. No less than the lesser of:
    - 6% of the employee's compensation or
    - Twice the amount of the employee's salary reduction contribution.

Qualified Employee

A qualified employee is one who is not a highly compensated or key employee as defined by sections 414(q) and 416(i) who:

- Has attained an age and completed a period of service (not over 21 and one year, respectively) specified in the plan
- Is not covered under a collective bargaining agreement that provides substantially the same benefits as those offered under the plan,

- Had at least 1,000 hours of service during the preceding plan year and

- May, under conditions that apply to all plan participants, elect any qualified benefit offered under the plan.

New section 125(j), effective for years beginning after 2010. Old sections 125(j) and (k) are redesignated as sections 125(k) and (i), respectively.

W-2 Reporting Requirements

Employers are required to disclose the cost of each employee's employer-sponsored health care insurance coverage on Forms W-2.

New section 6051(a)(14), effective for years beginning after 2010

Notes: The IRS announced that it will not require compliance with the requirements of section 6051(a)(14) on Forms W-2 issued for 2011. See Notice 2010-69

Fees on Specified Health Insurance Policies or Plans

The issuer of a specified health insurance policy is liable for a fee of $2.00 ($1.00 for policy years ending during fiscal year 2013) times the average number of lives covered under the policy.

A specified health insurance policy is any health or accident insurance policy (including one under a group plan) that covers individuals residing in the United States, unless substantially all of the coverage consists of exempted benefits; i.e.:

- Accident or disability income insurance, or any combination thereof,

- Coverage issued as a supplement to liability insurance

- Liability insurance

- Workers' compensation or similar insurance

- Credit-only insurance

- Coverage for on-site medical clinics

- Coverage specified by regulations under which medical benefits are secondary or incidental to other insurance

- Limited scope dental or vision coverage

- Insurance for long-term care, nursing home care, home health care, community-based care, or any combination thereof.

- Similar limited-scope coverage as specified by regulations

- Coverage only for a specified disease or illness

- Hospital or other fixed indemnity insurance,

- Medicare supplemental health insurance (as defined under section 1882(g)(1) of the Social Security Act) and

- Coverage supplemental to the coverage provided under Chapter 55, Title 10 of the United States Code (i.e., medical and dental benefits for members of the armed services and certain retirees), and similar supplemental coverage provided under a group health plan.

The same fee structure applies sponsors of applicable self-insured health plans.

An applicable self-insured health plan is any plan:

- Maintained by an employer,

- That provides health and accident coverage,

- Where any part of the benefit is not provided by insurance.

The amount of both fees is tied to inflation for policy or plan years beginning after September 30, 2014.

New sections 4375 and 4376 as to specified policies and self-insured plans, respectively; effective for policy / plan years ending after September 30, 2012 and before September 30, 2019

Limitation on Deductions for Compensation Paid by Health Insurance Providers

The deduction for compensation paid to an applicable individual for any disqualified year beginning after 2012, attributable to services performed during that year, is limited to $500,000.

In addition, the deduction for deferred compensation paid in a year beginning after 2012 attributable to services performed by an applicable individual during any disqualified year beginning after 2009, is limited to $500,000 reduced (not below zero) by the sum of:

1. Compensation paid to the applicable individual during the disqualified year for which a deduction was allowed or would have been but for the $500,000 limitation, plus

2. Any amounts paid in any other year before the year of the actual payment for services performed during the disqualified year.

An applicable individual is an officer, director or employee of, or any other person who performs services for or on behalf of, a covered health insurance provider.

A covered health insurance provider is, for years beginning between 2009 and 2013, any insurance company, HMO or any other person licensed by a state to issue insurance, that receives premiums for providing health insurance coverage (see section 9832 for definitions).

For years beginning after 2012, a covered health insurance provider is a health insurance provider if at least 25% of its gross premiums from providing health insurance coverage are attributable to minimum essential coverage as defined at section 5000A.

Aggregation rules at section 414(b)(c)(m)and (o) apply, except that the brother-sister and combined group rules at section 1563(a)(2) and (3) are disregarded for purposed of applying section 414(b), (c) and (o)).

New section 162(m)(6), effective for payments made in years beginning after 2012

<u>Notes:</u> The effect of the new rules is that, for any payment made in a year beginning after 2012, the deduction for compensation for services performed in a disqualified year (which could be any year beginning after 2009) is limited to $500,000, regardless of when it is paid.

Additional Medicare Tax

The Medicare tax is increased by .9%, from 1.45% to 2.35%, on wages and income from self-employment above $200,000, $250,000 on a joint return and $125,000 on the return of a married taxpayer filing separately.

New sections 3101(b)(2) as to wages and 1401(b)(2)(A) as to SE income, effective for wages received and SE income earned in years beginning after 2012.

Tax on Investment Income

The Reconciliation Act added a new tax on investment income (broadly defined) of individuals, estates and trusts.

Individuals

The tax on individuals is 3.8% of the lesser of:

1. The taxpayer's net investment income or

2. Modified AGI above $200,000 for single taxpayers and heads of households, $250,000 on joint returns and $125,000 on the returns of married taxpayers filing separately.

Net investment income includes:

- Net income from interest, dividends, annuities, and rents and royalties not derived in the ordinary course of a trade or business.

- It also includes net income from passive activities, the net income of traders in securities and/or commodities, and net gain or loss on the disposition of property held for investment.

- A look-though rule applies to dispositions of partnership interests and S corporation stock.

- In addition, income from the investment of working capital is treated as net investment income for this purpose.

Modified AGI is AGI plus the foreign earned income exclusion.

Estates and Trusts

The tax on estates and trusts is 3.8% of the lesser of:

1. Undistributed net investment income (as defined above) or

2. AGI above the dollar amount that corresponds to the point at which the highest income tax rate applicable to estates and trusts begins (that amount was $11,500 for 2009).

New section 1411, effective for years beginning after 2012

Increased Medical Expense Deduction Threshold

The 7.5%-of-AGI threshold for unreimbursed medical expenses is increased to 10%; however, it remains at 7.5% for years beginning after 2012 and before 2017, if the taxpayer or spouse has attained age 65 by the end of the year.

Amendments to section 213(a) and new section 213(f), effective for years beginning after 2012

Limit on Health FSA Salary Reduction Contributions

Cafeteria plan benefits paid under a health flexible spending arrangement will not be treated as qualified benefits unless the plan limits the amount of each employee's annual salary reduction contributions for the health flexible spending arrangement to $2,500 (adjusted for inflation beginning in 2014).

New section 125(i), effective for years beginning after 2012

Premium Assistance Credit

Low-income taxpayers will receive refundable credits to help cover the cost of health insurance purchased through an exchange (that the states, as mentioned above, are required to establish).

The amount of the credit will be determined by Health and Human Services and will be available to taxpayers who:

- Do not have insurance through an employer
- Purchase a policy through a state exchange and
- Have household income between 100% and 400% of the federal poverty level based on family size and income for the year ending two years before the enrollment period.

The taxpayer will enroll in a plan, and report his or her income to the exchange. Treasury will pay the amount of the credit directly to the insurance provider, and the taxpayer will then pay the difference between the amount of the premium and the credit.

New section 36B, effective for years ending after 2013

Excise Tax on Uninsured Individuals

Individuals who fail to carry minimum essential insurance coverage generally will be subject to a penalty tax of the lesser of:

1. The sum of the monthly penalty amounts for each individual (e.g., the taxpayer, spouse, and dependents) for whom there is a failure to carry minimum coverage or

2. The national average premium for the “bronze” level of coverage through the insurance exchanges.

The monthly penalty amount is 1/12 of the greater of:

1. The lesser of the sum of the applicable dollar amounts for each uninsured individual or 300% of the adult applicable dollar amount for the year, or

2. An applicable percentage of household income.

    - The adult applicable dollar amount is $95 in 2014, $325 in 2015 and $695 in 2016, adjusted for inflation for years after 2016.

    - The applicable dollar amount for individuals under age 18 is half of the applicable amount for adults.

    - The applicable percentage of household income is 1% for 2014, 2% in 2015 and 2.5% in years after 2015.

Several classes of individuals are exempt from the penalty tax. They include:

- Religious objectors,

- Incarcerated individuals

- Illegal aliens,

- Members of Native American tribes,

- Individuals eligible for Medicare or other government-sponsored coverage,

- Individuals household income below the federal income tax filing threshold,

- Individuals for whom the cost of employer-provided or “bronze”-level coverage would exceed 8% of household income and

- Individuals who qualify under case-by-case hardship exceptions

New section 5000A, effective for years ending after 2013

Increased Reporting Requirements

Health insurance providers (including employers that self-insure) that provide minimum essential coverage to any individual are required to make reports to the covered individual; and the IRS, listing:

- The name, address and federal ID number of the covered individual,
- The dates during which he or she was covered,
- Whether the coverage is a qualified plan provided through an exchange,
- The amounts of any tax credits or cost-sharing reductions the covered individual received and
- Any additional information Treasury identifies as necessary.

New section 6055, effective for calendar years beginning after 2013

Cafeteria Plans

Premiums for coverage under a qualified health plan offered through an exchange generally will not be treated as qualified benefits under cafeteria plans. However, there is an exception for qualified employers.

A qualified employer is, generally, a small employer (i.e., generally, one that employed an average of no more than 100 employees in the immediately preceding calendar year) that elects to make all of its full-time employees eligible under a qualified plan offered in the small group market through an exchange.

Beginning in 2017, large employers can become qualified employers, if the state allows insurance companies in the large group market to offer qualified health plans through an exchange.

Amendments to section 125(f), effective for years beginning after 2013; Act sections 1312(f)(2) and 1304(b) as to the definition of qualified employer and small employer.

Penalties for Certain Large Employers

Employers generally are not required to provide health insurance coverage for their employees. However, applicable large employers are subject to a penalty tax if at least one employee has been certified as having enrolled in a health plan through an exchange and as receiving a premium assistance credit under Code section 36B or a cost-sharing reduction under Act sections 1402 or 1412.

An applicable large employer is, generally, one that had an average of at least at least 50 full-time employees during the immediately preceding calendar year. However, there is an exception for employers that had over 50 full-time employees for no more than 120 days during the year, if the employees in excess of 50 were seasonal employees as defined by the Department of Labor.

For purposes of determining the number of employees:

- A full-time employee is one who performs an average of at least 30 hours of service per week.

- Full-time equivalents count as full-time employees.

    - The number of full-time equivalents is determined monthly by dividing the number of hours worked by non-full time employees by 120.

- The aggregation rules for employers under common control and affiliated service groups at section 414(b), (c), (m) and (o) apply.

- Employers not in existence during the previous year will use reasonable expectations for the current year.

- A predecessor of an employer is treated as the employer.

Computations

If an applicable large employer fails to offer at least basic essential coverage to all of its full-time employees, the penalty for a given month is $166.67 multiplied by the number of full-time employees in excess of 30 during that month.

If the employer does offer at least minimum basic coverage, the penalty is the lesser of:

1. $250 times the number of full-time employees receiving a premium assistance credit or cost-sharing reduction for that month or

2. What the penalty would have been had the employer not offered basic essential coverage (i.e., $166.67 times the number of full-time employees in excess of 30 for that month).

Both dollar amounts are subject to adjustment for inflation after 2014.

Exception for Employers Providing Free-Choice Vouchers

The penalty does not apply with respect to any employee to whom the employer provides a free choice voucher.

Act section 10108 requires employers that offer basic essential coverage and pay any part of the premiums to provide free choice vouchers to any employee:

- Whose household income is no more than 400% of the federal poverty level,
- Whose required contribution under the plan would be over 8% but no more than 9.8% of his or her household income and
- Who does not participate in the employer's plan.

New section 4980H, effective for months after 2013

Excise Tax on High-Cost Employer Plans

The Reconciliation Act imposes an excise tax on the issuers or administrators of so-called "Cadillac" plans at a rate of 40% on the excess of the annual premiums above threshold amounts of $10,200 for individuals and $27,500 for families; $11,850 and $30,950 for certain high-risk professions (all amounts adjusted for inflation after 2018).

The high-risk professions are law enforcement, fire protection activities, provision of out-of hospital medical services, construction, mining, agriculture (but not food processing), forestry and fishing (see Act section 9001).

New section 4981, effective for tax years beginning after 2017

HR 1586

The President signed HR 1586 shortly after it passed the House on August 10, 2010. It contains seven provisions limiting the use of the foreign tax credit and a technical amendment to the HIRE Act.

Matching Rules

Generally effective for foreign taxes paid or accrued after December 31, 2010, foreign tax credits are not allowed until the year the related income is taken into account for U.S. tax purposes. The same rule applies to the computation of E&P of and deemed paid credits from section 902 corporations.

New section 909

Covered Asset Acquisitions

Effective for transactions after 2010 (subject to transition relief for contracts between unrelated parties binding on and at all times after January 1, 2011), the foreign tax credit is not allowed for the *disqualified portion* of a foreign tax paid or accrued in connection with a *covered asset acquisition.*

A covered asset acquisition is:

- A revaluation of assets under a section 338(a) or section 754 election,
- Any transaction treated as an asset acquisition for U.S. tax purposes, but disregarded or treated as a stock acquisition for foreign income tax purposes and
- Any similar arrangements identified by regulation.

The disqualified portion is essentially the credit with respect to foreign income not taxed by the U.S. on account of differences in assets for U.S. vs. foreign tax purposes.

New section 901(m) Old section 901(m) is redesignated as section 901(n)

Tax Treaties

Effective for tax years beginning after August 10, 2010, separate foreign tax limitations apply to any item that:

- Generally would be treated as U.S.-source income, but
- Is treated as foreign-source income under a treaty, where
- The taxpayer elects to be taxed under the provisions of the treaty.

New section 904(d)(6) Old section 904(d)(6) is redesignated as section 904(d)(7)

The Deemed Paid Credit - Section 956 Inclusions

The foreign taxes a U.S. shareholder of a controlled foreign corporation (CFC) is deemed to have paid attributable to the CFC's acquisition of U.S. property is limited to the lesser of:

- The foreign taxes deemed paid under existing law or
- The foreign taxes deemed paid if cash equal to the amount included in the domestic corporation's income attributable to the CFC's E&P had been distributed through the chain of ownership beginning with the CFC that owns the U.S. property and ending with the U.S. shareholder.

New section 960(c), effective for acquisitions of U.S. property after August 10, 2010.

Redemptions by Foreign Subsidiaries

If over 50% of the dividends arising in connection with a redemption where the acquiring corporation is a foreign corporation would not be subject to U.S. taxes in the year during which the dividend arises or includible in the E&P of a controlled foreign corporation, the E&P of the acquiring foreign corporation is disregarded for purposes of determining the amount and source of the dividends.

New section 304(b)(5)(B), effective for redemptions after August 10, 2010. Old section 304(b)(5)B) is redesignated as section 304(b)(5)(C).

Interest Expense Allocations

If over 50% of a foreign corporation's gross income is effectively connected income and at least 80% of its stock (by vote or value) is owned directly or indirectly by members of an affiliated group, all of the foreign corporation's assets and interest expense are taken into account for purposes of allocating and apportioning the affiliated group's interest expense.

Amendments to section 864(e)(5), effective for years beginning after August 10, 2010.

Repeal of the 80/20 Rule

Generally effective for tax years beginning after December 31, 2010, the 80/20 rule exempting interest and dividends paid by resident aliens and/or domestic corporations from the 30% withholding tax is repealed.

Grandfathered domestic corporations (i.e. that met the 80/20 test for their last year beginning before 2011 and continue to meet a new 80/20 test in years beginning after 2010 and that have not added a substantial line of business) can continue to exempt part of their interest and dividend payments.

Amendments to section 871

Technical Amendment to Section 6501(c)

The normal three-year statute applies if failure to provide information required by sections 6038A, 6038B, 6038D, 6046, 6046A, 6048 or 1295(b) was due to reasonable cause and not willful neglect.

Amendment to section 6501(c)(8), effective for returns filed after March 18, 2010

<u>Notes:</u> The HIRE Act originally extended the statute to six years, with no provision for a reasonable cause exception.

Elimination of the Advanced Earned Income Credit

The election to receive advance payments of the EIC is repealed, effective for years beginning after 2010.

Section 3507 repealed; amendments to sections 32 and 6051