

Review of Recent 2010 Tax Developments

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Despite failing to pass an estate tax bill or resolve 2011 tax rates, Congress and the IRS have still found time to fiddle with the tax code and regulations. The following is a summary of the most important tax developments that have occurred in the past three months that may affect you, your family, your investments, and your livelihood. Please call us for more information about any of these developments and what steps you should implement to take advantage of favorable developments and to minimize the impact of those that are unfavorable.

New law gives tax breaks to small business. The Small Business Jobs Act of 2010, which was signed into law on September 27, 2010, includes a number of important tax provisions, including liberalized and expanded expensing for 2010 and 2011, revived bonus depreciation for 2010, five-year carryback of unused general business credits for eligible small businesses, removal of cell phones from the listed property category, and liberalized tax shelter penalty rules. We will have more on this new law in a subsequent article.

New tax breaks for hiring new employees. Employers are exempted from paying the employer 6.2% share of Social Security (i.e., OASDI) employment taxes on wages paid in 2010 to newly hired qualified individuals. These are workers who: (1) begin employment with the employer after Feb. 3, 2010 and before Jan. 1, 2011, (2) certify by signed affidavit, under penalties of perjury, that they haven't been employed for more than 40 hours during the 60-day period ending on the date the individual begins employment with the qualified employer; (3) do not replace other employees of the employer (unless those employees left voluntarily or for cause), and (4) aren't related to the employer under special definitions. The payroll tax relief applies only for wages paid from Mar. 19, 2010 through Dec. 31, 2010.

Employers also may qualify for an up-to-\$1,000 tax credit for retaining qualified individuals. The workers must be employed by the employer for a period of not less than 52 consecutive weeks, and their wages for such employment during the last 26 weeks of the period must equal at least 80% of the wages for the first 26 weeks of the period.

The IRS had issued guidance on these tax breaks in the form of frequently asked questions (FAQs). Updated FAQs explain: when an employee is considered to begin work; how the exemption can be claimed for a new hire who replaces a prior employee; that the exemption can be taken for someone who was self-employed for the entire 60-day lookback period; that minors may sign the HIRE Act employee affidavit (Form W-11); and what counts as wages for the retention credit.

Longer NOL carryback option for businesses-guidance available. The IRS has issued guidance in a question and answer (Q&A) format to address a number of specialized issues that have arisen under the new optional longer net operating loss (NOL) carryback period that was provided by the Worker, Homeownership, and Business Assistance Act of 2009 (WHBAA). Under WHBAA, an irrevocable

election of a 3, 4, or 5-year carryback period for an applicable NOL for a tax year ending after Dec. 31, 2007, and beginning before Jan. 1, 2010, is generally available for one tax year (except for an eligible small business (ESB) loss). The WHBAA election is an expansion of the increased carryback period election provided by the American Recovery and Reinvestment Act of 2009 (ARRA), which was available only to ESBs, and only for 2008 NOLs. The guidance addresses many questions left unanswered by the statutory provisions. For example, it makes clear that if a taxpayer previously made an ARRA election, it doesn't have to continue to qualify as an ESB in the year of the WHBAA NOL in order to make a WHBAA election. A taxpayer must qualify as an ESB only for the tax year of the ARRA election. Also, the IRS has revised the Instructions for Form 1139, Corporation Application for Tentative Refund (Rev. August 2010), to explain how businesses make the WHBAA election.

Relief for homeowners with corrosive drywall. As widely reported in media over the past year, the housing boom caused a lot of drywall to be imported (mainly from China) which proved to contain excess sulfur causing corrosion in the structure into which it was installed. The IRS is allowing individuals with corrosive drywall to apply a safe harbor formula to treat the costs of repairing the defective drywall as a casualty loss. The safe harbor applies for original and amended federal income tax returns filed after Sept. 29, 2010. Reported problems have occurred with certain imported drywall installed in homes between 2001 and 2008. Homeowners have reported blackening or corrosion of copper electrical wiring and copper components of household appliances, as well as the presence of sulfur gas odors. In the case of any individual who pays to repair damage to his personal residence or household appliances that results from corrosive drywall, the IRS won't challenge his treatment of damage resulting from corrosive drywall as a casualty loss (which might otherwise be difficult to achieve under the regular rules) if the loss is determined and reported under the safe harbor rule. A taxpayer who does not have a pending claim for reimbursement may claim as a loss all unreimbursed amounts paid during the tax year to repair damage to his personal residence and household appliances resulting from corrosive drywall. A taxpayer who has a pending claim (or intends to pursue reimbursement) may claim a loss for 75% of the unreimbursed amount paid during the tax year to repair damage to the taxpayer's personal residence and household appliances that resulted from corrosive drywall.

Regulations on election to defer COD income. For debt discharges in tax years ending after Dec. 31, 2008, a taxpayer may elect to have any cancellation of debt (COD) income from the reacquisition of an applicable debt instrument after Dec. 31, 2008, and before Jan. 1, 2011, included in gross income ratably over five tax years. The IRS has issued two sets of regulations on this rule: one applies to C corporations, the other applies to partnerships and S corporations. The regulations cover many complicated issues that arise with the election. For example, the C corporation regulations cover topics such as acceleration of deferred cancellation of debt (COD) income and deferred original issue discount deductions, and the calculation of earnings and profits as a result of making an election.

Financial reform package changes mark-to-market rule. The "Restoring American Financial Stability Act of 2010" was signed into law on July, 21, 2010. This landmark financial reform package contained a tax provision broadening the list of contracts that are excepted from mark-to-market treatment. Taxpayers must report gains and losses from regulated futures contracts and other "Section 1256 contracts" on an annual basis under the "mark-to-market" rule. The term Section 1256

contract means: regulated futures contracts, foreign currency contracts, nonequity options, dealer equity options, and dealer securities futures contracts. It does not include any securities futures contract or option on such a contract unless the contract or option is a dealer securities futures contract. Under the new law, for tax years beginning after July 21, 2010, all of the following also are excepted from the definition of a Section 1256 contract: any interest rate swap; currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement.

Reporting changes for uncertain tax positions finalized and liberalized. The IRS has released a final Schedule UTP (Form 1120), Uncertain Tax Position Statement, and an announcement detailing many liberalizations to the reporting requirements, which initially apply only to large corporations. In addition, the agency has taken steps to protect taxpayer communications with practitioners and to ensure that the program is properly applied by its own personnel. The key changes include: a five-year phase-in of the reporting requirement based on a corporation's asset size; no reporting of a maximum tax adjustment; no reporting of the rationale and nature of uncertainty in the concise description of the position; and no reporting of administrative practice tax positions.

Over-the-counter drug costs will no longer be reimbursable. Effective Jan. 1, 2011, unless prescribed or insulin, the cost of over-the-counter medicines cannot be reimbursed from flexible spending arrangements (FSA), health reimbursement arrangements (HRA), Health Savings Accounts (HSA) and Archer Medical Savings Accounts (Archer MSA). The IRS has issued guidance explaining that an individual may be reimbursed for over-the-counter medicines or drugs, so long as the individual obtains a prescription for the medicines or drugs. It also makes clear that expenses incurred for over-the-counter medicines or drugs purchased without a prescription before Jan. 1, 2011 may be reimbursed tax-free at any time by an employer-provided plan, including an FSA or HRA, under the terms of the employer's plan.

Simplified per diem rates lowered effective Oct. 1, 2010. Reimbursements of an employee's business travel costs (lodging, meal and incidental expenses (M&IE)) at a per diem rate are payroll- and income-tax free if simplified substantiation is provided and the daily rate doesn't exceed the federal per diem rate (the maximum amount that the federal government reimburses its employees) for the locality of travel for that day. While the per diem rates vary by travel destination, employers can make reimbursements at the simplified "high-low" per diem rates, which assign one per diem rate to high-cost areas within the continental U.S., and another to non-high-cost areas. The IRS has issued the "high-low" simplified per diem rates for post-Sept. 30, 2010, travel. An employer may reimburse up to \$233 for high-cost localities (\$168 for lodging and \$65 for M&IE) and \$160 for other localities (\$108 for lodging and \$52 for M&IE). The list of high-cost areas is also updated.