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2010 FIRST QUARTER FEDERAL TAX DEVELOPMENTS

The first quarter of 2010 brought many tax developments from Congress, the IRS and the courts. We have highlighted some of these important federal tax developments below.

Health care reform. In March, President Obama signed comprehensive health care reform legislation (the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act). The health care reform package does not mandate employer-provided coverage but beginning in 2014 large employers that do not offer coverage will pay a penalty. Large employers that offer coverage but the coverage fails to meet minimum essential standards will also pay a penalty. Tax credits for small employers are available immediately for 2010 tax years. Individuals must obtain minimum essential coverage after 2013 unless they are treated as exempt; otherwise they will pay a penalty. Starting in 2013, the new law broadens the Medicare tax base for higher income taxpayers, including amounts paid on investment income, and, after 2017, imposes an excise tax on high-dollar health insurance plans.

HIRE Act. President Obama signed the Hiring Incentives to Restore Employment (HIRE) Act in March, providing businesses with payroll tax relief, a worker retention tax credit and enhanced Code Sec. 179 expensing. Payroll tax forgiveness applies to wages paid to covered workers who are on the employer's payroll after March 18, 2010 and before January 1, 2011. The covered employee must begin employment after February 3, 2010 and before January 1, 2011. The HIRE Act also allows employers to claim a worker retention credit for qualified employees.

Estate tax. The federal estate tax does not apply to decedents dying after December 31, 2009 and before January 1, 2011. Also, beginning in 2010, the stepped up basis at death rules are replaced with modified carryover basis at death rules applicable to estates holding assets with unrealized capital gains of more than \$1.3 million. In December 2009, the House passed the Permanent Estate Tax Relief Act, which would permanently extend the top federal estate tax rate of 45 percent with a \$3.5 million exclusion (\$7 million for married couples). The Senate, however, has failed to take up the House bill. Some action this year is expected.

Individual tax rates. President Obama urged Congress in his Fiscal Year (FY) 2011 federal budget proposals to extend the individual marginal rate cuts enacted in 2001 but allow the top two individual marginal income tax rates to revert to 36 percent and 39.6 percent respectively after 2010. Higher income individuals also would pay 20 percent tax on qualified dividends and capital gains after 2010 under the president's proposal. Congress is expected to take up the individual marginal rate cuts and the dividend/capital gains tax rates over the summer of 2010.

Homebuyer credit. In January, the IRS issued an updated version of Form 5405, First-Time Homebuyer Credit and Repayment of the Credit. Because of documentation requirements for claiming the credit, taxpayers who claim the credit on their 2009 return must file a paper return and attach Form 5405 and a properly executed copy of a settlement statement used to complete the purchase. The IRS noted that settlement documents can vary from one location to another. For a newly

constructed home where a settlement statement is unavailable, a copy of the certificate of occupancy generally will be accepted, the IRS advised.

Audit rates. IRS statistics released in March indicate that the examination rate for individual taxpayers between FY 2008 and FY 2009 remained generally static at an overall audit rate of one percent for individuals. The audit rate was 1.86 percent for taxpayers with adjusted gross incomes (AGIs) between \$200,000 and \$500,000 and 5.35 percent for taxpayers with AGI between \$1 million and \$5 million.

Maximum fair market values. The IRS released in January the maximum fair market values (FMVs) for business automobiles, trucks and vans first placed into service in 2010 and for which the vehicle cents-per-mile rule and the fleet-average valuation rule may apply. The maximum FMVs for use of the vehicle cents-per-mile valuation rule in 2010 are \$15,300 for a passenger automobile and \$16,000 for a truck or van, which includes automobiles built on a truck chassis, such as minivans and sport-utility vehicles (SUVs) built on a truck chassis.

Vehicle depreciation. Depreciation limits for business automobiles, trucks and vans first placed in service in 2010 as well as the annual income inclusion amounts for vehicles first leased in 2010 were released by the IRS in February. The maximum depreciation limits for passenger automobiles first placed in service during the 2010 calendar year are \$3,060 for the first tax year; \$4,900 for the second tax year; \$2,950 for the third tax year; and \$1,775 for each tax year thereafter. The amounts for trucks and vans first placed in service during the 2010 calendar year are \$3,160 for the first tax year; \$5,100 for the second tax year; \$3,050 for the third tax year; and \$1,875 for each tax year thereafter. If Congress decides to extend bonus depreciation for another year into 2010, first year amount will increase by \$8,000, as was the case in 2009.

Uncertain tax positions. In February, the IRS announced a controversial proposal to require certain businesses to report directly on their annual income tax returns any uncertain tax positions determined under financial accounting standards. The IRS is developing a new schedule to implement the reporting requirement. The new reporting requirement will not take effect immediately and will not apply to tax returns filed in 2010 for the 2009 tax year.

409A correction program. Because of the complex and detailed requirements for plans to comply with Code Sec. 409A and the severe consequences for violations, employers urged the IRS to develop a document correction program. In January, the IRS announced a document correction program for Code Sec. 409A nonqualified deferred compensation plans. The program is a follow-up to the 409A correction program for operational failures.

Passive activity losses. After a number of court losses, IRS acquiesced "in result only" to a 2009 decision by the Court of Federal Claims decision (Thompson v. U.S.) holding that a member's interest in a limited liability company taxed as a partnership is not a limited partnership interest for passive activity loss (PAL) purposes under Code Sec. 469. The IRS also indicated that it will issue more guidance and amend existing regulations.

Tax shelter penalties. The IRS has extended until June 1, 2010 its moratorium on collecting penalties under Code Sec. 6707A for undisclosed tax shelter transactions. Additionally, the agency also will continue to delay until June 1, 2010 filing new notices of federal tax lien for collecting amounts due solely to Code Sec. 6707A penalties. Both the House and Senate have passed bills ameliorating the penalty for small businesses.

Retirement plan payments. A taxpayer who received early distributions from two individual retirement annuities was liable for the Code Sec. 72(t) 10 percent additional tax, the U.S. Tax Court held in February (*Prough v. Commissioner*). The taxpayer failed to establish the distributions met the substantially equal periodic payments exception. The Obama administration is reportedly studying the annuitization of retirement plan payments.

Housing allowances. The IRS issued its table of adjusted limitations in March on housing expenses for 2010, adding new foreign locations and slightly raising the housing allowance for most locations. Code Sec. 911 allows U.S. taxpayers living abroad to exclude their foreign earned income and housing costs from gross income. The Tax Increase Prevention and Reconciliation Act of 2005 allows the IRS to adjust the standard formula limitation for determining the amount of employer-paid housing excluded from foreign earned income, based on geographic differences in housing costs relative to housing costs in the U.S.

Like-kind exchanges. In March, the IRS unveiled a much-anticipated safe harbor for participants in multiple-party like-kind exchanges under Code Sec. 1031 that have experienced hardship because of the default of qualified intermediaries (QIs) during the economic downturn. The safe harbor for reporting gain or loss is available to taxpayers that initiated deferred like-kind exchanges but failed to complete the exchange due to a QI's default on its obligation to timely acquire and transfer replacement property when its assets are frozen in bankruptcy or receivership.

Royalties. In March, the Court of Appeals for the Second Circuit found that a taxpayer can deduct royalties paid to license trademarks for selling the products. The Second Circuit's decision is significant because it is the first to address the treatment of intellectual property royalties under the uniform capitalization rules of Code Sec. 263A.

Student FICA exception. In a major concession, the IRS agreed in March to accept claims that medical residents qualify under the student FICA exception and are entitled to refunds for FICA (Social Security) taxes. The new IRS policy, however, does not apply to current payments but only to tax periods ending before April 1, 2005. Generally, courts have held that medical residents were not subject to FICA taxes because their services were incident to and for the purpose of pursuing an educational course of study.

Return preparers. The IRS announced in January the results of a study of its oversight of tax return preparers. All paid signing preparers will be required to register with the IRS. Unenrolled preparers (practitioners who are not CPAs, attorneys, enrolled agents and, in some cases, licensed public accountants) will be required to successfully complete continuing education classes and competency testing.

These are just some of the many federal tax developments during the first quarter of 2010. Please contact our office if you have any questions about these or any tax developments.

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