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Practice Areas

Taxation

Good Company

Significant Tax Developments During the First Quarter of 2010

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Most of our Good Company subscribers are probably aware that enactment of the recent health reform legislation included changes in the tax law. The health care debate so dominated the news that it would have been easy to miss other tax developments during the first quarter of 2010, including passage of the Hiring Incentives to Restore Employment Act (the "HIRE Act"), which created a tax credit to spur job creation this year. In this article, we will look at the impact on small businesses of the tax provisions of the health reform legislation and the major provisions of the HIRE Act, as well as other non-legislative tax developments that could affect you.

Tax Provisions in the Health Reform Legistlation Affecting Small Businesses

Small business owners and their employees may be affected by tax law changes included in the recently enacted health reform legislation. The major changes involve tax credits, excise taxes, and penalties. Whether these changes will affect a business depends on a variety of factors, such as the number of employees the business has.

Tax credits for certain small employers that provide insurance

The new law provides small employers with a tax credit (*i.e.*, a dollar-for-dollar reduction in tax) for non-elective contributions to purchase health insurance for their employees. The credit can offset an employer's regular tax or its alternative minimum tax liability.

Employers eligible for the credit. To qualify, a business must offer health insurance to its employees as part of their compensation and contribute at least half the total premium cost. The business must have no more than 25 full-time equivalent employees ("FTEs"), and the employees must have annual full-time equivalent wages that average no more than $50,000. However, the full amount of the credit is available only to an employer with 10 or fewer FTEs and whose employees have average annual full-time equivalent wages from the employer of less than $25,000.

Years the credit is available. The first phase of the credit is available for any tax year beginning in 2010, 2011, 2012, or 2013. Eligible small employers claiming the credit during this phase must have "qualifying health insurance," defined as health insurance coverage purchased from an insurance company licensed under state law. For tax years beginning after 2013, the credit is only available to eligible small employers that purchase health insurance coverage for their employees through a state

exchange. While the credit for this second phase is only available for two years, the maximum two-year coverage period does not take into account any tax years beginning in years before 2014. Thus, eligible small employers could potentially qualify for this credit for six tax years - four years under the first phase and two years under the second phase.

Calculating the amount of the credit. For tax years beginning in 2010, 2011, 2012, or 2013, the credit is generally 35% of the employer's non-elective contributions toward the employees' health insurance premiums. For tax years beginning after 2013, it is generally 50% of the same contributions. However, in both cases, the credit phases out as firm-size and average wages increase.

Additional Deduction. The employer is also entitled to an "ordinary and necessary" business expense deduction equal to the amount of the employer contribution minus the dollar amount of the credit. For example, if an eligible small employer pays 100% of the cost of its employees' health insurance coverage and the amount of the tax credit is 50% of that cost (*i.e.*, in tax years beginning after 2013), the employer can claim a deduction for the other 50% of the premium cost.

Limitations. Self-employed individuals, including partners and sole proprietors, two percent shareholders of an S corporation, and five percent owners of the employer are not treated as employees for purposes of this credit. There is also a special rule to prevent sole proprietorships from receiving the credit for the owner and his or her family members. Thus, no credit is available for any contribution to the purchase of health insurance for these individuals and the individual is not taken into account in determining the number of FTEs or average full-time equivalent wages.

Small business exemption from penalties for not offering coverage to employees

The new law imposes penalties on certain businesses for not providing coverage to their employees (the so-called "pay or play" penalty). However, most small businesses will not have to worry about this provision because the penalty does not apply to employers with fewer than 50 employees. For businesses with at least 50 employees, the possible penalties vary depending on whether or not the employer offers health insurance to its employees. These provisions take effect January 1, 2014.

The excise tax on high-cost health plans

The new law also places an excise tax on high-cost employer-sponsored health coverage. Specifically, it is a 40% excise tax on insurance companies, based on premiums that exceed certain amounts. The tax is not imposed directly on employers themselves unless they are self-funded. However, it is expected that employers and workers will ultimately bear this tax in the form of higher premiums passed on by insurers.

Provisions of the HIRE Act Affecting Small Businesses

Tax credit to spur job creation

The HIRE Act provides businesses with an exemption from paying Social Security tax this year for workers hired after February 3, 2010 and before January 1, 2011, if they had been unemployed for at least 60 days. The maximum value of the credit would be equal to 6.2 percent of wages up to $106,800, which is the FICA wage cap. The Medicare tax still applies, and new hires who replace employees qualify for the credit only if those workers quit or were terminated for cause. Businesses will also get a credit of up to $1,000 for each of those workers kept on at least one year.

Extension of Higher Expensing Limits on Depreciable Property

The act also extends the Section 179 expensing limits through this year. The extension permits qualifying

businesses to write off up to $250,000 of assets placed in service in 2010. Full expensing will be available until over $800,000 of assets are put in use.

Other Selected Developments in the Tax Law

Employment tax audits

As of February 2010, the IRS has commenced the Employment Tax Audit Initiative (the “Initiative”) targeted at determining whether employers pay all their required employment taxes to fund Social Security and Medicare benefits. The Initiative will involve IRS audits of 6,000 randomly selected U.S. companies over the next three years (2,000 each year), in addition to the 60,000 employment tax audits the IRS annually conducts. The IRS will select large and small employers for the Initiative and is training seasoned employment tax auditors specially for the Initiative. Employers will know if they are being audited as part of the Initiative if they receive a “Letter 3850-B” or a letter indicating that they are subject to a “compliance research examination.”

The Initiative will provide data for a study of employment tax compliance intended to help reduce the size of the “tax gap” - the difference between the tax the IRS estimates is due and the amount actually paid by taxpayers. The audits are expected to focus on ensuring that all employers and workers are “in the system” (*i.e.*, they are filing timely, accurate, and fully paid returns), workers are properly classified as employees or independent contractors, all remuneration subject to employment tax is reported (*e.g.*, fringe benefits and reimbursements are properly reported) and that compensation paid to an S corporation shareholder/employee is not set at an unreasonably low amount to reduce employment tax liability.

Availability of passive activity losses for LLC members

Over the past few years the IRS has lost a string of cases involving the ability of LLC members to qualify as materially participating in a passive activity. An LLC member who materially participates in the LLC’s business activity can deduct losses that would otherwise be suspended under the passive activity loss rules. In each of the cases, the IRS argued that an LLC member should be treated the same as a limited partner in determining how to apply the regulations that govern whether an owner of an interest in a passive activity materially participates in the activity. The IRS regulations provide seven ways in which an owner of an interest in a passive activity can qualify as materially participating. Limited partners are only allowed to take advantage of a few of those.

In March 2010, the IRS announced that it would no longer litigate this issue and that it will be issuing guidance in the next few months to reflect the fact that LLC members will not be treated as limited partners for this purpose. As a result, LLC members, unlike limited partners, will be able to qualify as materially participating in an activity, not only if they participate in the activity for 500 hours or more per year, but also if they satisfy any one of several other standards that involve special circumstances and as little as 100 hours of participation per year.

Reporting of uncertain tax positions

You may have heard that the IRS has announced that it is developing a schedule to require certain business taxpayers to report uncertain tax positions on their tax returns (the “Schedule”). While you may be familiar with reporting uncertain tax positions for financial reporting purposes under Financial Accounting Standards Board Interpretation (FIN) No. 48, the tax filing rules for the Schedule will involve different standards. In particular, if your company has total assets of $10 million or less, this reporting requirement will not apply. If you exceed the filing threshold, however, the Schedule will require a concise description of those positions and information on the maximum amount of potential federal tax liability attributable to each uncertain tax position (determined without regard to the taxpayer's risk analysis regarding its likelihood of prevailing on the merits). The Schedule would be filed with the appropriate federal business tax return. The IRS plans to require the filing of the new Schedule for returns relating to the calendar year 2010 and for fiscal years that begin in 2010, but only for certain U.S. and foreign corporations. The IRS will announce the first year of filing for other businesses, such as LLCs,

partnerships, tax-exempt organizations, regulated investment companies and real estate investment trusts, after it has received and considered comments.

Like-kind exchange relief for those snared by Qualified Intermediaries in bankruptcy or receivership

In general, no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of a like kind which is held either for productive use in a trade or business or for investment. In like-kind exchanges in which the properties are not exchanged simultaneously, the taxpayer will generally transfer property to a qualified intermediary (a "QI"), which will then sell the property to a buyer, use the proceeds from that sale to purchase like-kind property (the "replacement property") and transfer the replacement property to the taxpayer. If the taxpayer receives the replacement property within a specified period and meets other requirements, the transaction will be treated as a like-kind exchange of property with the QI and the taxpayer will not recognize gain on the exchange.

Unfortunately, many QIs went bankrupt in the last few years, posing a problem for taxpayers who used them. However, the IRS has now granted relief for taxpayers who were unable to timely complete a like-kind exchange because their QI entered into bankruptcy or receivership. The IRS will not treat taxpayers as being in actual or constructive receipt of exchange proceeds if they cannot complete an exchange because of the default of a QI in bankruptcy or receivership. Affected taxpayers may use a special safe harbor method to report gain or loss.

Estate planning uncertainty

As of this writing, there is still no estate or generation-skipping transfer tax for individuals who die this year. (See the previous issue of Good Company for a full discussion of how this occurred). Because of changes to the income tax basis rules for property acquired from a decedent in 2010, however, some heirs could actually face higher combined estate and income tax costs if their loved one dies in 2010 than would have been the case if death had occurred in 2009. Congress could still retroactively reinstate the estate and generation-skipping transfers taxes to the beginning of this year and restore the favorable prior income tax basis rules that wipe out income tax on pre-death appreciation in asset values. But, so far, there is no clear indication of what lawmakers will do. Apart from tax uncertainty, the continuing inaction could also pose a problem for individuals with wills using formula clauses. These clauses work well when the estate tax is in force, but they may produce unintended consequences when there is no estate tax. Action may need to be taken if it becomes clear that Congress will not be addressing the situation.

Chances of being audited

The IRS has issued its annual data book, providing statistical data on its fiscal year 2009 activities, including how many tax returns it audited broken down by categories. Of the 138,788,744 total individual income tax returns with a filing requirement (this excludes returns filed only to receive an economic stimulus payment) in calendar year 2008, 1,425,888 (1%) were audited. For business returns other than farm returns showing total gross receipts of $100,000 to $200,000, 4.2% were audited. For business returns other than farm returns showing total gross receipts of $200,000 or more, 3.2% were audited. For returns showing total positive income of $200,000 to $1 million, 2.3% not showing business activity were audited, and 3.1% showing business activity were audited.

Even by the standard of the past few years, which saw many substantial changes to the federal tax laws, the first quarter of 2010 was an especially active time. And we have not yet seen the end of tax legislation for 2010. Congress is still considering many other tax changes that are likely to be enacted before the end of the year. Given the pace of change already this year, it may be prudent to check in with your tax or corporate lawyer to ensure that you and your business are taking maximum advantage of these changes and others yet to come.

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