

# Federal Tax Update

February 15, 2011

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# Agenda

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## Legislative Developments

- for individuals
  - for businesses
  - Certainty – for now
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## Judicial Developments

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## Administrative Developments

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# Legislative Developments

- changes for individuals

# **Legislative changes for individuals**

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- ✓ Individual income tax relief
- ✓ Estate tax changes
- ✓ Education tax incentives
- ✓ Partial payroll tax holiday
- ✓ Healthcare provisions affecting individuals

# Individual income tax relief

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- Extends 3 principal components of the individual tax system through 2012
  - Lower rates on earned income, long-term capital gain, and qualified dividend income
  - Changes in rate brackets and personal exemptions that provide marriage penalty relief
  - Increase in the child credit from \$500 to \$1,000
- Increases AMT exemption amount

# Income tax rates

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- Maintains 6 individual income tax brackets ranging from 10 to 35 percent over next 2 years
- Qualified dividends and long-term capital gains
  - Top rates hold at 15%
  - Rate remains at 0% for taxpayers in the 15% and 25% regular tax brackets
- Rates revert to pre-2003 levels in 2013, pending further legislation

# PEP & Pease, marriage penalty relief

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- Extends repeal of limitations on exemptions and deductions for higher-income individuals for 2 years
  - Personal exemption phaseout (PEP)
  - Itemized deduction limitation (Pease limitation)
- Extends EGTRRA's marriage penalty relief through 2012
  - Standard deduction for joint filers = twice the deduction for single filers
  - 15 percent bracket for joint filers = twice the corresponding bracket for single filers

# Child tax credit

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- Extends child tax credit modifications through 2012
  - Threshold for claiming the refundable credit is \$3,000 of earned income
  - Allowed to claim the credit fully against the AMT
  - Expansion of refundability

# Alternative minimum tax relief

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- AMT patch for 2010 and 2011
- Exemption amounts increased
  - 2010: \$47,450 for unmarried filers, \$72,450 for married-joint filers
  - 2011: \$48,450 for unmarried filers, \$74,450 for married-joint filers
- Congress must address issue again at end of 2011
- Budget offsets for \$70 billion cost?

# Miscellaneous individual provisions

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- Extends through 2012 other family tax benefits
  - Increase in adoption credit and income exclusion for employer-assistance programs to \$10,000
  - Employer-provided child care tax credit
  - Modifications to dependent care tax credit
  - Modifications and simplification of EITC

# Estate tax changes

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- Act reinstates estate and GST taxes retroactive to beginning of 2010
- Modifies gift tax beginning in 2011
- Estates of 2010 decedents may still elect to use former 2010 law
  - 0% tax rate and modified carryover basis rules
- Clarity and certainty through 2012

# New estate tax regime

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- \$5 million exemption per spouse
- Top rate of 35% retroactive from the beginning of 2010 through 2012
- Exemption indexed for inflation
- 2010 carryover basis rules retroactively repealed
- Assets passed on qualify for step up in basis to fair market value

# Portability of Estate Tax Exemption

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- Decedent's unused estate exemption can shift to surviving spouse
- Election to use must be made by executor
- IRS permitted to review deceased's prior gift tax and estate tax returns
- IRS granted broad regulatory authority to provide future guidance

# Other Miscellaneous Estate Tax Provisions

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- Expands availability of installment payments for estates
- Clarifies installment payment provisions
- Allows deduction of estate taxes paid to any state or D.C. for decedents dying after 12/31/2009
- Possible that estate tax could return to pre-2003 structure in 2 years

# Filing of Estate Tax Returns

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- New time extensions for
  - Filing of a tax return for certain estates
  - Making tax payments
  - Making a disclaimer with respect to an interest of property passing by reason of the decedent's death
- Applies to decedents dying between 12/31/2009 and 12/17/2010
  - Due date is 9 months after 12/17/2010

# Education tax incentives

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- Extends through 2012 education incentives
  - Employee exclusion for employer-provided educational assistance
  - Student loan interest deduction
  - Coverdell education savings account contribution limit
  - Expansion of the scope of “qualified scholarships”
  - Bond-financing mechanisms for education facilities
  - American Opportunity Tax Credit, a refundable tax credit up to \$2,500 for undergraduate education expenses

# Partial payroll tax holiday

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- Temporary reduction of the Social Security payroll tax for 2011
- Wage earners' rate reduced from 6.2% to 4.2%
- Self-employed individuals' rate reduced from 12.4% to 10.4%
- Relief applies to all wages or other income subject to social security tax
- Replaces Making Work Pay tax credit

# Health care legislation

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- \$438 billion tax package
  - Tax increases on high-income individuals
  - Excise taxes on high-cost group health plans (“Cadillac Plans”)
  - New fees on selected health care-related industries
  - Other business and individual revenue raisers

# Sources of tax revenue for Health Care Legislation

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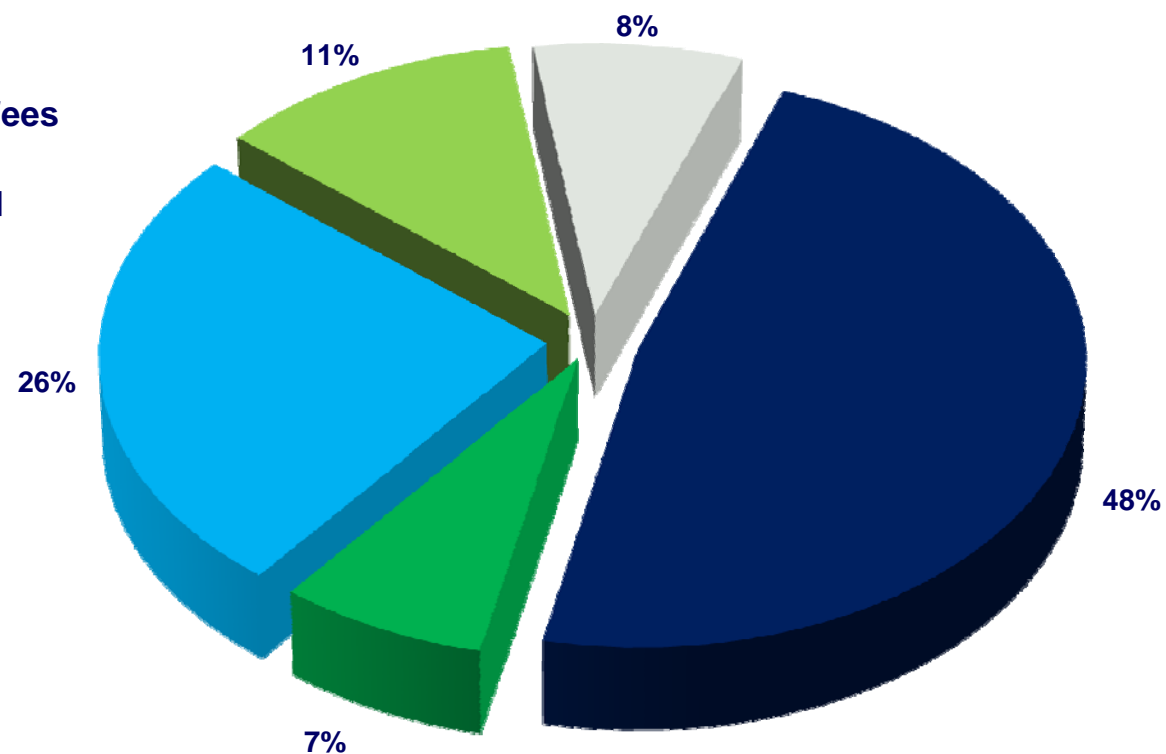
■ High-income individuals

■ Cadillac plan tax

■ Health-industry fees

■ Business related

■ Individuals



# Medicare tax increase: Earned Income

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- Additional 0.9% Medicare Hospital Insurance tax (HI tax) on:
  - Self-employed individuals
  - Employees
- Applies to earnings or wages in excess of \$200,000 (\$250,000 for joint returns)
- Does *not* change the employer-portion of HI tax
- Self-employed individuals are not permitted to deduct any portion of the additional tax
- Effective for taxable years beginning after December 31, 2012

# Unearned income Medicare contribution

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- 3.8% Medicare “contribution” levied on income from interest, dividends, capital gains, annuities, royalties, and rents
- Does not include income that is derived in the ordinary course of a trade or business and not treated as a passive activity
- Tax applied against the lesser of the taxpayer’s net investment income or modified adjusted gross income in excess of \$200,000 for singles (\$250,000 for joint filers)
- Effective taxable years beginning after December 31, 2012

# Excise tax on high-cost health plans

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- Nondeductible 40% excise tax imposed on the “excess benefit” provided in any month under any employer-sponsored health plan
- Excess benefit is a benefit the cost of which, on an annual basis, exceeds \$10,200 a year for individuals (\$27,500 for families)
- Premium thresholds for retirees and employees in high-risk professions are increased by \$1,650 for individuals (\$3,450 for families)
- Cost-of-living adjustment (based on CPI-U) for years after 2019
- Effective for taxable years beginning after December 31, 2017

# Healthcare law affecting individuals

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- New refundable health care premium tax credit
- Restrictions on health-related accounts and reimbursements
  - Eliminates nontaxable reimbursements of Over-the-counter (“OTC”) medications unless prescribed by a doctor
  - \$2,500 limit on health Flexible Spending Arrangements (“FSA”)
  - Penalty on nonqualified Health Savings Account (“HAS”) distributions
- Itemized deduction for medical expenses threshold increase to 10% of AGI (from 7.5%)
- Begins closing the Medicare ‘donut hole’

# Individual mandate & penalty

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- Individuals must obtain “minimum essential coverage” or pay a penalty beginning in 2014, with exceptions
- Penalty is not insurance premium
  - Penalty phased in starting in 2014, reaching the greater of \$695 or 2.5 percent of income in 2016, and indexed for inflation thereafter
- Subject of considerable legal and judicial activity over constitutionality

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# Legislative Developments

- changes for businesses

# **Legislative changes for businesses**

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- ✓ Expensing & bonus depreciation
- ✓ Business extenders
- ✓ Healthcare legislation
- ✓ Economic substance codification (and individuals)
- ✓ International tax provisions

# Expensing & bonus depreciation

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- Extends for 2 years (2011 & 2012) the 50% bonus depreciation for qualified property
- Property must be placed in service before 1/1/2013
- Taxpayers can expense 100% of basis in qualified property placed in service from 9/9/2010 through 12/31/2011

# Interaction with Small Business Jobs Act

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Placed-in-service date	Depreciation bonus
1/1/2008 – 9/8/2010	50%
9/9/2010 – 12/31/2011	100%
1/1/2012 – 12/31/2012	50%

- Property must be purchased new (not used)
- Qualified property includes:
  - Property with a MACRS recovery period of 20 years or less;
  - Certain computer software;
  - Water utility property; or
  - Qualified leasehold improvement property.

# Refundable Minimum Tax Credit in lieu of bonus depreciation

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- Provides for another temporary election to claim a refundable credit in lieu of bonus depreciation
  - Not available for property placed in service in 2010.
  - Re-enacted for property placed in service during 2011 and 2012, referred to as “round 2 extension property”
- Allows for “monetizing” a portion of minimum tax credits generated from payment of Alternative Minimum Tax (“AMT”) in years prior to 2006
- Credits claimed cannot exceed \$30 million
- Some exceptions apply

# Less generous for some?

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- Corporations will not be able to monetize old Research & Experimentation credits by forgoing bonus depreciation for their round 2 extension property.
  - Different from the 2008-2009 credit in lieu program

# State tax implications

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- Some states do not follow the federal bonus depreciation rules
- Other states modify the federal rules
- Added complexity
- Detailed recordkeeping to aid in reconciling differences
- Covered in Multi-State presentation this evening

# Section 179 expensing limitation

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- Additional year of increased section 179 expensing
- Effective for tax years beginning in 2012
- Limitation raised to \$125,000, reduction begins at \$500,000
- Amounts will return to \$25,000 and \$200,000, respectively, after 2012

# Business extenders

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- Act extends litany of expired or expiring tax provisions through 2011
  - Business
  - Energy
  - Disaster relief
- Expired provisions are extended retroactively to beginning of 2010

# Interaction of credits

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- 2010 research credits have “preferred status”
- May be “monetized”
- May offset future AMT liability

# Financial statement impact

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- Retroactive legislation can affect tax expense/benefit in prior/current year
- May require:
  - Update of annual effective tax rate
  - Changes to current and/or deferred tax accounts
- Companies may elect to convert certain credits to refundable credits

# Healthcare legislation

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- Annual fee on U.S. health insurance providers
- Annual fee on pharmaceutical manufacturers and importers of branded prescription drugs (including certain biological products)
- 2.3% excise tax on medical devices

# Other revenue provisions of Health Care Legislation

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- Deduction for Medicare Part D subsidy eliminated
- Deduction limits for compensation paid by health insurance providers
- New nonprofit hospital requirements
- Credit for small-business employee health coverage to offset the cost of employee health insurance
- ‘Black liquor’ ineligible for cellulosic biofuel producer credit under section 40(b)

# Employer-provided health insurance

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- Employers not required to provide health coverage to employees, but penalties apply beginning in 2014 to encourage them to do so
  - \$2,000 penalty per employee, first 30 employees exempted

# Health Care Legislation: Reporting and compliance

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- Additional wage (W-2) reporting requirements for employers
- Expanded business payment (1099) reporting
- New reporting requirements related to individual mandate & employer penalties
- Disclosure of tax return information to determine eligibility for tax credits and health programs

# Economic substance codification

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- Effective date – transactions entered into after March 31, 2010
- Transactions shall be treated as having economic substance only if:
  - Transaction changes a taxpayer's economic position in a meaningful way apart from the federal income tax effects
  - AND
  - Taxpayer must have a substantial purpose apart from federal income tax effects for entering into the transaction.
- 40% strict-liability penalty for tax understatements attributable to undisclosed noneconomic substance transactions
- 20% penalty if transaction is adequately disclosed
- No reasonable-cause exception
- IRS resistant to providing guidance to Taxpayers (Notice 2010-62)

# International tax provisions

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- President signed into law the Education Jobs and Medicaid Assistance Act (H.R. 1586) on August 10, 2010
- \$10 billion in provisions to tighten foreign tax credit rules and make other international tax law changes
- Used to pay for Medicaid and education spending
- Departure from Pay As You Go (“PAYGO”) budgeting rules
  - Tax increases used to pay for tax decreases, not spending, until now

# Foreign tax credit provisions

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- Prevent the “splitting” of foreign tax credits from related income
- Disallow credit for foreign taxes imposed on income eliminated from the U.S. tax base in asset acquisitions
- Limit the deemed-paid taxes from lower-tier foreign corporations
- Modification of affiliation rules for allocating interest expense
- Separately basket items resourced under tax treaties

# Other international tax provisions

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- Limit direct foreign-to-foreign deemed dividends via redemptions
- Repeal the 80/20 rules
- Technical correction to statute of limitations provision in the HIRE Act



A measure of certainty –  
for now

# A free hand for 2011

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- Short-lived certainty in tax rates, AMT status, estate planning, availability of incentives and credits
- Congress faces 3 choices in setting tax agenda this year
  - Limited essential actions
  - Renew debate over 2001/2003 tax cuts
  - Serious discussion of deficit reduction and tax reform

# Changing PAYGO dynamic

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- Tax relief subject to statutory PAYGO
- Various offsets not enacted still remain
- Rule changes in GOP-controlled House shift focus on offsets in that chamber from tax increases to spending cuts (CUTGO)
- Broad-based revenue raisers unlikely
- Targeted, anti-abuse measures more likely

# A closing observation

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- Further debate on Bush-era tax cuts or tax reform may spill into 2012
- Discussion in 2012 will be weighed down by presidential election-year politics

# A closing observation

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- The fiscal commission established by President Obama recently published its report on US fiscal reforms: “The Moment of Truth”
- Goals:
  - Lower rates, broaden the base, and cut spending in the tax code,
  - Reduce the deficit (hint: increase taxes),
  - Maintain or increase progressivity of the tax code,
  - Make America the best place to start a business and create jobs.

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# Judicial Developments

# Judicial Developments

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- ✓ Tax Accounting Methods
- ✓ Partnership Structures
- ✓ International Tax
- ✓ Work-Product Privilege
- ✓ Tax Shelter Developments

# Tax Accounting Methods

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- Robinson Knife Mfg. case (600 F.3d 121):
  - In favor of the taxpayer
  - Taxpayer not required to capitalize to inventory the costs of sales-based royalties
  - 2<sup>nd</sup> Circuit reversed previous Tax Court ruling
  - Subsequently the subject of a new proposed regulation

# Partnership Structures

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- Canal Corp. case (135 T.C. 9):
  - In favor of the IRS
  - Structured joint venture transaction found to be a disguised sale of property, rather than a debt-financed contribution of property to a partnership
  - In its venture with Georgia Pacific, Chesapeake Corp. did not retain enough responsibility for the venture's debt to provide basis that could have allowed distributions to be tax-free return of capital
  - Penalties also upheld despite opinion from respected advisor

# International Tax

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- Xilinx case in 9<sup>th</sup> Circuit (598 F.3d 1191):
  - In favor of the taxpayer
  - Taxpayer not required to include in R&D credit base period costs of stock-based compensation under a cost-sharing arrangement
  - 9<sup>th</sup> Circuit reversed its own previously withdrawn opinion
  - IRS concurred with the result, but not the reasoning (AoD 2010-03)
  - 2003 amendments to transfer pricing regulations reduce the ongoing significance of this matter

# Work-Product Privilege

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- Textron cases (577 F.3d 21, et. al.):
  - 1st Circuit had ruled in ‘09 that tax accrual workpapers are available to IRS, reversing previous decisions by district court and circuit panel
  - Key: “prepared for use in possible litigation”?
  - In May, 2010 the U.S. Supreme Court refused to hear the taxpayer’s appeal, to the surprise of most observers
- Deloitte case (610 F.3d 129):
  - D.C. Circuit ruled that DuPont’s tax accrual documentation, prepared by Deloitte, is protected by the work-product privilege and thus not available to the IRS
  - Key: “developed in anticipation of litigation”?

# Tax Shelter Developments

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- Several 2010 wins for the IRS:
  - Jade Trading
  - Stobie Creek
  - Petaluma FX
  - Sala and others
- Last notable wins for taxpayers came in late '09

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# Administrative Developments

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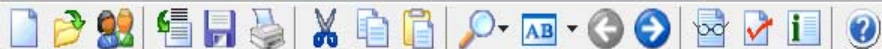
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- ✓ Uncertain Tax Positions
- ✓ E-Filing Mandate
- ✓ Broker Reporting of Basis Information
- ✓ Foreign Bank Account Reporting
- ✓ Foreign Account Tax Compliance Act
- ✓ Oversight of Tax Return Preparers
- ✓ Remaining Implications of 5-year NOL Carryback Election
- ✓ Section 382 Limitations on NOLs
- ✓ Tax return processing delays

# Reporting of Uncertain Tax Positions

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- Schedule UTP is required for corporations beginning with calendar year 2010 tax returns with assets greater than \$100 million
- Applies to taxpayers who prepare or are included in financial statements, if the taxpayer or related entity determines its US federal income tax reserves under FIN 48



**SCHEDULE UTP  
(Form 1120)**

Department of the Treasury  
Internal Revenue Service

**Uncertain Tax Position Statement**

▶ File with Form 1120, 1120-F, 1120-L, or 1120-PC.  
▶ See separate instructions.

OMB No. 1545-0123

**2010**

Name of entity as shown on page 1 of tax return

EIN of entity

This Part I, Schedule UTP (Form 1120) is page  of  Part I pages.

**Part I** **Uncertain Tax Positions for the Current Tax Year.** See instructions for how to complete columns (a) through (f).  
Enter, in Part III, a description for each uncertain tax position (UTP).

Check this box if the corporation was unable to obtain information from related parties sufficient to determine whether a tax position is a UTP (see instructions) ▶

(a) UTP No.	(b) Primary IRC Section (e.g., "61", "108", etc.)			(c) Timing Codes (check if Permanent, Temporary, or both)		(d) Pass-Through Entity EIN	(e) Major Tax Position	(f) Ranking of Tax Position
<input type="text"/>	<input type="text"/>	<input type="text"/>	<input type="text"/>	P <input type="checkbox"/>	T <input type="checkbox"/>	<input type="text"/>	<input type="checkbox"/>	<input type="text"/>
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FEC Instructions to Schedule

FED Schedule UTP--Uncertain

# E-Filing Mandate

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- IRS now requires all individual income tax returns prepared by “specified tax return preparers” after December 31, 2010 to be e-Filed.
- Specified Tax Return Preparer
  - TY2010 - Files more than 100 individual and trust income tax returns in a calendar year
  - TY2011 – Files more than 11 individual and trust income tax returns in a calendar year
- Clients may independently choose to file on paper
  - Must file Form 8948, Preparer Explanation for Not Filing Electronically

# Broker Reporting of Basis Information

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- IRS requires stock brokers and mutual fund companies to report basis information for most stock purchased in 2011 and all stock purchased in 2012 and later years
- Form 1099-B will be expanded in 2011 to include the cost basis
  - Expanded form will also be used to report whether gain or loss realized on the transactions is long-term or short-term
- Form will be first used for calendar year 2011 sales, and must be filed with the IRS and furnished to investors in early 2012
- See IRS Notice 2010-67 for more details

# Oversight of Tax Return Preparers

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- New regulations require all paid tax return preparers to obtain and use a preparer identification number (“PTIN”)
- IRS proposed additional regulations requiring competency tests and continuing professional education for paid tax return preparers that are not attorneys, CPAs, and enrolled agents
- IRS hopes this will increase confidence in the tax system and result in greater compliance with tax laws

# Foreign Bank Account Reporting

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- U.S.-Swiss confrontation
  - Sparked by whistleblowing former banker
  - Swiss banks agreed to share limited lists of U.S. accountholders
- 2009 offshore voluntary disclosure program
  - Roughly 3,000 taxpayers came forward
- New 2011 offshore voluntary disclosure initiative
  - Deadline of August 31, 2011
  - Penalties greater than '09 program, less than in future

# Foreign Account Tax Compliance

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- New reporting & withholding requirements for foreign financial institutions
  - Beware broad scope and definitions
- Notice 2010-60

# 5-Year NOL Carryback: Future Implications

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- Suspends the 90% limitation on use of any alternative minimum tax NOL deduction attributable to carrybacks and carryforwards of the applicable NOL for which an extended carryback period is elected.
  - Election must have been made by September 15, 2010

# Section 382 Limitations on NOLs

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- Notice 2010-49, Notice 2010-50 and Final Regulation Section 1.382-7
- Highly technical, address complex & nuanced situations
  - Shifting value between different classes of stock
  - Definition of built-in gain
  - Changes to small shareholder rules

# Tax return processing delay

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- Late changes in the tax law required reprogramming IRS processing systems
- Most affected items:
  - State & local sales tax deduction
  - Higher education tuition and fees deduction and educator expenses deduction
  - Taxpayers who itemize on form 1040 Schedule A
- Normal processing was to resume February 14

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# Questions?

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