2010 Regional Forums
Employee Benefits and Employment Taxes

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7.) **IRS Announces 2010 COLA Limits For Qualified Plans, (Oct. 22, 2009)** ***IR-2009-94*** © 2010, CCH INCORPORATED. All Rights Reserved. A WoltersKluwer Company
8.) **CCH Federal Tax Weekly, Practitioners' Corner: Businesses Brace For IRS Employment Tax Compliance Audit Project, (Sep. 17, 2009)** © 2010, CCH INCORPORATED. All Rights Reserved. A WoltersKluwer Company
9.) **Social Security wage base remains at $106,800 for 2011 Social Security News Release, 10/15/2010** © 2010 Thomson Reuters/RIA. All rights reserved.
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1. Federal Tax Day - Current, Code Sec 132: Clothing Provided to Employees Was De Minimis Fringe Benefit (LTR 201005014), (Feb. 8, 2010) © 2010, CCH INCORPORATED. All Rights Reserved. A WoltersKluwer Company

The value of articles of clothing and accessories provided by a political subdivision of a state to employees was excluded from the employees' gross income as de minimis benefits under Code Sec. 132. The employees were required to wear the clothing while providing services for the taxpayer. The items were of low value, and the taxpayer demonstrated that it was unreasonable to account for the value of the items because tracking the fair market value of the items would have resulted in substantial administrative costs. Furthermore, the information that the taxpayer provided objectively supported the notion that the values of the items, taking into consideration the frequency with which employees received them, were so small that the costs of accounting for them would be administratively impracticable.

IRS Letter Rulings and TAMS (Current),UIL No. 0132.04-00 Certain fringe benefits; De minimus fringe. IRS Letter Ruling 201005014 (Oct. 28, 2009),Internal Revenue Service, (Oct. 28, 2009)

LTR 201005014, October 28, 2009

Symbol: CC:TEGE:EOEG:ET2-PLR-122803-09

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[Code Sec. 132]

Certain fringe benefits; De minimus fringe.

This is in response to a letter dated April 23, 2009, and supplemented by letters dated June 30, August 20, and September 15, 2009, submitted on behalf of Taxpayer by its authorized representative, requesting a ruling that the value of certain articles of clothing and accessories provided by Taxpayer to employees are excluded from gross income as de minimis fringe benefits under Internal Revenue Code (Code) section 132(a)(4). The ruling contained in this letter is based upon information and representations submitted by Taxpayer, and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of this request for ruling, such material is subject to verification upon examination. The information submitted in the request is substantially as set forth below.

FACTS

Taxpayer is a political subdivision in State A. It is divided into departments, several of which are further divided into divisions and sections (collectively, departments).

FACTS

Taxpayer is a political subdivision in State A. It is divided into departments, several of which are further divided into divisions and sections (collectively, departments).

Taxpayer has over X employees, many of whom are eligible to receive work-related articles of clothing and accessories, including tee shirts, polo shirts, sweaters, jackets, swimsuits, socks, sweatshirts, coats, pants, jeans, shorts, gloves, hats, fanny packs, belts, clip-on ties, and equipment bags. Most of the items bear Taxpayer's logo or other information identifying the individual as an employee of Taxpayer. Employees are required to wear the clothing items while performing services for Taxpayer.

Taxpayer's departments may secure items annually under a contract system that begins when the City Council—which is Taxpayer's legislative branch that is responsible, in part, for adopting annual operating and capital budgets—appropriates an amount for Taxpayer to spend on clothing. Vendors then submit bids to provide particular items, such as tee shirts, that, if accepted, comprise contracts under which any department may order the item. These contracts rarely enumerate either the precise number of items that Taxpayer will collectively order, or the precise cost of each item, but do usually specify a maximum number of items that Taxpayer may order. Esca-

lation clauses and variations in the material and size of an item can cause the cost of an item to vary, for example by allowing a vendor to charge one amount for a tee shirt in year one, but to charge a different amount for the same tee shirt in year two. Even within the same year, it is possible for a vendor to charge different amounts for a medium tee shirt as compared to an otherwise-identical large tee shirt, or for a medium tee shirt of one material grade and a medium tee shirt of a higher grade.

Once a vendor contract has been authorized, departments may secure items by ordering them directly from the vendors. The vendors submit invoices to the departments' fiscal officers, who forward them to the City Auditor after confirming that the goods were received. The City Auditor pays the invoice.

Storeroom supervisors issue items to employees in accordance with department policies. Department policies typically entitle employees to items both when they commence their employment and when they need replacements.

The exact frequencies with which the policies entitle new employees to receive items vary. Some, for example, limit new employees to a single provision of a particular item. Taxpayer provided the text of one collective bargaining agreement which requires the department to “provide an initial issue of rain jacket and rain pants to all [of its] refuse collectors.” Other departments' policies, however, allow new employees to receive multiple provisions of particular items upon hiring. Replacement items are typically distributed on an “as” or “if” needed basis.

Additionally, different categories of employees may be entitled to different quantities of an item. Variables affecting the number of items any individual employee receives can include employment status (e.g., full-time, part-time, seasonal, volunteer, etc), job function, and department. For example, Department A's “Garment Distribution and Replacement” policy bases the number of tee shirts that it distributes to instructors on the number of hours that those instructors work—instructors who work twelve hours per week or more receive three tee shirts; those who work six to eleven hours receive two tee shirts, and those working one to five hours per week receive one tee shirt. As another example, Section A's policy categorically allows full-time, part-time, and seasonal employees to receive certain items, but allows other employees to receive them only “as established by the Director or designee.” Finally, some departmental policies allow employees to wear appropriate personal clothing in lieu of the Taxpayer-provided clothing items to which they are entitled.

Because departments do not typically distribute every item ordered in a year, many store items for future use. Taxpayer cannot enumerate the particular number of items that each employee receives each year. However, it has represented “that the items generally are provided to employees no more frequently than annually,” and, as part of its submission, has also provided copies of department polices and a table that are consistent with this representation. The table summarizes the number of items each department ordered, the number of items each department issued, and the number of employees entitled to receive the items. The table indicates that, in most instances, individual employees receive less than one item per year. That is, the number of employees eligible to receive a given item typically exceeded the number of items distributed by the department.

RULING REQUESTED

The values of articles of clothing and accessories provided by Taxpayer to employees (as specified in the table included as part of Taxpayer's submission) are excluded from gross income as de minimis fringe benefits under Code section 132(a)(4).

LAW

Code section 61(a)(1) provides that gross income means any income from whatever source derived, including, but not limited to, compensation for services including fringe benefits.

Code section 132(a)(4) states that gross income does not include the value of a de minimis fringe benefit provided to an employee. Code section 132(e)(1) states:

The term “de minimis fringe” means any property or service the value of which is (after taking into account the frequency with which similar fringes are provided by the employer to the employer's employees) so small as to make accounting for it unreasonable or administratively impracticable.

Section 1.132-6(b)(1) of the Treasury Regulations states:

Generally, the frequency with which similar fringes are provided by the employer to the employer's employees is determined by reference to the frequency with which the employer provides the fringes to each individual employee. For example, if an employer provides a free meal in kind to one employee on a daily basis, but not to any other employee, the value of the meals is not de minimis with respect to that one employee even though with respect to the employer's entire workforce the meals are provided “infrequently.”

Section 1.132-6(b)(2) of the Treasury Regulations states:

Notwithstanding the rule of paragraph (b)(1) of this section … where it would be administratively difficult to determine frequency with respect to individual employees, the frequency with which similar fringes are provided by the employer to the employer's employees is determined by reference to the frequency with which the employer provides the fringes to the workforce as a whole. Therefore, under this rule, the frequency with which any individual employee receives such a fringe benefit is not relevant and in some circumstances, the de minimis fringe exclusion may apply with respect to a benefit even though a particular employee receives the benefit frequently. For example, if an employer exercises sufficient control and imposes significant restrictions on the personal use of a company copying machine so that at least 85 percent of the use of the machine is for business purposes, any personal use of the copying machine by particular employees is considered to be a de minimis fringe.

Section 1.132-6(c) of the Treasury Regulations states:

Unless excluded by a provision of chapter 1 of the Internal Revenue Code of 1986 other than section 132(a)(4), the value of any fringe benefit that would not be unreasonable or administratively impracticable to account for is includible in the employee's gross income. Thus … the provision of any cash fringe benefit is never excludable under section 132(a) as a de minimis fringe benefit. Similarly … a cash equivalent fringe benefit (such as a fringe benefit provided to an employee through the use of a gift certificate or charge or credit card) is generally not excludable under section 132(a) even if the same property or service acquired (if provided in kind) would be excludable as a de minimis fringe benefit. For example, the provision of cash to an employee for a theatre ticket that would itself be excludable as a de minimis fringe … is not excludable as a de minimis fringe.

ANALYSIS

The Code and Regulations require Taxpayer to establish that the value of the items it seeks to exclude as de minimis fringes is so low as to make accounting for them administratively impracticable. Neither the Code nor the Regulations specify a particular value above which an item can no longer be considered a de minimis fringe.

Even an item with a low value may not be a de minimis fringe if an individual receives it too frequently. Code section 132(e) therefore requires Taxpayer to establish that it does not provide items so frequently that the aggregate value is not de minimis. Section 1.132-6(b)(1) of the Treasury Regulations generally requires taxpayers to establish this frequency by referencing the frequency with which the employer provides the fringes to each individual employee (the "employee-measured" frequency standard). If the taxpayer can establish that it would be administratively difficult to determine such employee-measured frequency, it may instead reference the frequency with which the employer provides the fringes to the workforce as a whole, under section 1.132-6(b)(2) of the Treasury Regulations (the "employer-measured" frequency standard).

Finally, Taxpayer must establish that it would be unreasonable or administratively impracticable to account for the value of the items. It is for this reason that section 1.132-6(c) of the Treasury Regulations specifies that employer provisions of cash or equivalents are generally not excludable under Code section 132(c), even if the same property or service acquired (if provided in kind) would be excludable as a de minimis fringe—there are little-to-no administrative costs associated with accounting for the fair market value of a cash-denominated item.

Applying the facts to these standards, the items that Taxpayer has provided to its employees qualify as de minimis fringe benefits under Code section 132(e). Taxpayer has provided evidence objectively demonstrating that the items are of low value, were not distributed too frequently, and it would be administratively impracticable to account for the value of the items.

Value of Benefits

The items identified by Taxpayer are of low value. Using the cost of the items as an approximation of their values, it is reasonable to conclude that the items listed in Taxpayer's ruling request are de minimis fringes if Taxpayer can also establish both that the frequency with which the items were distributed does not preclude such a finding, and that it would be administratively impracticable to account for each item's value.

Frequency with which Taxpayer Distributed Benefits

It is appropriate for Taxpayer to use the employer-measured frequency standard. As discussed earlier, section 1.132-6(b)(2) of the Treasury Regulations states that the employer-measured frequency standard is available to Taxpayer if it can establish that it would be administratively difficult for it to use the employee-measured frequency standard. Whether the frequency determination is administratively difficult is based on an objective demonstration of difficulty, not an unsupported assertion. Further, an employer cannot tailor its procedures to make accounting for fringe benefits administratively difficult for the purpose of achieving de minimis fringe benefit treatment. American Airlines v. United States, 40 Fed. Cl. 712, 725 (Ct. Cl. 1998) [98-1 USTC ¶50,323], aff'd, 204 F.3d 1103, 1112

(Fed. Cir. 2000) [2000-1 USTC ¶50,236] (stating that "difficulty caused by the employer's chosen accounting system … does not constitute administrative impracticability"). In this case, Taxpayer has established administrative difficulty by providing objective evidence that the costs associated with determining employee-measured frequency would exceed the nominal tax revenue generated by including the value of the benefits in income.

In particular, Taxpayer's submission indicates that the administrative costs it would have to incur to establish employee-measured frequency include requiring department storerooms to track the number of items that each employee received, maintaining records for each employee, and routinely transmitting the records to fiscal officers. These records would also have to be provided for payroll departments and the City's auditor. Adding additional difficulty are the facts that (1) many departments—particularly those that provide the items on an "as-needed" basis—do not distribute items at regular intervals; (2) Taxpayer provides many items to volunteers, a population whose receipt of employer-provided items is inherently difficult to track; and (3) Not all employees opt to receive all items which they are entitled to receive under departmental policies.

The relevant inquiry for purposes of determining employer-measured frequency is not the frequency with which each individual employee actually received the benefits, but the frequency with which all employees collectively received the benefits. Section 1.132-6(b)(2) of the Treasury Regulations. Generally, this analysis requires determining the number of times particular or similar benefits were provided to the work force as a whole.

Taxpayer's submission summarizes departmental policies that enumerate the maximum number of items that employees may receive in a given year. These policies typically entitle employees to items when hired and replacements on an as needed basis. We do not consider the provision of the items once, or perhaps twice, annually as so frequent that, given the low value of each item, the provision could not properly be characterized as de minimis.

Administratively Impracticable to require Taxpayer to Account

Although the determination of administrative impracticability is inherently a function of facts and circumstances, one objective guidepost exists where the administrative costs associated with determining the value of the benefit and accounting for it may be more expensive than providing the benefit.

As shown above, neither the values of the items, nor the frequencies with which Taxpayer provides these items to employees, independently prevent these items from qualifying as de minimis fringes. These items will, therefore, fail to qualify as de minimis fringe benefits only if the administrative costs of accounting for their fair market values is so low that requiring Taxpayer to make such an accounting is not unreasonable or administratively impracticable. Taxpayer's submission, however, demonstrates based on objective data that Taxpayer would have to incur substantial administrative costs to account for the fair market value of each item.

Establishing a system to track each individual item's cost would be expensive. Such accounting would be impossible unless vendors provided invoices detailing the particular types and amounts of clothing that each department purchased. Taxpayer has indicated that vendors do not presently provide such detailed invoices, and do not possess the resources to provide such invoices. Vendors would undoubtedly pass at least some portion of the recordkeeping costs associated with establishing such a system to Taxpayer.

And it would be even more burdensome to require Taxpayer to account for each item's fair market value, as the Code and Regulations require. Simply requiring Taxpayer to pinpoint each item's fair market value would be difficult, as the variables discussed above—such as escalation clauses and variations in clothing sizes and materials—which cause items' costs to vary, would also cause items' fair market values to vary. Because most of the items bear Taxpayer's insignia or other writing, there may not be a readily ascertainable fair market value for the items, making it even more difficult for Taxpayer to determine fair market value. Complicating matters even further is the fact that Taxpayer cannot measure administrative impracticability—and thus each item's fair market value—until it actually provides the benefits. Thus, although it would likely be most efficient for Taxpayer to determine these items' values when it received large quantities of them, Taxpayer would have to forgo making this determination until the time at which it actually distributed the items. This would be the only way for Taxpayer to ensure that employees' Forms W-2, Wage and Tax Statements, accurately reflected the items' values.

Taxpayer would also have to incur costs to maintain records of the fair market value of each item that each employee received. Its necessarily large and bureaucratic structure would, however, make this process costly. Taxpayer has determined that this tracking process would require a storeroom worker to complete a form every time an employee received an item. This form would have to identify the employee, the item received, the date received, and the item's fair market value. Storerooms would have to maintain these records, and routinely (which Taxpayer defines as most likely weekly) prepare reports and transmit copies of the records to their department's fiscal officer. The fiscal officer would have to transfer the forms to the payroll department for a preliminary calculation of the taxable amount to be added to each employee's wages. Taxpayer would ultimately have to transfer all information—including copies of each paper form—to its Auditor's office for a final review. The Auditor's office would have to add the appropriate amount to each employee's wages. Each department would have to maintain copies of associated forms and records for many years.

Although many of the administrative costs discussed above are a result of Taxpayer's large and decentralized structure, it is notable for the purposes of a de minimis fringe analysis that there is no indication that Taxpayer designed this system with an intent to make it administratively impracticable to track the items' values. Rather, the size and nature of Taxpayer's operations necessitates such an administrative structure. This objectively supports Taxpayer affirmative representation that “the difficulty in accounting for the provision of the items at issue herein is not of [Taxpayer's] own making.”

To summarize, Taxpayer has demonstrated that it is unreasonable to account for the value of the items because it would have to incur substantial administrative costs to track the fair market value of each item it provides to its employees. The information it has provided objectively supports the notion that these items' values—while taking into consideration the frequency with which employees receive them—are so small that the administrative costs that would be associated with accounting for them would make such an accounting administratively impracticable.

RULING

Based on the information submitted and the representations made, we rule that the values of articles of clothing and accessories provided by Taxpayer to employees (as specified in the table included as part of Taxpayer's submission) are excluded from gross income as de minimis fringe benefits under Code section 132(a)(4).

This private letter ruling is directed only to Taxpayer, who requested it. Code section 6110(k)(3) provides that it may not be used or cited as precedent.

A copy of this letter ruling must be attached to any federal income tax return to which it is relevant.

Sincerely, Paul Carlino, Senior Technician Reviewer, Employment, Tax Branch 2, Tax Exempt and Government Entities.

2. CCH Federal Tax Weekly, Effective Date Of Transportation Benefit Electronic Media Rules Delayed To 2011, (Dec. 17, 2009) ***Notice 2009-95*** © 2010, CCH INCORPORATED. All Rights Reserved. A WoltersKluwer Company

For the third time in three years, the IRS has delayed the effective date of guidance (Rev. Rul. 2006-57) on employer-provided transportation benefits using smartcards, debit or credit cards, or other electronic media. The delay is intended to give mass transit operators more time to update their systems for the new rules. The new effective date of Rev. Rul. 2006-57 is January 1, 2011.

Background

Rev. Rul. 2006-57 explains when employer-provided transportation benefits using smart cards, debit or credit cards, or other electronic media qualify as transportation fringe benefits. The value of transit pass benefits provided to employees through the use of a "smartcard" purchased from a transit company is a qualified transportation fringe benefit if the card is usable only as fare media.

Additionally, the value of transit pass benefits provided through the use of a terminal-restricted debit card purchased from a third party is a qualified transportation fringe benefit if the card may only be used at points of sale where nothing other than fare media is sold. If a terminal-restricted debit card may be used to purchase items other than fare media, the value of the transit pass benefits is a qualified transportation fringe benefit only if the card is used in connection with a bona fide reimbursement arrangement.

Delay

Rev. Rul. 2006-57 had an original effective date of January 1, 2008. Many mass transit systems told the IRS that they needed more time to modify their technology to make it compatible with the requirements of Rev. Rul. 2006-57.

Comment

Taxpayers may rely on Rev. Rul. 2006-57 with respect to transactions occurring before January 1, 2011.

3. ***Rev. Proc. 2010-10*** **IRS Releases 2010 Auto And Truck Fringe Benefit Maximum FMVs For Cents-Per-Mile And Fleet** © 2010, CCH INCORPORATED. All Rights Reserved. A WoltersKluwer Company

Average Valuation

The IRS has released 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. Reversing the trend set from 2008

to 2009, the 2010 values for both valuation rules are higher than the 2009 values.

CCH Take Away. The value of the fringe benefit from personal use of a company vehicle may be computed by multiplying the number of miles driven for personal purposes by the standard mileage rate. However, among other requirements, the cents-per-mile rule cannot be used to value an automobile whose fair market value, as of the first day on which it is made available to any employee for personal use, exceeds certain amounts set under Reg. §1.61-21(d) and (e). The consumer price indices needed to compute the automobile and truck/van values for 2010 were available in mid-November. *CCH, a Wolters Kluwer business, correctly predicted those amounts at that time (see the November 25, 2009 issue of this newsletter).*

Cents-per-mile valuation

One of the permitted methods of valuation an employer can use to value the personal use of an employer-provided automobile is the mileage allowance rate, which for 2010 is 50 cents-per-mile. The maximum FMVs for use of the vehicle cents-per-mile valuation rule in 2010, as provided in Rev. Proc. 2010-10, 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.

•Comment

The 2010 FMVs are higher than the 2009 FMVs. In 2009, the maximum FMVs were $15,000 for automobiles and $15,200 for trucks and vans. In 2008, the maximum FMVs for automobiles were $15,000, and $15,900 for trucks and vans.

Fleet-average valuation

An employer that maintains a fleet of at least 20 automobiles can value the FMV of each automobile as equal to the average value of the entire fleet. The fleet-average value is the average of all the FMVs of all vehicles in the fleet. The maximum FMVs for use of the fleet-average valuation rule in 2010 are:

- $20,300 for a passenger automobile; and
- $21,000 for a truck or van.

In 2009, the FMV for automobiles, trucks and vans was $19,900.

The fleet-valuation rule cannot be used if the value of any automobile in the fleet exceeds these values. Moreover, the fleet-valuation rule cannot be used if the number in the fleet declines to less than 20 for more than one-half of the days in any year.

4. *H.R. 4994, H.R. 4851* House Passes Taxpayer Assistance Act; Obama Signs Continuing Extension Act © 2010, CCH INCORPORATED. All Rights Reserved. A WoltersKluwer Company

Returning from their spring recess, House members passed the *Taxpayer Assistance Act of 2010 (TAA) (H.R). 4994* on April 14 and Senate lawmakers approved an extension of eligibility for COBRA premium assistance in the *Continuing Extension Act of 2010 (CEA) (H.R). 4851* on April 15. President Obama immediately signed the *CEA*. Before Memorial Day, Congress may act on finalizing a tax extenders bill, extend the estate tax and provide relief to victims of Ponzi schemes.

CCH Take Away. In a much welcomed development, the TAA would remove cell phones from the listed property rules. Listed property includes items for use in a business but which lend themselves easily to personal use. If a cell phone is used exclusively for business, all use is excludable from income (as a working condition fringe benefit). Any amount that represents personal use is included in the wages of the employee. However, if the employee owns the phone, the listed property requirements do not apply. Any amounts the employer reimburses the employee for business use of the employee's own phone may be excluded from wages if the employee accounts for the expense under the accountable plan rules.

5. Federal Tax Day - Current, 2010 Cost of Living Adjustments for Pension Plans Announced (Notice 2009-94), (Nov. 25, 2009) © 2010 CH INCORPORATED. All Rights Reserved. A WoltersKluwer Company

The IRS has announced cost-of-living adjustments (COLAs) applicable to dollar limitations on benefits under qualified retirement plans and to other provisions affecting such plans that take effect on January 1, 2010. The maximum limitation for the Code Sec. 415(b)(1)(A) annual benefit for defined benefit plans remains unchanged at $195,000, while the Code Sec. 415(c)(1)(A) limitation for defined contribution plans remains unchanged for 2010 at $49,000. Also, for participants who separated from service before January 1, 2010, the Code Sec. 415(b)(1)(B) limitation is computed by multiplying the participant's compensation limit, as adjusted through 2009, by 1.0000. The compensation amounts under Reg. §1.61-21(f)(5)(i) concerning the definition of "control employee" for fringe benefit valuation purposes remains unchanged at $95,000.

The annual compensation limit under Code Secs. 401(a)(17), 404(l), 408(k)(3)(C) and 408(k)(6)(D)(ii) remains unchanged at $245,000. The annual compensation limitation under Code Sec. 401(a)(17) for eligible participants in certain governmental plans that,

under the plan as in effect on July 1, 1993, allowed COLAs to the compensation limitation under the plan to be taken into account, remains unchanged at $360,000. Various other amounts were also adjusted.

Notice 2009-94, 2009FED ¶46,539

6. Federal Tax Day - Current, Farmer Denied Deduction for Medical Expense Reimbursements (Shellito, TCM), (Mar. 4, 2010) © 2010, CCH INCORPORATED. All Rights Reserved. A WoltersKluwer Company

A married farmer was denied a Schedule F deduction for medical expense and health insurance premium reimbursements paid to his spouse under a purported employee benefit plan since there was insufficient evidence that his spouse was his bona fide employee. The wife had worked on the farm for more than 20 years alongside her husband for no compensation. When they engaged the services of a certified public accountant, he advised them to establish an employee medical reimbursement plan and assisted them in the creation of the documents, including an employment agreement.

The farmer paid his spouse $100 per month after the employment agreement was executed, in addition to reimbursing her for medical expenses and insurance premiums that she continued to pay out of their joint checking account. The employment agreement was a mere formalism because nothing actually changed either in the behavior of the spouse or the payment of health expenses.

The accuracy-related penalty for substantial understatement of income tax was not imposed. The couple acted in good faith and had reasonable cause to rely on the advice of their accountant.

Tax Court Memoranda (Current), Milo L. and Sharlyn K. Shellito v. Commissioner., U.S. Tax Court, CCH Dec. 58,148(M), T.C. Memo. 2010-41, 99 T.C.M. 1160, (Mar. 3, 2010)

Milo L. and Sharlyn K. Shellito v. Commissioner.

U.S. Tax Court, Dkt. No. 10223-06, TC Memo. 2010-41, 99 TCM 160, March 3, 2010.

[Appealable, barring stipulation to the contrary, to CA-10.—CCH.]

[Code Secs. 162 and 6662]

Deductions: Reimbursements: Medical expenses: Penalties, civil: Substantial understatement of tax: Reasonable cause for reliance on professionals.–

A married farmer was denied a Schedule F deduction for medical expense and health insurance premium reimbursements paid to his spouse under a purported employee benefit plan since there was insufficient evidence that his spouse was his bona fide employee. The wife had worked on the farm for more than 20 years alongside her husband for no compensation. When they engaged the services of a certified public accountant, he advised them to establish an employee medical reimbursement plan and assisted them in the creation of the documents, including an employment agreement. The farmer paid his spouse $100 per month after the employment agreement was executed, in addition to reimbursing her for medical expenses and insurance premiums that she continued to pay out of their joint checking account. The employment agreement was a mere formalism because nothing actually changed either in the behavior of the spouse or the payment of health expenses. The accuracy-related penalty for substantial understatement of income tax was not imposed because the couple acted in good faith and had reasonable cause to rely on the advice of their accountant.—CCH.

Frank W. Bastian and Reggie L. Wegner, for petitioners; Peter N. Scharff, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

THORNTON, Judge: Respondent determined deficiencies of $3,995 and $6,947 in petitioners' 2001 and 2002 Federal income taxes, respectively, and a $1,389 accuracy-related penalty under section 6662(a) for 2002. [1] The issues for decision are:

(1) Whether petitioners are entitled for 2001 and 2002 to deduct under section 162(a) amounts they claimed for employee benefit programs on Schedules F, Profit or Loss From Farming; and (2) whether petitioners are liable for the section 6662(a) accuracy-related penalty for 2002.

FINDINGS OF FACT

The parties have stipulated some facts, which we incorporate herein. When they petitioned the Court, petitioners resided in Kansas. During the years at issue and for an unspecified period before then, petitioners were married, with two dependent children. Hereinafter, references to petitioner are to Milo Shellito and references to Mrs. Shellito are to Sharlyn Shellito.

Petitioner has engaged in a farming business since about 1978. In 2001 and 2002 his farming operation covered about 2,300 acres. Most of this land he leased from his father or other parties. Petitioners jointly owned about 47 acres. They also jointly owned three pickup trucks that were used on the farm. Petitioner individually owned other farm equipment, including a tractor and a combine.

Petitioners held a joint checking account. They each wrote checks from the account to pay expenses. During 2001, 2002, and prior years a number of commercial/agricultural loans were taken out to finance petitioner's farming operations. Both petitioners signed most of the promissory notes for the loans.

Mrs. Shellito has assisted on the farm since at least 1982. The nature of her services has remained fairly constant over time. Before, during, and after the years at issue her services included: Assisting with the planting and harvesting of crops; operating tractors and equipment; feeding and caring for cattle; building and repairing fencing; maintaining and performing basic equipment repairs; running various errands; and performing accounting and bookkeeping services. Before 2001, at least, Mrs. Shellito received no compensation for these services.

In 2001, upon the advice of his banker, petitioner engaged a certified public accountant (C.P.A.) to prepare taxes and perform payroll services for the farming business. The C.P.A. advised petitioner that he could qualify for an employee medical reimbursement plan if Mrs. Shellito were petitioner's employee. The C.P.A. created a document which petitioners signed on or about May 29, 2001. The document states:

EMPLOYMENT AGREEMENT

Agreement made effective as of May 29, 2001 by Milo Shellito to employee Sharlyn Shellito. Employer is engaged in the business of farming at the following address * * *

Employer employs, engages, and hires employee as a hired hand to operate farm machinery work and handle cattle, do repairs, run errands, and another farm related chores, and employee accepts and agrees to such hiring, engagement, and employment, subject to the orders, advice and directions of employer.

The employer has the right to terminate the employee at anytime. The employee has the right to quit at anytime.

The C.P.A. helped petitioners fill out a preprinted application for AgriPlan/BIZPLAN, a medical expense reimbursement plan, which offered medical expense reimbursements to eligible employees. Petitioner signed this application on May 29, 2001. The application lists Mrs. Shellito as the only eligible employee of petitioner. It indicates that available benefits for Mrs. Shellito were to consist of unlimited reimbursement of health insurance premiums for her and her family, reimbursement of up to $15,000 of out-of-pocket medical expenses for her and her family, and $50,000 of term life insurance for Mrs. Shellito. [2]

Also on May 29, 2001, an individual checking account was opened in Mrs. Shellito's name. Acting on the C.P.A.'s advice, on June 7, 2001, and each month thereafter in 2001 and 2002, petitioner wrote Mrs. Shellito a $100 check from their joint checking account, which she deposited into her individual checking account. The memo line on most of the checks and each accompanying deposit ticket stated that the check represented wages or salary. Mrs. Shellito used these funds to pay for medical care for herself, petitioner, and their dependent children.

2001 Items and Tax Treatment

For the part of 2001 after May 29, 2001, Mrs. Shellito paid $7,899 in expenses for medical care and health insurance premiums for herself, petitioner, and their dependent children, as follows:

Expense/Premium	***Amount***
Out-of-pocket medical expenses [1]	$4,671
Medical mileage	97
Insurance premiums [2]	*3,131*
Total	7,899

[1]This amount includes $4,479 that Mrs. Shellito paid from her separate checking account and $192 that she paid directly from petitioners' joint checking account.

[2]This $3,131 of insurance premiums comprised these three items: (1) $689 that Mrs. Shellito paid to Conesco Health Insurance Co. for

an insurance policy under which she was the primary insured; (2) $1,990 that Mrs. Shellito paid to American Republic Insurance Co. for an insurance policy under which petitioner was the primary insured; and (3) $452 that was automatically debited from petitioners' joint checking account for premiums paid to American Fidelity Insurance Co. for a cancer expense insurance policy that listed petitioner as the named insured.

Beginning July 18, 2001, and continuing periodically thereafter throughout 2001, petitioner wrote Mrs. Shellito checks totaling $5,400, drawn on their joint checking account. She deposited them in her separate checking account. The accompanying deposit tickets indicate that the deposits represented medical reimbursements from Mr. Shellito. [3]

On January 11, 2002, petitioners executed a document entitled “Employee Benefit Expense Transmittal”, which they sent to AgriPlan/BIZPLAN. In this document petitioner claimed eligible expenses incurred for eligible plan participants during 2001 of $10,323. [4] On February 20, 2002, AgriPlan/BIZPLAN sent a yearend report to petitioner. The report indicated that on the basis of a review of the Employee Benefit Expense Transmittal, the total submitted benefit expenses were $15,593 and that this amount could be deducted as a business expense on petitioner's business tax return. [5]

Petitioner issued to Mrs. Shellito a Form W-2, Wage and Tax Statement, reporting wages paid of $754 in 2001. [6] Petitioners reported this amount as wages on their 2001 Form 1040, U.S. Individual Income Tax Return, which their C.P.A. prepared. On the Schedule F attached to their 2001 Form 1040, petitioners claimed a $15,593 deduction for “Employee benefit programs” and a $700 deduction for “Labor hired”. On their 2001 Form 1040 petitioners listed Mrs. Shellito's occupation as “HOUSE WIFE”.

In the notice of deficiency respondent disallowed $14,904 of the amount that petitioners had claimed for “Employee benefit programs”; i.e., all but $689. [7] Respondent allowed petitioners a $2,898 offsetting adjustment for “Self Employed Health Insurance”. [8]

2002 Items and Tax Treatment

For 2002 Mrs. Shellito incurred or paid $22,307 of expenses for medical care and health insurance premiums for herself, petitioner, and their dependent children, as follows:

Expense/Premium	***Amount***
Out-of-pocket medical expenses	$15,975
Medical mileage	435
Insurance premiums [1]	*5,897*
Total	22,307

[1]This $l5,897 of insurance premiums comprised these two items: (1) $l1,702 that Mrs. Shellito paid to Conesco Health Insurance Co. for the insurance policy under which she was the primary insured; and (2) $l4,195 that Mrs. Shellito paid to American Republic Insurance Co. for an insurance policy that listed petitioner as the primary insured.

During 2002 petitioner wrote Mrs. Shellito, on their joint checking account, checks totaling $20,800, which she deposited in her separate checking account. The accompanying deposit tickets indicate that the deposits represented medical reimbursements from petitioner.

On January 30, 2003, petitioners executed a document entitled “Employee Benefit Expense Transmittal”, which they sent to AgriPlan/BIZPLAN. In this document petitioner claimed expenses for eligible plan participants during 2002 of $22,202, consisting of $5,897 insurance premiums and $16,305 of medical expenses. [9] On February 14, 2003, AgriPlan/BIZPLAN sent a yearend report to petitioner. The report indicated that on the basis of a review of the Employee Benefit Expense Transmittal, the total submitted benefit expenses were $22,202 and that after a $1,305 negative adjustment, the total benefit expenses that could be claimed as a business expense on petitioner's business tax return were $20,897. [10]

Petitioner issued to Mrs. Shellito a Form W-2 reporting wages paid of $1,292 in 2002. [11] Petitioners reported this amount as wages on their 2002 Form 1040, which their C.P.A. prepared. On the Schedule F attached to their 2002 Form 1040, petitioners claimed a $20,897 deduction for “Employee benefit programs” and a $1,200 deduction for “Labor hired”. On their 2002 Form 1040 petitioners listed Mrs. Shellito's occupation as “HOUSE WIFE”.

In the notice of deficiency respondent disallowed $20,208 of the amount that petitioners had claimed for “Employee benefit programs”; i.e., as for 2001, all but $689. [12] Respondent allowed petitioners a $3,646 offsetting adjustment for “Self Employed Health Insurance”. [13]

OPINION

I. *Employee Benefit Plan Expenses*

Before 2001 Mrs. Shellito had worked on petitioners' family farm without compensation for about 20 years. In 2001, upon the advice of their C.P.A., petitioners signed a document whereby Mrs. Shellito purportedly became her husband's at-will employee. Although the document makes no reference to compensation, petitioner purportedly agreed to pay Mrs. Shellito $100 a month plus medical benefits in the form of reimbursements for medical expenses and health insurance premiums incurred for herself, petitioner, and their dependent children. Petitioners contend that pursuant to section 162(a) they are entitled to deduct these purported reimbursements as employee benefit plan expenses. For the reasons explained below, we disagree.

A. *Burden of Proof*

As a general matter, the Commissioner's determination is presumptively correct, and the taxpayer bears the burden of proving entitlement to claimed deductions. Rule 142(a); *INDOPCO, Inc. v. Commissioner*, [92-1 USTC ¶50,113], 503 U.S. 79, 84 (1992). In certain circumstances, the burden of proof with respect to any factual issue may be shifted to the Commissioner. Sec. 7491(a). The parties disagree as to whether petitioners have met the statutory requirements to shift the burden of proof to respondent. Because we do not decide this case by reference to the placement of the burden of proof, we need not and do not decide whether petitioners have met the requirements under section 7491(a) to shift the burden of proof to respondent.

B. *Section 162(a)*

Section 162(a)(1) allows a deduction for all ordinary and necessary expenses paid or incurred in carrying on any trade or business, including a reasonable allowance for “salaries or other compensation for personal services actually rendered”, such as any amount paid to an employee pursuant to an employee benefit plan for an expense that the employee pays or incurs. Sec. 1.162-10(a), Income Tax Regs.; see *Frahm v. Commissioner* [Dec. 57,185(M)], T.C. Memo. 2007-351. [14] Respondent concedes that pursuant to this provision petitioners are entitled to most of the claimed deductions for “Employee benefit programs” if Mrs. Shellito is properly considered her husband's employee. [15] Respondent contends, however, that petitioners are not entitled to these deductions because Mrs. Shellito was not a bona fide employee of her husband. We agree with respondent.

C. *Analysis*

Citing *Matthews v. Commissioner* [Dec. 45,491], 92 T.C. 351, 361 (1989), affd. [90-2 USTC ¶50,363], 907 F.2d 1173 (D.C. Cir. 1990), and like cases, petitioners contend that under the common law agency test, the crucial consideration is the right of control, or lack of it, which the employer may exercise over the putative employee. Petitioners assert that petitioner has employed Mrs. Shellito since 1982 because since then she has performed her services on the family farm under petitioner's control and instruction. They contend that petitioners entered into an employment agreement on May 29, 2001, to “formalize” this preexisting employer-employee relationship.

We do not agree that the purported employment agreement formalized a preexisting employer-employee relationship because we do not believe there was any such preexisting relationship. The existence of remuneration is an “‘essential condition’” of an employer-employee relationship. *O'Connor v. Davis*, 126 F.3d 112, 116 (2d Cir. 1997) (quoting *Graves v. Women's Profl. Rodeo Association, Inc.*, 907 F.2d 71, 73 (8th Cir. 1990)); see *McGuinness v. Univ. of N.M. Sch. of Med.*, 170 F.3d 974, 979 (10th Cir. 1998). Absent remuneration, there is no “plausible” employment relationship and consequently no need to undertake a common law agency analysis. *Graves v. Women's Profl. Rodeo Association, Inc.*, *supra* at 73-74.

According to petitioners' own testimony, before May 29, 2001, Mrs. Shellito received no remuneration for her services. [16] Consequently, because this essential condition of an employment relationship was missing, Mrs. Shellito was not her husband's employee before 2001, irrespective of the degree of control he might have exercised over her. Rather, it appears to us that during these many years Mrs. Shellito rendered her services as part of the “‘shared enterprise’” of marriage, *Cray v. Cray*, 867 P.2d 291, 299 (Kan. 1994) (quoting *Berish v. Berish*, 432 N.E.2d 183, 184 (Ohio 1982)), as petitioners worked together to make a living and raise their family.

We are not convinced that anything happened in 2001 that materially changed the nature of petitioners' economic relationship. Mrs. Shellito's tasks on the farm were unchanged. More significantly, Mrs. Shellito's purported “compensation” was, we believe, illusory.

In essence, the purported compensation arrangement was that petitioner would reimburse Mrs. Shellito for family medical expenses and insurance premiums that she paid. [17] In paying these expenses from her separate checking account, Mrs. Shellito ostensibly assumed the obligation to pay family medical expenses that under Kansas law were as much her husband's liability as her own. See *St. Francis Regl. Med. Ctr., Inc. v. Bowles*, 836 P.2d 1123, 1125 (Kan. 1992) (pursuant to the common law "doctrine of necessaries", as recognized under Kansas law based upon the concept of "unity of marriage", each spouse is liable for the other's "necessaries", including "medical services"). We do not see that Mrs. Shellito obtained any economic benefit from her husband's "reimbursing" her, from their joint checking account, for medical expenses for which he was also liable. [18]

In the absence of proof to the contrary, petitioners are presumed to own equally the funds in their joint checking account. See *Walnut Valley State Bank v. Stovall*, 574 P.2d 1382 (Kan. 1978). Consequently, we consider the funds paid from their joint checking account to have been paid equally by each of them. Cf. *Higgins v. Commissioner* [Dec. 18,046], 16 T.C. 140 (1951) (husband was entitled to deduct on his separate return only half of the interest paid from his and his wife's joint checking account). Insofar as Mrs. Shellito was "reimbursed" with her own funds from the joint checking account, she clearly obtained no economic benefit. Insofar as she was "reimbursed" with her husband's funds from the joint checking account, any resulting economic benefit is directly offset and negated by her assuming and paying her husband's liability for the family medical expenses.

When all is said and done, it appears to us that Mrs. Shellito's and her family's medical expenses and health insurance premiums continued, in effect, to be paid from petitioners' joint checking account just as they always had been. We conclude that Mrs. Shellito received no remuneration under the purported employment arrangement and consequently during the years at issue, as in the preceding years, there was no bona fide employment relationship.

Petitioners executed the purported employment agreement for tax reasons on the advice of their C.P.A., who had prepared the document for them. Petitioner testified forthrightly that he started paying Mrs. Shellito in June of 2001 because "it would be a tax break that I could use." Citing *Seidel v. Commissioner* [Dec. 30,990(M)], T.C. Memo. 1971-238, petitioners contend that the mere fact that petitioner had a tax-savings motive does not affect the validity of the purported employee benefit plan that he adopted. This may be true but is beside the point—even a valid employee benefit plan is unavailing in the absence of a bona fide employment relationship. Although a "tax-avoidance motive for structuring a transaction in a particular way is not inherently fatal," a transaction between family members deserves a heightened level of "skepticism and scrutiny" to determine the transaction's substance. *True v. United States* [99-2 USTC ¶50,872], 190 F.3d 1165, 1174 n.6 (10th Cir. 1999); see *Hamdi v. Commissioner* [Dec. 48,844(M)], T.C. Memo. 1993-38, affd. without published opinion 23 F.3d 407 (6th Cir. 1994). Exercising that heightened skepticism and scrutiny, we conclude that in substance petitioners' purported employment agreement was a mere formalism that, for the reasons previously discussed, did not give rise to a true employment relationship. [19]

In support of their argument that Mrs. Shellito was petitioner's bona fide employee, petitioners note that in the notice of deficiency respondent did not disallow the deduction petitioners claimed on Schedule F for "wages" that petitioner paid Mrs. Shellito and also allowed for each year at issue $681 of the expenses that petitioners claimed for employee benefit programs. The notice of deficiency does not explain the treatment of these items, and respondent has offered no explanation in this proceeding. [20] Whatever inferences might be drawn from respondent's treatment of these items are counterbalanced, however, by inferences that might be drawn from petitioners' describing, on their Forms 1040 for each year at issue, Mrs. Shellito's occupation as "HOUSE WIFE"—a characterization that we believe was accurate.

In sum, we conclude that because she received no remuneration and the purported employment agreement was a mere formalism, Mrs. Shellito was not petitioner's bona fide employee for the years at issue. [21] Consequently, petitioner is not entitled under section 162(a) to any deduction for employee program benefits in excess of the amounts respondent has allowed.

II. *Accuracy-Related Penalty*

Respondent determined that for 2002 petitioners are liable for an accuracy-related penalty under section 6662(a). Section 6662(a) and (b)(2) imposes a 20-percent accuracy-related penalty on any portion of a tax underpayment that is attributable to, among other things, any substantial understatement of income tax, defined in section 6662(d)(1)(A) as an understatement that exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000. Sec. 6662(d)(1).

The accuracy-related penalty does not apply with respect to any portion of the underpayment if it is shown that the taxpayer had reasonable cause and acted in good faith. Sec. 6664(c)(1). Such a determination is made by taking into account all facts and circumstances, including the experience and knowledge of the taxpayer and his or her reliance on a professional tax adviser. See sec. 1.6664-4(b)(1), Income Tax Regs.

Petitioners sought and in good faith, we believe, followed the tax advice of their C.P.A., who steered them into setting up the medical reimbursement plan, helped them fill out the application for it, drafted the purported employment agreement for them, and prepared their tax returns for the years at issue. Taking into account all the facts and circumstances, including petitioners' lack of experience and

knowledge regarding tax matters, we conclude that they reasonably relied upon the C.P.A.'s advice in claiming the disputed deductions. Cf. *United States v. Boyle* [85-1 USTC ¶13,602], 469 U.S. 241, 251 (1985) ("When an accountant or attorney *advises* a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice."). We do not sustain imposition of the accuracy-related penalty.

To reflect the foregoing,

An appropriate decision will be entered.

Footnotes

[1] All Rule references are to the Tax Court Rules of Practice and Procedure, and all section references are to the Internal Revenue Code in effect for the years at issue. Numbers have been rounded to the nearest dollar
[2] There is no indication in the record that petitioner ever provided Mrs. Shellito any term life insurance.
[3] Petitioners allege that petitioner actually paid Mrs. Shellito more than the $5,400 of reimbursements described above because he paid additional amounts directly to insurance companies on Mrs. Shellito's behalf. Although we do not find petitioners' allegations well founded, because our analysis does not depend upon the exact amount of reimbursements that petitioner allegedly paid Mrs. Shellito, we need not address this issue further.
[4] We are unable to correlate this number with other evidence in the record.
[5] The record does not conclusively explain the discrepancy between the $15,593 listed on this yearend report and the $10,323 of expenses that petitioner claimed on the Employee Benefit Expense Transmittal or the $7,899 of medical expenses that Mrs. Shellito incurred after May 29, 2001.
[6] This amount represents $700 of total monthly cash payments plus $54 of employment taxes that petitioner reported paying on Mrs. Shellito's behalf. On Form 943, Employer's Annual Tax Return for Agricultural Employees, petitioner reported liability for employment taxes of $107 for 2001
[7] The parties agree that this $689 represents the premium that Mrs. Shellito paid in 2001 on the Conesco Health Insurance Co. insurance policy that listed her as the primary insured..
[8] The record does not indicate how this adjustment was calculated.
[9] Although $22,202 is close to the $22,307 of medical expenses incurred or paid by Mrs. Shellito during 2002, the record does not explain the seeming discrepancy.
[10] The report contains no explanation of the $1,305 negative adjustment. It appears, however, that this was the amount by which petitioner's $16,305 of reported medical expenses exceeded the $15,000 limit on reimbursements of out-of-pocket expenses as indicated on petitioner's AgriPlan/BIZPLAN application.
[11] This amount represents $1,200 of total monthly cash payments plus $92 of employment taxes that petitioner reported paying on Mrs. Shellito's behalf for 2002. On Form 943 petitioner reported liability for employment taxes of $184 for 2002.
[12] As noted *supra* note 7, the parties agree that $689 represents the premium that Mrs. Shellito paid in 2001 on the Conesco Health Insurance Co. insurance policy under which she was the primary insured. In 2002 the premium that Mrs. Shellito paid on this insurance policy was actually $1,702. The record contains no explanation as to why respondent allowed this deduction for 2002 in the amount of the 2001 premium.
[13] The record does not indicate how this adjustment was calculated.
[14] Under sec. 105(b), accident and health insurance payments made directly or indirectly to an employee to reimburse expenses for medical care are, with certain limitations, excludable from the employee's gross income. For this purpose, amounts received under an "accident or health plan for employees" are treated as amounts received through accident or health insurance. Sec. 105(e). Ostensibly pursuant to this provision, petitioners have excluded from Mrs. Shellito's gross income the medical expense reimbursements that petitioner allegedly paid to her. This claimed exclusion, which is not at issue in this case, is inconsequential in the light of our holding that Mrs. Shellito was not petitioner's employee and received no compensation from him.

Pursuant to sec. 162(l)(1), a self-employed individual may deduct a percentage (60 percent in 2001, 70 percent in 2002) of any amount paid or incurred for insurance that constitutes medical care for the taxpayer or the taxpayer's spouse or children. In the notice of deficiency respondent allowed petitioners adjustments for "Self Employed Health Insurance" for each year at issue, ostensibly pursuant to sec. 162(l)(1). Although we are unable to correlate the derivation of the amounts of these adjustments with the evidence of record, the parties have not raised and accordingly we do not reach any issue regarding these adjustments.
Respondent contends that even if Mrs. Shellito were deemed petitioner's employee, petitioners are not entitled to deduct certain relatively small amounts that respondent alleges were paid before May 29, 2001, or amounts that respondent contends exceed petitioner's actual reimbursements to Mrs. Shellito. In the light of our holding that Mrs. Shellito was not a bona fide employee of petitioner, it is unnecessary to address these contentions.
[16] Mrs. Shellito testified that petitioner did not pay her or provide her any form of compensation before May 29, 2001. Similarly, petitioner testified that he started paying Mrs. Shellito and providing her "medical insurance" in 2001.
[17] Although petitioner "paid" Mrs. Shellito (from their joint checking account) $100 "wages" each month in addition to reimbursements for medical expenses, he testified that he reimbursed her for the amount of "medical bills and stuff" that was "above and beyond the $100 that I'd paid her prior to." In essence, then, the $100 per month of "wages" appears to have been simply a component of the medical expense reimbursements that petitioner allegedly paid Mrs. Shellito.

[18] Relatively small amounts of the medical expenses in question were automatically debited from petitioners' joint checking account. In addition, Mrs. Shellito paid small amounts of the medical expenses in question from petitioners' joint checking account. These circumstances do not affect our conclusion that Mrs. Shellito obtained no economic benefit from the purported employment agreement.
[19] This conclusion is not altered by the fact that petitioner reported Mrs. Shellito's "wages" on Forms W-2 and paid relatively small amounts of employment taxes in furtherance of the claimed deductions for employee benefit programs, the economic benefit of which, if sustained, would far exceed the relatively small amount of employment taxes incurred.
[20] It might be inferred that respondent's allowing the deduction for "wages" paid might have been meant to counterbalance petitioners' including these amounts in gross income as wages. Cf. *Haeder v. Commissioner* [Dec. 54,211(M)], T.C. Memo. 2001-7 n.10 (noting that the Commissioner had determined that the taxpayers' income should be reduced by wages the husband allegedly paid to his wife). The allowance of the $689 deduction for employee benefit programs for both 2001 and 2002 is more puzzling. The parties agree that this $689 deduction represents the premium that Mrs. Shellito paid in 2001 on her Conesco Health Insurance Co. policy. In 2002, however, her premium on this policy was $1,702.
[21] Cf. *Frahm v. Commissioner* [Dec. 57,185(M)], T.C. Memo. 2007-351 (holding that employee benefit plan expenses were allowable under sec. 162(a); the Commissioner conceded the existence of a valid employment relationship between the married taxpayers); *Eyler v. Commissioner* [Dec. 57,184(M)], T.C. Memo. 2007-350 (disallowing claimed sec. 162(a) deduction for want of proof that the taxpayer husband paid health insurance premiums in his capacity as his wife's employer pursuant to an unwritten health plan rather than in his individual capacity as the primary insured under the health policy); *Albers v. Commissioner* [Dec. 56,960(M)], T.C. Memo. 2007-144 (disallowing claimed sec. 162(a) deduction because taxpayers failed to prove that the employer husband paid his employee wife, pursuant to an employee benefit plan, amounts to reimburse her for medical expenses that she incurred or paid); *Francis v. Commissioner* [Dec. 56,834(M)], T.C. Memo. 2007-33 (without deciding the bona fides of a purported employment relationship between the married taxpayers, disallowing disputed amounts of sec. 162(a) deduction for want of evidence that any compensation the taxpayer husband paid his wife was reasonable in amount); *Haeder v. Commissioner*, *supra*, (disallowing claimed sec. 162(a) deduction on the basis that the taxpayer's wife was not his bona fide employee because she performed no services "other than those reasonably expected of a family member")

.7. IRS Announces 2010 COLA Limits For Qualified Plans, (Oct. 22, 2009) *IR-2009-94* © 2010, CCH INCORPORATED. All Rights Reserved. A WoltersKluwer Company

Cost of living adjusted amounts applicable to qualified retirement plans for 2010 will be unchanged from 2009. The current deflationary period will not reduce most retirement plan limits, the IRS explained. The 2010 cost of living adjustments (COLAs), as applied by their Internal Revenue Code-based counterparts, affect the maximum limits for a variety of contributions and distributions for 2010, including defined benefit accounts, 401(k)s, and other defined contribution plans, as well as limits on employee stock ownership plans (ESOPs) and benefits to highly-compensated employees.

CCH Take Away. There had been some concern that many of the figures would decrease in 2010 because of deflation within the benchmarks used to ordinarily index retirement plan contribution and distribution dollar amounts (the third quarter 2008 CPI-U compared against third quarter 2009). "The figures all keyed off Code Sec. 415(d)," Lou Mazawey, principal, The Groom Law Group, Chartered, Washington, D.C., told CCH. That provision calls for adjustment procedures similar to the procedures used to adjust Social Security benefits. "Social Security benefits can never decrease," Mazawey explained.

Benefit plans

Defined contribution plans. The limits on elective deferrals to 401(k)s, 403(b)s, certain 457s, and the federal government's Thrift Savings Plan remain unchanged at $16,500. The limit on annual additions to defined contribution plans also remains unchanged at $49,000 for 2010.

Comment

Defined benefit plans, with certain exceptions, must pay flat rate premiums to the Pension Benefit Guaranty Corporation (PBGC), Mazawey told CCH. The per-participant flat-rate premium for plan year 2010 is $35 for single-employer plans, reflecting a $1 increase from 2009. The flat-rate premium for multi-employer plans remains unchanged at $9. "The PBGC's COLA is tied to a different index," Mazawey explained.

Defined benefit plans and ESOPs. The annual benefit limitation under a defined benefit plan, the maximum amount a plan may pay a participant each year, remains unchanged at $195,000 for 2010. The amount for determining the maximum ESOP account subject to a five-year distribution period also remains unchanged at $985,000. The dollar amount used to determine the lengthening period of the five-year distribution also remains unchanged at $195,000 for 2010.

Catch-up contributions

Eligible individuals age 50 and above may make catch-up contributions to IRAs, 401(k)s and other savings arrangements. The catch-up amount for IRAs remains unchanged for 2010 at $1,000.

The catch-up amount for 401(k)s, 457s, 403(b)s, and SEPs also remains unchanged at $5,500 for 2010. The $2,500 catch-up amount for SIMPLE plans is not indexed for inflation.

More amounts

Additional inflation-adjusted 2010 amounts relevant to qualified plans include:

- The Code Sec. 414(q)(1)(B) limitation used in the definition of a highly-compensated employee remains unchanged at $110,000.
- The dollar limitation concerning the definition of key employee in a top heavy plan remains unchanged at $160,000.
- The compensation amounts relevant to the definition of control employee for fringe benefit valuation purposes remains unchanged at $95,000.
- The annual compensation limits under Code Sec. 401(a)(17) (relating to the maximum compensation counted for an eligible employee in a qualifying plan); Code Sec. 404(l) (addressing the deductibility of employer contributions); Code Sec. 408(k)(3)(c) (nondiscrimination rules for SEPs); and Code Sec. 408(k)(6)(D)(ii) (the deferral percentage for SEPs) remain unchanged at $245,000.
- The Code Sec. 408(p)(2)(E) limitation regarding SIMPLEs remains unchanged at $11,500.
- The adjusted gross income limit on deductible IRA contributions for active participants filing joint returns or qualifying widow(er) remains unchanged at $89,000. For all other taxpayers, the limit remains unchanged at $55,000.

8. CCH Federal Tax Weekly, Practitioners' Corner: Businesses Brace For IRS Employment Tax Compliance Audit Project, (Sep. 17, 2009) © 2010, CCH INCORPORATED. All Rights Reserved. A WoltersKluwer Company

Before the end of the year, the IRS is expected to extend its National Research Program (NRP) to employment tax compliance. The IRS is using random audits under the NRP to update its estimates of the extent to which noncompliance with employment tax obligations contributes to the $300+ billion tax gap. The IRS is also looking for "drivers" of employment tax noncompliance. Previous NRP studies have randomly selected S corps and other taxpayer groups for audits.

Comment

"This is a very serious issue because the IRS may be more lenient if you are behind on income taxes, but is much less lenient if you have not paid employment taxes," Benson Goldstein, a senior technical manager with the American Institute of Certified Public Accountants (AICPA) told CCH. " Sometimes, a business in a financial bind (the current recession is a good example) may make the wrong decision by saying to itself, "I'll just use this money temporarily, put it back later, and everything will be fine." However, the consequence is that the business continues to stay in a financial bind or steps into an even worse financial bind," Goldstein cautioned.

Background

In its Fiscal Year (FY) 2009 work plan, the IRS Office of Federal, State and Local Governments (FSLG) reported that it would use the NRP to help identify sources of the U.S. tax gap related to employment taxes. The IRS Advisory Council also recommended that the agency utilize the NRP to explore employment tax and independent contractor issues. Citing a lack of current data, the IRS Advisory Council advocated for the program to increase the efficiency of collection efforts in the area. Additionally, the Treasury Inspector General for Tax Administration (TIGTA) encouraged the IRS to review how it addresses employer misclassification of employees as independent contractors. TIGTA recommended that the IRS consider a national compliance study to measure the impact of worker misclassification on the tax gap.

Noncompliance

The IRS's estimates of the tax gap are largely based on studies from 10 or more years ago. Treasury and the IRS have estimated that employment tax underreporting accounted for approximately $54 billion of the gross $345 billion tax gap. Underreporting of FICA accounted for $14 billion; underreporting of self-employment tax accounted for $39 billion; and underreporting of unemployment tax accounted for $1 billion. Underpayments of employment taxes also contributed $5 billion to the tax gap.

Autumn start

In July, the IRS reported that it will launch its NPR study of employment tax compliance this autumn. Starting in October, the NPR study will focus on employment tax reporting and filing with the goal of measuring compliance and discovering reasons for non-compliance. IRS officials have indicated that the NRP study of employment tax compliance will be a multi-year project.

Comment

"This NRP is focusing on four broad areas: worker classification, fringe benefits, non-filers, and officers' compensation. These are all different issues," Goldstein said.

Preparing for audits

Taxpayers will be randomly selected for the NPR study of employment tax noncompliance. Consequently, there is little that a business taxpayer can do to prepare for the NRP study.

The IRS has released limited information about the criteria it uses to select taxpayers for the NRP. The NRP was created in 2000 and the IRS has described it as a comprehensive effort to measure payment, filing and reporting compliance for different types of taxes and various sets of taxpayers.

Several years ago, the IRS identified some of the databases it uses to select returns for the NRP, such as the Return Transaction File and the Information Returns Master File. The IRS also has used data from third party sources in past NRP audits. In some cases, the IRS has excluded taxpayers from an NRP study that have been subject to other types of compliance projects by the agency.

Two recent NRP studies may shed some light on what business taxpayers can expect. An ongoing NRP study of individuals examined approximately 13,000 randomly selected individual tax returns from the 2006 tax year. The IRS indicated that similar sample sizes would be used in subsequent tax years (2007 and 2008). Some of the taxpayers selected for the NRP individual compliance study were notified by the IRS in writing that they would be part of the program. However, other taxpayers selected for the NRP individual study were not contacted by the IRS if the agency was able to obtain matching and third-party data that confirmed the accuracy of their returns.

The IRS also recently conducted an NRP study of S corp returns. The NRP selected approximately 5,000 returns filed by S corps for the 2003 and 2004 tax years.

Comment

"The study itself is probably not going to result in a…huge number of audits...a drop in the bucket in terms of the overall numbers of business taxpayers out there," Goldstein told CCH. " The IRS is really just trying to get a sampling of different issues and how to treat them. " However, Goldstein noted that the IRS is hiring more auditors. "In a general context, I could see the IRS definitely cranking up the number of audits, trying to increase the enforcement and collection of general nonpayment of taxes. While there may be a significant examination issue here; in the end, it's a huge collection issue," he stated.

Training for employees

At the same time, the IRS has been issuing guidance to its personnel on the treatment of employment-related income. IRS Chief Counsel recently released Program Manager's Technical Advice (PMTA) 2009-056, which addresses when examiners may make interest-free adjustments to an employer's erroneous underpayments of employment tax under Code Sec. 6205. Chief Counsel explained application of the provision, as well as final regulations in T.D. 9405.

Chief Counsel determined that, under Code Sec. 6205, no interest is assessed against an employer who erroneously underpays employment tax, yet immediately agrees to the IRS's findings during audit and files an adjusted return with payment. Form 2504, Agreement to Assessment and Collection of Additional tax and Acceptance of Over-Assessment, Chief Counsel stated, qualifies as an adjusted return. However, interest would begin to accrue, Chief Counsel warned, in instances where:

- The employer did not provide payment along with its adjusted return; or
- The employer refuses to agree to the IRS's findings and does not file an adjusted return.

Chief Counsel also released a memorandum recently on the tax consequences and proper reporting of employment-related judgments and settlements. According to Chief Counsel, IRS personnel are to use a four-step process in determining the correct treatment of employment-related settlement payments. IRS personnel should examine:

(1) The character of the payment and the nature of the claim giving rise to the payment,
(2) Whether the payment is an item of gross income,
(3) Whether the payment is for wages for employment tax purposes, and
(4) The appropriate reporting for the payment and any attorneys' fees.

"The Treasury and the IRS have estimated that employment tax underreporting accounted for approximately $54 billion of the gross $345 billion tax gap."

9. Social Security wage base remains at $106,800 for 2011 Social Security News Release, 10/15/2010 © 2010 Thomson Reuters/RIA. All rights reserved.

The Social Security Administration has announced that the wage base for computing the Social Security tax (OASDI) in 2011 remains unchanged for the third year in a row at $106,800.

RIA observation: Monthly Social Security and Supplemental Security Income (SSI) benefits for more than 58 million Americans will not automatically increase in 2011. The Social Security Act provides for an automatic increase in these benefits if there is an increase in the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W) from the third quarter of the last year a cost-of-living adjustment (COLA) was determined to the third quarter of the current year. As determined by the Bureau of Labor Statistics, there is no increase in the CPI-W from the third quarter of 2008, the last year a COLA was determined, to the third quarter of 2010, therefore, there can be no COLA in 2011. Since there is no COLA, the statute also prohibits a change in the maximum amount of earnings subject to the Social Security tax as well as the retirement earnings test exempt amounts.

The Federal Insurance Contributions Act (FICA) imposes two taxes on employers, employees, and self-employed workers—one for Old Age, Survivors and Disability Insurance (OASDI; commonly known as the Social Security tax), and the other for Hospital Insurance (HI; commonly known as the Medicare tax).

The FICA tax rate for employees and employers is 7.65% each—6.2% for OASDI and 1.45% for HI. For self-employed workers, the FICA tax is 15.3%—12.4% for OASDI and 2.9% for HI. There is a maximum amount of compensation subject to the OASDI tax, but no maximum for HI.

RIA illustration : On a salary of $106,800 (or more), an employee and his employer each will pay $6,621.60 in Social Security tax in 2011, the same as in 2010 and 2009.

RIA illustration : A self-employed person with at least $106,800 in net self-employment earnings will pay $13,243.20 for the Social Security part of the self-employment tax in 2011, the same as in 2010 and 2009.

RIA observation: Self-employed workers deduct half of their self-employment tax above-the-line in arriving at adjusted gross income.

RIA observation: The FICA tax rates have remained unchanged since '90.

10. EBSA issues additional FAQs on health care reform implementation © 2010 Thomson Reuters/RIA. All rights reserved.

DOL's Employee Benefits Security Administration (EBSA) has issued a second series of frequently asked questions (FAQs) addressing various implementation issues arising under the Affordable Care Act. The latest FAQs, which were prepared jointly by DOL, IRS and HHS (the Departments), address issues concerning grandfathered health plans, rescissions, preventive health services, and policy year for effective date purposes.

The ongoing guidance reflects the view of the Departments to emphasize assisting (rather than imposing penalties on) plans, issuers, and others that are working diligently and in good faith to understand and come into compliance with the Affordable Care Act.

Grandfathered plans. The FAQs address the following issues concerning the interim final regs applicable to grandfathered plans:

> (1) Reg. § 54.9815-1251T(g)(1) delineates six situations in which a group health plan or health insurance coverage ceases to be a grandfathered health plan. According to the FAQs, any changes in these six areas (as measured from Mar. 23, 2010) change a health plan so significantly that they will cause a group health plan or health insurance coverage to relinquish grandfather status. However, for a plan that is continuing the same policy, these six changes are the only changes that would cause a cessation of grandfather status. (Q1)

(2) The grandfather analysis applies on a benefit-package-by-benefit-package basis. Thus, for example, if a plan offers three benefit options—a PPO, a POS arrangement, and an HMO—as separate benefit packages, and the HMO relinquishes grandfather status, that does not affect the grandfather status of the other benefit packages. (Q2)
(3) Under Reg. § 54.9815-1251T(g)(1)(v), a plan will lose grandfather status if a decrease in an employer's contribution rate towards the cost of coverage is greater than five percentage points. According to the Departments, since these standards apply on a tier-by-tier basis, if a group health plan modifies the tiers of coverage it had on Mar. 23, 2010 (for example, from self-only and family to a multi-tiered structure of self-only, self-plus-one, self-plus-two, and self-plus-three-or-more), the employer contribution for any new tier would be tested by comparison to the contribution rate for the corresponding tier on Mar. 23, 2010. However, if a plan adds one or more new coverage tiers and does not eliminate or modify any previous tiers and those new tiers cover classes of individuals not previously covered, the new tiers would not be analyzed under those standards. Thus, for example, if a plan with only a self-only coverage tier added a family coverage tier, the level of employer contribution toward the family coverage would not cause the plan to lose grandfather status. (Q3)
(4) Under Reg. § 54.9815-1251T(g)(1)(iv), a plan will lose grandfather status if it increases a copayment by an amount that exceeds medical inflation plus 15 percentage points (or, if greater, $5 plus medical inflation). According to the Departments, since each change in cost sharing is separately tested, a plan will lose grandfather status if, for example, the plan sponsor raises the copayment level for a category of services (such as outpatient or primary care) by an amount that exceeds those standards, even if the plan sponsor retains the copayment level for other categories of services (such as inpatient care or specialty care). (Q4)
(5) The FAQs provide that the interim regs do not bar group health plans from continuing to provide incentives for wellness by providing premium discounts or additional benefits to reward healthy behaviors by participants or beneficiaries, by rewarding high quality providers, and by incorporating evidence-based treatments into benefit plans. However, if a plan includes penalties (such as cost-sharing surcharges), those may implicate the standards for losing grandfather status and must be examined carefully. (Q5)

Dental and vision benefits. Under HIPAA, dental and vision benefits generally constitute "excepted benefits" exempt from HIPAA coverage if they are offered under a separate plan and are not an integral part of the plan in that participants have a right not to elect coverage and must pay an additional premium if they do. According to the Departments, this exception from coverage will carry forward to the Affordable Care Act market reform requirements, so that if a plan provides its dental or vision benefits pursuant to a separate election by a participant, and the plan charges even a nominal employee contribution towards the coverage, those benefits would constitute excepted benefits not covered by the reform provisions. (Q6)

Rescissions. According to the Affordable Care Act and the interim regs, a group health plan, or a health insurance issuer offering group or individual health insurance coverage, can't rescind coverage except in the case of fraud or an intentional misrepresentation of a material fact. The Departments state that the exception to the rescission prohibition is not limited to rescissions based on fraudulent or intentional misrepresentations about prior medical history. Furthermore, some terminations of coverage during the normal course of business are not even considered to be rescissions by the Departments, such as:

... retroactive eliminating coverage back to the date of termination of employment, when employers with a plan that only covers active employees reconciles lists of eligible individuals with their plan or issuer via data feed once per month; or
... terminating coverage retroactive to a divorce where a plan does not cover ex-spouses, and the plan is not notified of a divorce, and the full COBRA premium is not paid by the employee or ex-spouse for coverage. (Q7)

Preventive health services. According to the interim regs regarding preventive health services, if a recommendation or guideline for a recommended preventive health service does not specify the frequency, method, treatment, or setting for the provision of that service, a plan or issuer can use reasonable medical management techniques to determine any coverage limitations under the plan. The Departments state that, to the extent not specified in a recommendation or guideline, a plan or issuer may rely on the relevant evidence base and these established techniques to determine the frequency, method, treatment, or setting for the provision of a recommended preventive health service. (Q8)

Effective date. With respect to the overall effective date of the Affordable Care Act, the Departments state that compliance for policies in the individual market sold on or after Sept. 23, 2010 cannot be effective on a date other than the date that coverage begins, even though carriers in the health insurance individual market may designate a fixed policy year, but continue to issue policies throughout the year.

If a policy begins to cover an individual effective on a date that is on or after Sept. 23, 2010, the initial policy year for that individual, for purposes of determining the Affordable Care Act's effective date, begins on the first date on which the coverage is effective, even if this initial period of coverage is an abbreviated policy year. Thus, for example, it may run from Oct. 1, 2010 through Dec. 31, 2010, with a new calendar-based policy year beginning on Jan. 1, 2011 (assuming the individual renews the policy).

However, if issuers had relied in good faith on guidance or instructions from a state insurance regulator indicating that the provisions of the Affordable Care Act are not applicable until the beginning of the first full policy year of the individual coverage, the De-

partments will afford the carriers a reasonable period of time after the issuance of the FAQs to come into compliance. Nonetheless, given the issuance of these FAQS on October 8, 2010, issuers may not rely in good faith on any contrary guidance or instruction issued by a state insurance regulator after Oct. 8, 2010. (Q9)

11. Federal Taxes Weekly Alert, Key 2011 tax items as calculated by RIA based on inflation data © 2010 Thomson Reuters/RIA. All rights reserved.

Interest exclusion for higher education. The interest on U.S. savings bonds redeemed to pay qualified higher education expenses may be tax-free. The exclusion is phased-out for certain higher income individuals. The phase-out level is adjusted annually for cost-of-living increases. The phase-out for 2011 will begin at modified adjusted gross income above $71,100 ($106,650 on a joint return). For 2010, the corresponding figures are $70,100 and $105,100.

Qualified transportation fringe benefits. For 2011, an employee will be able to exclude up to $230 (same as for 2010) a month for qualified parking expenses, and up to $120 a month (down from $230) of the combined value of transit passes and transportation in a commuter highway vehicle.

Education credits. For 2011, the Hope (for 2009 and 2010 called the American Opportunity Credit) and Lifetime Learning credits phase out ratably for taxpayers with modified AGI of $51,000 to $61,000 ($102,000 to $122,000 for joint filers). For 2011, the Hope credit will be 100% of up to $1,200 of qualified higher education tuition and related expenses plus 50% of the next $1,200 such expenses.

For 2010, the American Opportunity Credit (formerly called the Hope Credit) phased out ratably for taxpayers with modified AGI of $80,000 to $90,000 ($160,000 to $180,000 for joint filers). For 2010, the Lifetime Learning credit phased out ratably for taxpayers with modified AGI of $50,000 to $60,000 ($100,000 to $120,000 for joint filers).

For 2010, the American Opportunity Credit (formerly called the Hope Credit) was 100% of up to $2,000 of qualified higher education tuition and related expenses plus 25% of the next $2,000 of such expenses.

Adoption credit. An individual is allowed a credit against income tax (and AMT) for qualified adoption expenses. The total expenses that may be taken as a credit for all tax years with respect to the adoption of a child by the taxpayer will be limited to $13,360 for 2011 (up from $13,170 for 2010). For 2011, the credit for the adoption of a special-needs child will be $13,360 under Code Sec. 36C(a)(3) , regardless of the extent to which the taxpayer has qualified adoption expenses (up from $13,170 for 2010).

The credit will begin to phase out at AGI of $185,210 (up from $182,520 for 2010). The phaseout will be complete at $40,000 above the threshold.

Adoption exclusion. Similar inflation adjustments and phaseout rules apply for purposes of the exclusion for employer-provided adoption assistance. The total amount excludable per child (whether or not he has special needs) will be limited to $13,360 for 2011 (up from $13,170 for 2010). Note that the exclusion for the adoption of a child with special needs applies regardless of whether the employee has qualified adoption expenses.

MAGI limits for making deductible contributions by active plan participants to traditional IRAs. In general, an individual who isn't an active participant in certain employer-sponsored retirement plans, and whose spouse isn't an active participant, may make an annual deductible cash contribution to an IRA up to the lesser of: (1) a statutory dollar limit (for 2011, $5,000, increased to $6,000 for those age 50 or older), or (2) 100% of the compensation that's includible in his gross income for that year. If the individual (or his spouse) is an active plan participant, the deduction phases out over a specified dollar range of modified adjusted gross income (MAGI).

For taxpayers filing joint returns, the otherwise allowable deductible contribution will be phased out ratably for 2011 for MAGI between $90,000 and $110,000 (up from $89,000 and $109,000 for 2010).

For 2011, for single taxpayers and heads of household, the otherwise allowable deductible contribution will be phased out ratably for MAGI between $56,000 and $66,000 (same as for 2010). For married taxpayers filing separate returns, the otherwise allowable deductible contribution will continue to be phased out ratably for MAGI between $0 and $10,000 (same as for 2010).

For a married taxpayer who is not an active plan participant but whose spouse is such a participant, the otherwise allowable deductible contribution will be phased out ratably for 2011 for MAGI between $169,000 and $179,000 (up from between $167,000 and $177,000 for 2010).

MAGI limits for making contributions to Roth IRAs. Individuals may make nondeductible contributions to a Roth IRA, subject to the overall limit on IRA contributions. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with MAGI over certain levels for the tax year. For taxpayers filing joint returns, the otherwise allowable contributions to a Roth IRA will be phased out ratably for 2011 for MAGI between $169,000 and $179,000 (up from between $167,000 and $177,000 for 2010). For single taxpayers and heads of household it will be phased out ratably for MAGI between $107,000 and $122,000 (up from $105,000 and $120,000 for 2010). For married taxpayers filing separate returns, the otherwise allowable contribution will continue to be phased out ratably for MAGI between $0 and $10,000 (same as for 2010).

Saver's credit. For tax years beginning in 2011, an eligible lower-income taxpayer can claim a nonrefundable tax credit for the applicable percentage (50%, 20%, or 10%, depending on filing status and AGI) of up to $2,000 of his qualified retirement savings contributions, as follows:

... Joint filers: $0 to $34,000, 50%; $34,000 to $36,500, 20%; and $36,500 to $56,500, 10% (no credit if AGI is above $56,500).
... Heads of households: $0 to $25,500, 50%; $25,500 to $27,375, 20%; and $27,375 to $42,375, 10% (no credit if AGI is above $42,375).
... All other filers: $0 to $17,000, 50%; $17,000 to $18,250, 20%; and $18,250 to $28,250, 10% (no credit if AGI is above $28,250).

By way of comparison, for tax years beginning in 2010, an eligible lower-income taxpayer can claim a nonrefundable tax credit for the applicable percentage (50%, 20%, or 10%, depending on filing status and AGI) of up to $2,000 of his qualified retirement savings contributions, as follows:

... Joint filers: $0 to $33,500, 50%; $33,500 to $36,000, 20%; and $36,000 to $55,500, 10% (no credit if AGI is above $55,500).
... Heads of households: $0 to $25,125, 50%; $25,125 to $27,000, 20%; and $27,000 to $41,625, 10% (no credit if AGI is above $41,625).
... All other filers: $0 to $16,750, 50%; $16,750 to $18,000, 20%; and $18,000 to $27,750, 10% (no credit if AGI is above $27,750).

Items impacted by EGTRRA sunset. Calculations were not done in this article for the following items, which will be impacted by the EGTRRA sunset if Congress does not act:

... Phaseout of personal exemptions.
... Tax rate schedules (but see ¶ 12).
... Reduction of itemized deductions.
... Earned income tax credit.
... Refundable child credit.
RIA observation: The regular child credit, which has not been indexed, also will drop if the EGTTRA sunset kicks in, see Weekly Alert ¶ 39 07/22/2010.
... Student loan interest deduction.

RIA observation: For Senate passed legislation that would increase the expensing limit and investment based phaseout dollar amount for both 2010 and 2011, see ¶ 2.

A number of tax figures are adjusted each year for inflation based on the average Consumer Price Index (CPI) for the 12-month period ending the previous Aug. 31. The Aug. 2010 CPI has been released by the Labor Department. (U.S. Department of Labor, Consumer Price Index (for all-urban consumers), 9/17/2010) Using the CPI for Aug. 2010 (and the preceding 11 months), RIA calculated and reported in a separate article (see ¶ 43) the increases for 2011 to the standard deduction, the personal exemption, and a number of other items. This article provides RIA-calculated adjustments for 2011 for health, charitable, compliance and special entity items. Adjustments for the first two items that follow are based on the medical care component of the CPI.

Long-term care premiums. Amounts paid for insurance that covers qualified long-term care services are treated as medical expenses up to specified dollar limits that vary with the age of the taxpayer as of the close of the tax year. For a taxpayer age 40 or younger, the 2011 limit will be $340 (up from $330 for 2010); more than 40 but not more than 50, $640 (up from $620 for 2010); more than 50 but not more than 60, $1,270 (up from $1,230 for 2010); more than 60 but not more than 70, $3,390 (up from $3,290 for 2010); and more than 70, $4,240 (up from $4,110 for 2010).

Payments received under qualified long-term care insurance. Amounts received under a qualified long-term care insurance contract are generally excludable as amounts received for personal injuries and sickness, subject to a per diem limitation, which will be $300 in 2011 (up from $290 for 2010).

Archer MSAs. For Archer medical savings account (MSA) purposes, in 2011, a "high deductible health plan" will be a health plan—

- with an annual deductible of at least $2,050 and not more than $3,050 (up from $2,000 and $3,000 for 2010), in the case of self-only coverage, and
- with an annual deductible of at least $4,100 and not more than $6,150 (up from $4,050 and $6,050 for 2010), in the case of family coverage, and
- under which the annual out-of-pocket expenses required to be paid (other than for premiums) for covered benefits doesn't exceed —
  ... $4,100 (up from $4,050 for 2010) for self-only coverage, and
  ... $7,500 (up from $7,400 for 2010) for family coverage.

Insubstantial benefit charitable contribution limitation. Certain *de minimis* benefits provided by a charity to a donor don't affect the donor's charitable contribution deductions. Under these rules, charitable contributions will be fully deductible in 2011 if (1) the donor makes a minimum payment of $48.50 ($48 for 2010) and receives certain benefits with a cost of not more than $9.70 ($9.60 for 2010) or (2) the charity mails or otherwise distributes free unordered "low-cost articles" with a cost of not more than $9.70 ($9.60 for 2010). In addition, charitable contributions will be fully deductible if the benefit received by the donor isn't more than the lesser of $97 (up from $96 for 2010) or 2% of the amount of the contribution.

Dues paid to agricultural or horticultural organizations. Annual dues not exceeding $148 for 2011 (up from $146 for 2010) for membership in an agricultural or horticultural organization won't be unrelated business income despite any benefits or privileges to which members of the organization will be entitled.

Reporting exemption for exempt organizations with lobbying expenditures. For 2011, social welfare, agricultural and horticultural organizations are exempt from the requirement that they report to their members the portion of their dues allocable to lobbying if 90% or more of their annual dues are received from persons, families, or entities who pay dues of $103 or less (up from $101 for 2010).

Maximum hourly fee for attorneys under Code Sec. 7430(c)(1). The maximum hourly amount allowed for attorney's fees to a prevailing party under Code Sec. 7430(c)(1) will be $180 an hour for fees incurred in 2011 (same as for 2010).

Mechanics' lien priority over tax liens. The holder of a lien for $6,990 or less for the repair or improvement of a personal residence will have priority over notices of tax liens filed in 2011. This is up from $6,890 for 2010.

Sales price priority over tax liens. A nondealer purchaser of household goods, personal effects, etc. will be protected against a tax lien filed in 2011 if the sales price is not over $1,400 (up from $1,380 for 2010).

Property exempt from levy. The value of property exempt from levy under Code Sec. 6334(a)(2) (fuel, provisions, furniture, and other household personal effects, as well as arms for personal use, livestock, and poultry) may not exceed $8,370 for levies in 2011 (up from $8,250 for 2010). The value of property exempt from levy under Code Sec. 6334(a)(3) (books and tools necessary for the trade, business, or profession of the taxpayer) may not exceed $4,180 for levies issued in 2011 (up from $4.120 for 2010).

Using the CPI for Aug. 2010 (and the preceding 11 months), RIA calculated and reported in a separate article (see ¶ 43) the increases for 2011 to the standard deduction, the personal exemption, and a number of other items. This article provides RIA-calculated adjustments for 2011 for transfer tax and foreign items.

Gift tax annual exclusion. For gifts made in 2011, the gift tax annual exclusion will be $13,000 (same as for gifts made in 2010).

Special use valuation reduction limit. For estates of decedents dying in 2011, the limit on the decrease in value that can result from the use of special valuation will be $1,020,000 (up from $1,000,000 for 2009, when the estate tax was last imposed).

Determining 2% portion for interest on deferred estate tax. In determining the part of the estate tax that is deferred on a farm or closely-held business that is subject to interest at a rate of 2% a year, for decedents dying in 2011 the tentative tax will be computed on $1,360,000 (up from $1,330,000 for 2009) plus the applicable exclusion amount.

RIA observation: The two preceding items are included on the assumption that the estate tax returns in 2011.

Increased annual exclusion for gifts to noncitizen spouses. For gifts made in 2011, the annual exclusion for gifts to noncitizen spouses will be $136,000 (up from $134,000 for 2010).

Reporting foreign gifts. If the value of the aggregate “foreign gifts” received by a U.S. person (other than an exempt Code Sec. 501(c) organization) exceeds a threshold amount, the U.S. person must report each “foreign gift” to IRS. (Code Sec. 6039F(a)) Different reporting thresholds apply for gifts received from (a) nonresident alien individuals or foreign estates, and (b) foreign partnerships or foreign corporations. For gifts from a nonresident alien individual or foreign estate, reporting is required only if the aggregate amount of gifts from that person exceeds $100,000 during the tax year. For gifts from foreign corporations and foreign partnerships, the reporting threshold amount will be $14,375 in 2011 (up from $14,165 for 2010).

Expatriation. Under a mark-to-market deemed sale rule, all property of a covered expatriate is treated as sold on the day before the expatriation date for its fair market value. However, for 2011, the amount that would otherwise be includible in the gross income of any individual under these mark-to-market rules is reduced by $636,000 (up from $627,000 for 2010).

Foreign earned income exclusion. The foreign earned income exclusion amount increases to $92,900 in 2011 (up from $91,500 in 2010).

It is projected that if the current rates are extended for all taxpayers, the rate brackets and "break points" in each category of filer will remain the same for 2011.

12. Expanded student loan relief for health care professionals creates refund opportunity IR 2010-74 © 2010, CCH INCORPORATED. All Rights Reserved. A WoltersKluwer Company

In a news release, IRS reminds health care professionals that they may be due a refund on their 2009 returns if they received student loan relief under state programs rewarding those who work in underserved communities. They (and their employers) also may be due a refund for FICA (Federal Insurance Contributions Act) tax paid in 2009 on such student loan relief. The broadened student loan relief was enacted as part of the Patient Protection and Affordable Care Act (the Affordable Care Act) (P.L. 111-148), retroactively effective for amounts received in tax years beginning after 2008.

Background. Although a discharge of debt generally results in income to the debtor, income from cancellation of certain government and nongovernment student loans is excluded from gross income where the debt discharge is under a loan provision requiring the student to work for a certain period of time in certain professions for any of a broad class of employers. For loans made by a tax-exempt educational institution, the student's work must also fulfill a public-service requirement. The discharge isn't excluded if it is on account of services performed for the lender.

Similarly, although loan repayment programs generally result in income to the debtor, an individual may exclude amounts received under a state program described in Section 338I of the Public Health Service Act, which provides federal grants to states for their loan repayment programs. Similarly, an individual may exclude amounts received under the National Health Service Corps (NHSC) Loan Repayment Program (Section 338B(g) of the Public Health Service Act). These provide student loan repayments to participants who provide medical services in a geographic area that the Public Health Service identifies as having a shortage of health-care professionals.

Under the Affordable Care Act, for amounts received by an individual in tax years beginning after Dec. 31, 2008, the exclusion for amounts received under the National Health Service Corps loan repayment program or State loan repayment programs includes any amount received by an individual under any State loan repayment or loan forgiveness program that is intended to provide for the increased availability of health care services in underserved or health professional shortage areas (as determined by the State). (Code Sec. 108(f)(4))

Income tax refund. IRS's news release informs health care professionals impacted by the broadened exclusion that they may be due refunds if they reported income from repaid or forgiven loan amounts on their 2009 income tax returns. IRS suggests that those who believe they qualify for a refund should consult their State loan program offices to determine whether the program is covered by the Affordable Care Act.

Those filing for a refund on Form 1040X, Amended U.S. Individual Income Tax Return, are advised to claim the exclusion by writing “Excluded student loan amount under 2010 Health Care Act” in the Explanation of Changes box. Health care professionals may request an employer or other issuer to provide a Form W-2c, Corrected Wage and Tax Statement, or 1099, and may attach the corrected form to the Form 1040X. However, IRS stresses that Form 1040X may be filed without attaching a corrected form.

Payroll tax refund. An individual whose employer withheld and paid taxes under the Federal Insurance Contributions Act (FICA) on payments excluded under the Health Care Act should request that the employer seek a refund of withheld FICA on the employee's

behalf. Employers may claim a refund for their portion of FICA tax by filing a separate Form 941-X, Adjusted Employer's QUARTERLY Federal Tax Return or Claim for Refund, for each Form 941, Employer's QUARTERLY Federal Tax Return, which needs to be corrected. An employer filing a Form 941-X also is required to file Forms W-2c for each employee who benefits from the broadened exclusion under the Health Care Act.

13. IRA's failure to have a designated beneficiary couldn't be corrected after death PLR 201021038

IRS has privately ruled that a deceased taxpayer's IRA did not have a designated beneficiary under Code Sec. 401(a)(9) and a post-death judicial modification naming a designated beneficiary of the IRA could not be recognized for tax purposes.

Background. Under Reg. § 1.401(a)(9)-4, a designated beneficiary need not be specified in the name of the plan in order to be a designated beneficiary so long as the individual is identifiable under the plan. The member of a class of beneficiaries capable of contraction or expansion will be treated as being identifiable if it is possible to identify the class member with the shortest life expectancy. Further, Reg. § 1.401(a)(9)-4, Q&A-1, provides that the passing of an employee's interest to an individual under a will or otherwise under applicable state law will not make that individual a designated beneficiary under Code Sec. 401(a)(9)(E) unless that individual is designated as a beneficiary under the plan.

A person who is not an individual, such as the employee's estate, may not be a designated beneficiary. If a person other than an individual is designated as a beneficiary, the employee (or the IRA owner) will be treated as having no designated beneficiary for Code Sec. 401(a)(9) purposes. However, an exception applies for trust beneficiaries. Under this exception, trust beneficiaries (with respect to the trust's interest in an employee's retirement benefit) may be treated as designated beneficiaries if:

(1) the trust is valid under state law (or would be, except for the fact that there is no corpus),
(2) the trust is irrevocable or will become irrevocable, by its terms, on the employee's death,
(3) the beneficiaries with respect to the trust's interest in the employee's benefit are identifiable from the trust instrument, and
(4) relevant documentation has been timely provided to the plan administrator. (Reg. § 1.401(a)(9)-4, Q&A-5)

Reg. § 1.401(a)(9)-4, Q&A-4, provides that in order to be a designated beneficiary, an individual must be a beneficiary as of the date of the employee's death.

Facts. Wife A and Husband B created a revocable trust. As restated, the trust (i.e., Restated Trust) provided for the creation of various trusts on the first of A or B to die, including: a Survivor's Trust; a Bypass Trust (named beneficiary of IRA); a Marital Deduction Trust; and a Disclaimed Property Trust. The trustee was to distribute income from the Bypass Trust in installments, at least quarterly, for the health care, maintenance, support and welfare of the beneficiary of the trust but only if other resources were clearly inadequate or not reasonably available to meet the beneficiary's needs. The beneficiary of the Bypass Trust was to retain the power to allocate principal from the trust to Secondary Beneficiaries of the Bypass Trust and their descendants as long as the grantor beneficiary was competent and exercised the power in writing. To the extent that the Bypass Trust's beneficiary didn't effectively exercise this power of appointment, the balance of the Bypass Trust was to be disposed of under Article X of the Trust.

A and B amended the Restated Trust to provide that with respect to any IRA, 401(k) or other retirement plan payable to the trust on the death of either trust creator, it was their desire that the trustee utilize the minimum distribution rules described in the Code and applicable regs when making withdrawals from the retirement account.

On A's death, B became the sole Trustee of the trusts under the Restated Trust. He appointed his daughters C and D as co-trustees of the Bypass Trust and named the trustee of the Bypass Trust as the beneficiary of his IRA. When B died, after his required beginning date under Code Sec. 401(a)(9)(C), the Restated Trust and all the trusts administered under it became irrevocable. After B's death, under the Restated Trust's terms, all the trusts administered under it were consolidated and equally divided into the two Protective Trusts created for the benefit of C and D.

Acting as the Bypass Trust's trustees, C and D filed for a declaratory judgment in court to modify the Restated Trust to comply with certain requirements under Reg. § 1.401(a)(9)-4. The court, retroactive to B's death, modified the Restated Trust to provide, among other things, that: (1) all amounts received from the IRA custodian were to be distributed to the beneficiaries of the Protective Trusts; (2) the trustee was authorized to arrange direct distributions from the IRA to the beneficiary; and (3) C (B's oldest lineal descendant) was named as the designated beneficiary under Reg. § 1.401(a)(9)-4, Q&A-4, and the trust was to be administered so that all beneficiaries following C and D were successor beneficiaries.

Adverse ruling. The private letter ruling (PLR) ruled that B was treated as not having a designated beneficiary for his IRA for purposes of Code Sec. 401(a)(9). The PLR reasoned that the efforts to modify the Restated Trust's terms weren't to be given retroactive effect for federal tax purposes. As a result, the designated beneficiary of the IRA had to be determined under the terms of the Restated Trust as it existed at the time of B's death. Generally, IRS will only treat a state court order as controlling with respect to a reformation if the

reformation is specifically authorized by the Code (e.g., Code Sec. 2055(e)(3), which allows the parties to reform a split interest charitable trust so that the charitable interest will qualify for the charitable deduction). Since there was no applicable federal statute which authorized C and D's retroactive reformation of the Restated Trust, the modification wasn't recognized for federal tax purposes.

The Bypass Trust created under the terms of the Restated Trust was named as the beneficiary of B's IRA. If the trust meets the requirements in Reg. § 1.401(a)(9)-4, Q&A-5, it's permissible to look through the trust in order to determine who, if anyone, is the designated beneficiary. But here there was no identifiable designated beneficiary for the IRA at the time of B's death. Specifically, the terms of the Bypass and related trusts, did not require or authorize either C or D to receive all amounts that were distributed from the IRA. The Restated Trust's terms only authorize income and principal subject to a standard to be paid to or for the benefit of either C or D. Further, the Restated Trust's terms did not require that amounts distributed from the IRA, based on the life expectancy of C, be paid either to C, D, or any other natural person (human being).

The Restated Trust's terms allowed either C or D to appoint income or principal to descendants or charities. Because the terms allowed for the accumulation of amounts distributed from the IRA, the remainder beneficiaries had to be considered beneficiaries of the IRA for purposes of determining who, if anyone, was the IRA's designated beneficiary. Charitable organizations were clearly authorized to be potential/contingent beneficiaries under relevant provisions of the Restated Trust instrument. However, only individuals can be designated beneficiaries for purposes of satisfying the requirements of Code Sec. 401(a)(9).

The post-mortem judicial modification had the effect of creating a designated beneficiary after B's death. However, this wasn't recognized for purposes of Code Sec. 401(a)(9). Accordingly, the PLR concluded that the IRA was to be distributed as if B's IRA had no designated beneficiary. Because entities (i.e., charities) ineligible to be treated as designated beneficiaries were eligible to receive amounts from B's IRA, these charities were contingent beneficiaries under Code Sec. 401(a)(9).

14. VEBA could provide benefits to domestic partners without jeopardizing exempt status PLR 201022023

IRS has privately ruled that a VEBA that provided permissible health and insurance benefits, without limitation, to domestic partners who were dependents under Code Sec. 152 and Reg. § 1.501(c)(9)-3(a) would continue to meet the tax-exempt requirements of Code Sec. 501(c)(9). The private letter ruling (PLR) further ruled that the VEBA's exempt status wouldn't be adversely affected by providing de minimis benefits to domestic partners who weren't dependents if the total amount of such impermissible benefits didn't exceed 3% of the total benefits provided to all beneficiaries during the plan year.

Background. Under Code Sec. 501(c)(9), tax-exempt organizations include a voluntary employees' beneficiary association (VEBA) that provides for the payment of life, sick, accident or other benefits to the members of the association or their dependents or designated beneficiaries, if no part of the net earnings of the association inures (other than through the payments) to the benefit of any private shareholder or individual.

Under Code Sec. 152(a), a dependent includes, among others, any of the following individuals over half of whose support, for the calendar year in which the tax year of the taxpayer begins, was received from the taxpayer: sons and daughters; stepsons and stepdaughters; nieces and nephews; aunts and uncles; in-laws; and an individual (other than the spouse) who, for the tax year, had as his or her principal place of abode the taxpayer's home and was a member of the taxpayer's household.

Under Reg. § 1.501(c)(9)-3(a), a tax-exempt VEBA is allowed to provide permissible benefits to individuals who, relying on information furnished to it by a member, it in good faith believes is a person described in Code Sec. 152(a). Reg. § 1.501(c)(9)-3(b) through (e) detail the types of benefits that a VEBA may provide as well as who is eligible to receive these benefits (i.e., “permissible benefits”). An organization isn't described in Code Sec. 501(c)(9) if it systematically and knowingly provides benefits (of more than a de minimis amount) that aren't permitted.

Coverage under an accident or health plan for personal injuries or sickness incurred by individuals other than the employee, his or her spouse, or his or her dependents, as defined in Code Sec. 152 , isn't excludable from the employee's gross income under Code Sec. 106 . Reimbursements received by the employee through an employer provided accident or health plan aren't excludable from the employee's gross income under Code Sec. 105(b) unless the reimbursements are for medical expenses incurred by the employee, his or her spouse, or his or her dependents, as defined in Code Sec. 152. However, reimbursements that aren't excludable under Code Sec. 105(b) may be excludable under Code Sec. 104(a)(3) if they are attributable to employer contributions that were included in the employee's gross income.

Facts. Trust is a tax-exempt VEBA under Code Sec. 501(c)(9) that was established to provide health and insurance benefits to members, employees and dependents of members and employees of the Association. Health benefits include medical, hospital, dental, vision, and prescription drugs. Insurance benefits include disability, long term care and group life insurance. Trust has represented these to be permissible benefits under Reg. § 1.501(c)(9)-3(b) through (e). It represents that the health benefits and the group life insurance benefits are accounted for separately.

Some of Trust's covered beneficiaries are domestic partners who satisfy the definition of dependent under Code Sec. 152 and Reg. § 1.501(c)(9)-3(a). Trust determines whether a domestic partner is a dependent based on written and notarized certifications made by the employee and partner.

Trust wishes to provide benefits to domestic partners who do not meet the definition of a dependent. Trust describes the amount of benefits it will provide to non-dependent partners as de minimis. The total amount of impermissible benefits it will provide in a plan year, including health benefits to non-dependent domestic partners, will not exceed 3% of the total of all benefits it provides in the plan year to all Trust beneficiaries. Trust recognizes that since the domestic partner is not a dependent of the member or employee, the fair market value of the domestic partner's health coverage is income and wages to the member or employee.

IRS rules favorably. The PLR concluded that Trust will meet the tax-exempt requirements of Code Sec. 501(c)(9) if it provides permissible benefits, without limitation, to domestic partners who are dependents. Trust represented that it was providing permissible benefits to domestic partners who meet the definition of dependent in Code Sec. 152(a). It required notarized certification of the financial, residential, and other factors in determining whether domestic partners meet the definition of a dependent. The PLR ruled that under these facts, Trust didn't jeopardize its tax-exempt status by providing permissible benefits to these domestic partners. Any permissible benefits provided to these dependents weren't “impermissible” benefits under Reg. § 1.501(c)(9)-3(a).

Further, the PLR ruled that Trust may also provide benefits to domestic partners who aren't dependents without adversely affecting its tax-exempt status under Code Sec. 501(c)(9) if the total amount of impermissible benefits provided by it in a plan year is 3% or less of the total of all benefits provided by Trust in the plan year to all beneficiaries. Trust must also include in the gross income of members or employees the fair market value of the health coverage for domestic partners who weren't dependents of the members or employees.

15. Detailed guidance released on new small business health care credit Notice 2010-44, 2010-22 IRB; IR 2010-63

IRS has issued detailed guidance on the small employer health insurance credit created by the Patient Protection and Affordable Care Act (Affordable Care Act, P.L. 111-148). The guidance adopts a liberal approach to the statutory requirements, including three alternative methods for figuring total hours of service, and also explains how small employers claim the credit if their State provides a credit or subsidy for employee health coverage.

Background. Under the Affordable Care Act, effective for tax years beginning after Dec. 31, 2009, an eligible small employer (ESE) may claim a tax credit for nonelective contributions to purchase health insurance for its employees. (Code Sec. 45R) An ESE is an employer with no more than 25 full-time equivalent employees (FTEs) employed during its tax year, and whose employees have annual full-time equivalent wages that average no more than $50,000. (Code Sec. 45R(d)) However, the full 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 not more than $25,000. (Code Sec. 45R(c)) Aggregation rules apply in determining the employer. (Code Sec. 45R(b))

The contributions must be provided under a qualifying arrangement, i.e., one requiring the ESE to make a nonelective contribution for each employee who enrolls in certain defined qualifying health insurance offered by the ESE equal to a uniform percentage (not less than 50%) of the premium cost of the qualifying health plan. (Code Sec. 45R(d)(4)) A transition rule applies for 2010; see below.

The credit is a general business credit, can be carried back for one year and carried forward for 20 years, and can offset alternative minimum tax. (Code Sec. 38(b), Code Sec. 39(a)), Code Sec. 38(c)(4)(B)(vi))

Qualifying health insurance during initial credit phase. For any tax year beginning in 2010, 2011, 2012, or 2013, qualifying health insurance is health insurance coverage within the meaning of Code Sec. 9832(b)(1) (generally health insurance coverage bought from a State licensed insurance company). (Code Sec. 45R(g)(2))

Calculation of credit amount. For tax years beginning before 2014, the credit is equal to the lesser of the following two amounts multiplied by an applicable tax credit percentage:

(1) Total nonelective contributions the ESE made on behalf of the employees during the tax year for the qualifying health coverage.
(2) Total nonelective contributions the ESE would have paid if each employee were enrolled in a plan that had a premium equal to the average premium for the small group market in the State (or in an area in the State) in which the employer is offering health insurance coverage. Health and Human Services (HHS) determines whether separate average premiums apply for areas within a State and also determines the average premium for a State or sub-State area. (Code Sec. 45R(b))

RIA observation: In Rev Rul 2010-13, 2010-21 IRB, IRS released a state-by-state table of average health insurance premiums for the small group market for the 2010 tax year; see Weekly Alert ¶ 4 05/06/2010.

The applicable percentage is 35% for tax years beginning after 2009 and before 2014 (25% for tax exempts) and is 50% for tax years beginning after 2013 (35% for tax-exempts). For exempts, the credit is a refundable tax credit limited to the amount of the employer's payroll taxes (income tax and Medicare tax withheld from employees' wages and the employer share of Medicare tax on employees' wages) during the calendar year in which the tax year begins.

The credit is reduced for an ESE if:

> (1) It has more than 10 FTEs but not more than 25 FTEs. Find the number of FTEs by dividing (1) the total hours for which the ESE pays wages to employees during the year (but not more than 2,080 hours for any employee) by (2) 2,080.
> (2) Average wages per employee is between $25,000 and $50,000. (Code Sec. 45R(c)) Find average annual wages by dividing (a) total wages (as defined for FICA purposes, without regard to the wage base limitation) paid to employees during the ESE's tax year by (2) the number of the FTEs for the year. Round the result down to the nearest $1,000 (if not otherwise a multiple of $1,000). (Code Sec. 45R(d)(3)(A), Code Sec. 45R(e)(4))

If an ESE has more than 10 FTEs *and* average annual wages exceed $25,000, the credit reduction is the sum of the amount of the two reductions above. The Code Sec. 45R credit reduces the employer's Code Sec. 162 deduction for contributions to employees' health insurance coverage. (Code Sec. 45R(e)(5))

A sole proprietor, a partner in a partnership, a shareholder owning more than 2% of an S corporation, any owner of more than 5% of other businesses, a family member of any of these individuals, or a member of such a business owner's or partner's household: (1) are not considered employees for Code Sec. 45R purposes, (2) their wages or hours are not counted in determining either the number of FTEs or the amount of average annual wages, and (3) premiums paid on their behalf are not counted in determining the amount of the credit. (Code Sec. 45R(e))

In April, IRS issued preliminary guidance on the Code Sec. 45R credit in the form of frequently asked questions (FAQs) posted on its website; see Weekly Alert ¶ 1 04/08/2010. New Notice 2010-44 formalizes much of the guidance in April's FAQs, but also contains new guidance as well as clarification of points raised in the FAQs. Here's a summary of the more important aspects of the new Code Sec. 45R guidance.

Hours of service worked. An employee's hours of service for a year include each hour for which an employee is paid, or entitled to payment, for (a) the performance of duties for the employer; and (b) for vacation, holiday, illness, incapacity (including disability), layoff, jury duty, military duty or leave of absence (except that no more than 160 hours of service are required to be counted for an employee on account of any single continuous period during which the employee performs no duties). (Notice 2010-44, Sec. II.C.)

In calculating the total number of hours of service which must be taken into account for an employee for the year, the employer may use any of three methods:

> (1) determine actual hours of service from records of hours worked and hours for which payment is made or due (payment is made or due for vacation, holiday, illness, incapacity, etc.);
> (2) use a days-worked equivalency where the employee is credited with 8 hours of service for each day for which he would be required to be credited with at least one hour of service under (1), above; or
> (3) use a weeks-worked equivalency where the employee is credited with 40 hours of service for each week for which he would be required to be credited with at least one hour of service under (1), above. (Notice 2010-44, Sec. II.C.)

Finding the number of FTEs. The number of an employer's FTEs is found by dividing (a) the total hours of service, as determined above, credited during the year to employees taken into account for Code Sec. 45R purposes, by (b) 2,080. The result, if not a whole number, is then rounded to the next lowest whole number. In some circumstances, an employer with 25 or more employees may qualify for the credit if some of its employees work part-time. For example, an employer with 46 half-time employees (i.e., they are paid wages for 1,040 hours) has 23 FTEs and, therefore, may qualify for the credit. (Notice 2010-44, Sec. II.D.)

An example makes clear that in determining whether Code Sec. 45R applies, all FTEs must be taken into account, even though not all of them are enrolled in the employer's health insurance plan. (Notice 2010-44, Sec. II.D., Ex. 4)

What is health insurance coverage. For pre-2014 years, health insurance coverage for purposes of the Code Sec. 45R credit means benefits consisting of:

> ... Medical care (provided directly, through insurance or reimbursement, or otherwise) under any hospital or medical service policy or certificate, hospital or medical service plan contract, or health maintenance organization contract offered by a health insurance issuer.

... Limited-scope dental or vision; long-term care, nursing home care, home health care, community-based care, or any combination thereof.
... Coverage only for a specified disease or illness.
... Hospital indemnity or other fixed indemnity insurance.
... Medicare supplemental health insurance; and certain other supplemental coverage, and similar supplemental coverage provided to coverage under a group health plan. (Notice 2010-44, Sec. II.G.)

Health insurance coverage does not include the benefits listed in Code Sec. 9832(c)(1) (e.g., coverage only for accident or disability income insurance, auto medical payment insurance, coverage for on-site medical clinics). (Notice 2010-44, Sec. II.G.)

Different types of health insurance plans are not aggregated for purposes of meeting the qualifying arrangement requirement. So, for example, if an employer offers a major medical insurance plan and a stand-alone vision plan, it must separately satisfy the requirements for a qualifying arrangement for each type of coverage. The average premium for the small group market in the State does not apply separately to each type of permissible coverage, but rather provides an overall cap for all health insurance coverage provided by an ESE. (Notice 2010-44, Sec. II.G.)

State credits or subsidies for health insurance. Small employers providing health insurance to employees may receive a State tax credit (refundable or nonrefundable), or a State subsidy for part of employees' health insurance premiums. Generally, a premium subsidy is paid either directly to the employer or to the employer's insurance company (or another entity licensed under State law to engage in the insurance business). If the employer gets a State tax credit (whether refundable or nonrefundable), or a premium subsidy *paid directly to the employer*, then:

- the employer's premium payment is not reduced by the credit or subsidy when determining if it has satisfied the requirement to pay an amount equal to a uniform percentage (not less than 50%) of the premium cost; and
- the maximum amount of the Code Sec. 45R credit is not reduced because of a State tax credit or because of State payments directly to the employer. (Notice 2010-44, Sec. III.D.)

Generally, a State that makes payments directly to an insurance company (or another entity licensed under State law to engage in the insurance business) for a part of employee premiums is treated as making these payments on behalf of the employer for purposes of determining whether the employer satisfies the requirement to pay an amount equal to a uniform percentage (not less than 50%) of the premium cost of coverage; and the State premium payments are treated as an employer contribution under Code Sec. 45R for purposes of calculating the credit. (Notice 2010-44, Sec. III.D.)

However, the amount of the Code Sec. 45R credit cannot exceed the amount of the employer's net premium payments. For a State tax credit or a State subsidy paid directly to an employer, the employer's net premium payments are found by subtracting the State tax credit or subsidy from the employer's actual premium payments. For a State payment directly to an insurance company (or another entity licensed under State law to engage in the insurance business), the employer's net premium payments are its actual premium payments. (Notice 2010-44, Sec. III.D.)

Transition relief for tax year beginning in 2010. For a tax year beginning in 2010, an employer that pays an amount equal to at least 50% of the premium for *single (employee-only) coverage* for each employee enrolled in coverage is deemed to satisfy the uniformity requirement for a qualifying arrangement, even if the employer does not pay the same percentage of the premium for each employee. Thus, an employer meets the uniformity requirement if it pays at least 50% of single-coverage premiums for each employee receiving single coverage, and, if the employer offers more-expensive coverage (e.g., family or self-plus-one coverage), if it pays an amount for each employee receiving that more expensive coverage that is no less than 50% of the premium for single coverage for that employee (even if it is less than 50% of the premium for the more expensive coverage the employee is actually receiving). (Notice 2010-44, Sec. V.)

RIA observation: The 2010 transition rule in Notice 2010-44 phrases the relief as taking only one form. By contrast, IRS's FAQs issued last month seemed to phrase transition relief as taking one of two forms: (a) an employer paying at least 50% of the premium for each employee enrolled in coverage won't fail to maintain a qualifying arrangement merely because the employer does not pay a uniform percentage of the premium for each such employee; and (b) the requirement that the employer pay at least 50% of the premium for an employee applies to the premium for single (employee-only) coverage for the employee.

16. Timeline of tax changes in health care reform legislation

Close to a month ago, Congress passed and the President signed into law legislation that overhauls the U.S. health care system and affects nearly all taxpayers, many employers, and many elements of the health care industry (the Patient Protection and Affordable Care Act (Health Care Act, or “PPACA,” P.L. 111-148, and the Health Care and Education Reconciliation Act of 2010 (Reconcilia-

tion Act, or "HCERA," P.L. 111-152). The massive overhaul contains a host of tax changes, many of which are both complex and novel. To compound the challenge, the tax changes go into effect over a number of years—ten if two retroactively effective tax changes are counted and nine if they are not.

This Practice Alert should help practitioners get a fix on tax changes that are in effect right now, those that are looming on the horizon, and changes that are many years down the road. It presents a timeline of the tax changes in PPACA and HCERA, and a concise summary of each new tax provision, plus cross-references to a Tax Planning and Practice Guide (Highlights of the Tax and Benefits Provisions of the 2010 Health Care Act as Amended by the 2010 Health Care Reconciliation Act) for more information.

Tax Changes Retroactively Effective to 2009

Investment credit for qualifying therapeutic discovery projects. For expenses paid or incurred after Dec. 31, 2008, there is a new 50% nonrefundable investment tax credit for qualified investments in qualifying therapeutic discovery projects. (Code Sec. 48D) A total of $1 billion is allocated to such projects during the 2009 through 2010 period. The credit is available only to companies having 250 or fewer employees. A "qualifying therapeutic discovery project" is one designed to develop a product, process, or therapy to diagnose, treat, or prevent diseases and afflictions by: (1) conducting pre-clinical activities, clinical trials, clinical studies, and research protocols, or (2) developing technology or products designed to diagnose diseases and conditions, including molecular and companion drugs and diagnostics, or to further the delivery or administration of therapeutics. (Tax Planning & Practice Guide ¶ 408 04/01/2010)

Exclusion for state student loan repayment or loan forgiveness programs for health professionals. For amounts received by an individual in tax years beginning after Dec. 31, 2008, the gross income exclusion for amounts received under the National Health Service Corps loan repayment program or certain State loan repayment programs is modified to include any amount received by an individual under any State loan repayment or loan forgiveness program that is intended to provide for the increased availability of health care services in underserved or health professional shortage areas (as determined by the State). (Code Sec. 108(f)(4)) (Tax Planning & Practice Guide ¶ 407 04/01/2010)

Tax Changes Taking Effect in 2010

New qualification requirements for nonprofit hospitals. For tax years beginning after Mar. 23, 2010, detailed new qualification requirements apply to any Code Sec. 501(c)(3) organization that operates at least one hospital facility. (Code Sec. 501(r) and Code Sec. 6033(b)) These requirements include: conducting, implementing and widely publicizing a community health needs assessment; adopting and implementing a written financial assistance policy; and adopting and implementing a nondiscriminatory policy to provide emergency medical treatment to individuals. (Code Sec. 5000B(a)) (Tax Planning & Practice Guide ¶ 302 04/01/2010)

Tanning services excise tax. For indoor tanning services performed on or after July 1, 2010, a new 10% excise tax is imposed on any indoor tanning service, whether paid for by insurance or otherwise. The tax is imposed on tanning service recipients (although the provider is secondarily liable). (Code Sec. 5000B(a)) (Tax Planning & Practice Guide ¶ 303 04/01/2010)

Small employer health insurance credit. For tax years beginning after Dec. 31, 2009, an eligible small employer (ESE) is entitled to a tax credit for making nonelective contributions to buy health insurance for its employees. (Code Sec. 45R) An ESE generally is an employer with no more than 25 full-time equivalent employees (FTEs) employed during its tax year, and whose employees 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 not more than $25,000.) (Tax Planning & Practice Guide ¶ 106 04/01/2010; see also Weekly Alert ¶ 1 04/08/2010 and Weekly Alert ¶ 1 04/29/2010)

Expanded dependent coverage in employer health plans. Effective on Mar. 30, 2010, the general exclusion for reimbursements for medical care expenses under an employer-provided accident or health plan is extended to any child of an employee who hasn't attained age 27 as of the end of the tax year. (Code Sec. 105(b)) This change also applies to the exclusion for employer-proved coverage under an accident or health plan for injuries or sickness for such a child. A parallel change applies for voluntary employees' beneficiary associations (VEBAs) (Code Sec. 501(c)(9)), and for Code Sec. 401(h) accounts. (Code Sec. 401(h)) Code Sec. 162(l) is similarly amended to allow self-employed individuals to take a deduction for health insurance costs of any child of the taxpayer who has not attained age 27 as of the end of the tax year. (Code Sec. 162(l)(1)(D)) (Tax Planning & Practice Guide ¶ 107 04/01/2010; see also Weekly Alert ¶ 7 04/29/2010)

Codification of economic substance, imposition of new penalties. For transactions entered into after Mar. 30, 2010 and for underpayments, understatements, and refunds and credits attributable to transactions entered into after Mar. 30, 2010, the following rule applies to any transaction to which the economic substance doctrine is relevant: The transaction has economic substance only if, apart from federal income tax effects, (1) the transaction changes in a meaningful way the taxpayer's economic position; *and* (2) the taxpayer has a substantial purpose for entering into the transaction. (Code Sec. 7701(o)(1)) For underpayments attributable to transactions

entered into after Mar. 30, 2010, a new strict liability penalty under Code Sec. 6662 applies for an underpayment attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance (as defined in Code Sec. 7701(o)), or failing to meet the requirements of any similar rule of law. (Code Sec. 6662(b)(6)) The penalty rate is 20% (increased to 40% if the taxpayer doesn't adequately disclose the relevant facts affecting the tax treatment in the return or a statement attached to the return). (Code Sec. 6662(i)(1)) Several other penalty related provisions apply. (Code Sec. 6676(c)) (Code Sec. 162(l)(1)(D)) (Tax Planning & Practice Guide ¶ 402 04/01/2010)

Eased rules for adoption credit and exclusion for employer-provided adoption assistance. For tax years beginning after Dec. 31, 2009, the maximum adoption credit is increased to $13,170 per eligible child (a $1,000 increase) for both non-special needs adoptions and special needs adoptions. (Code Sec. 36C) The adoption credit is made refundable. The maximum exclusion for employer-provided adoption assistance also is increased to $13,170 per eligible child (a $1,000 increase). (Code Sec. 137) (Code Sec. 162(l)(1)(D)) (Tax Planning & Practice Guide ¶ 406 04/01/2010)

Tax breaks eliminated for health organizations with medical loss ratios below 85%. For tax years beginning after Dec. 31, 2009, health organizations whose medical loss ratio is below 85% cannot take advantage of the favorable tax provisions of Code Sec. 833 including treatment as a stock insurance company. (Code Sec. 833(c)(5)) (Code Sec. 162(l)(1)(D)) (Tax Planning & Practice Guide ¶ 304 04/01/2010)

Tightened rules for cellulosic biofuel producer credit. For fuels sold or used on or after Jan. 1, 2010, the cellulosic biofuel producer credit is not available for fuels with significant water, sediment, or ash content, such as “black liquor.” (Code Sec. 40(b)(6)(E)) (Code Sec. 162(l)(1)(D)) (Tax Planning & Practice Guide ¶ 403 04/01/2010)

Tax Changes Taking Effect in 2011

W-2 must include cost of employer-provided health insurance. For tax years beginning after Dec. 31, 2010, an employer must disclose on each employee's annual Form W-2 the value of the employee's health insurance coverage sponsored by the employer. (Code Sec. 6051(a)(14)) (Tax Planning & Practice Guide ¶ 203 04/01/2010)

Restricted definition of medicine for health plan reimbursements. The cost of over-the-counter medicines can't be reimbursed with excludible income through a health flexible spending arrangement (FSA), health reimbursement account (HRA), health savings account (HSA), or Archer MSA, unless the medicine is prescribed by a doctor. For HSAs and Archer MSAs, this applies for amounts paid with respect to tax years beginning after Dec. 31, 2010; for health FSAs and HRAs, it applies for expenses incurred with respect to tax years beginning after Dec. 31, 2010. (Code Sec. 106(f), Code Sec. 220(d)(2)(A), and Code Sec. 223(d)(2)(A)) (Tax Planning & Practice Guide ¶ 207 04/01/2010)

Boosted tax on nonqualifying HSA and Archer MSA distributions. For disbursements made during tax years starting after Dec. 31, 2010, the additional tax on distributions from an HSA that are not used for qualified medical expenses is increased from 10% to 20% of the disbursed amount, and the additional tax on distributions from an Archer MSA that are not used for qualified medical expenses is increased from 15% to 20% of the disbursed amount. (Code Sec. 220(f)(4)(A) and Code Sec. 223(f)(4)(A)) (Tax Planning & Practice Guide ¶ 209 04/01/2010)

Annual fee on drug manufacturers and importers. For calendar years beginning after Dec. 31, 2010, each manufacturer or importer with gross receipts from branded prescription drug sales that is engaged in the business of manufacturing or importing such drugs for sale to any specified government program or pursuant to coverage under any such program, must pay an annual nondeductible fee, which will be credited to the Medicare Part B trust fund. (PPACA Sec. 9008) The annual flat fee (e.g., $2.5 billion for 2011) is apportioned among the covered entities each year based on each entity's relative share of branded prescription drug sales taken into account during the previous calendar year. (Tax Planning & Practice Guide ¶ 305 04/01/2010)

Small employers may establish “simple cafeteria plans. For years beginning after Dec. 31, 2010, small employers (average of 100 or fewer employees on business days during either of the two preceding years) may provide employees with a “simple cafeteria plan.” (Code Sec. 125(j)) Under such a plan, the employer is provided with a safe harbor from the nondiscrimination requirements for cafeteria plans as well as from the nondiscrimination requirements for specified qualified benefits offered under a cafeteria plan, including group term life insurance, benefits under a self-insured medical expense reimbursement plan, and benefits under a dependent care assistance program. (Tax Planning & Practice Guide ¶ 405 04/01/2010)

Tax Change Taking Effect in 2012

Information reporting required for payments to corporations. For payments made after Dec. 31, 2011, businesses that pay any amount greater than $600 during the year to non-tax-exempt corporate providers of property and services will have to file an information report with each provider and with IRS. (Code Sec. 6041(h)) (Tax Planning & Practice Guide ¶ 401 04/01/2010)

Tax Changes Taking Effect in 2013

Increased HI tax for high-earning workers and self-employed taxpayers. For tax years beginning after 2012, an additional 0.9% hospital insurance (HI) tax applies under Code Sec. 3101(b)(2) to wages received with respect to employment in excess of: $250,000 for joint returns; $125,000 for married taxpayers filing a separate return; and $200,000 in all other cases. Under Code Sec. 1401(b)(2), the additional 0.9% HI tax also applies to self-employment income for the tax year in excess of the above figures. (Code Sec. 6051(a)(14)) (Tax Planning & Practice Guide ¶ 205 04/01/2010)

Surtax on unearned income of higher-income individuals. For tax years beginning after Dec. 31, 2012, an unearned income Medicare contribution tax is imposed on individuals, estates, and trusts. (Code Sec. 1411) For an individual, the tax is 3.8% of the lesser of either (1) net investment income or (2) the excess of modified adjusted gross income over the threshold amount ($250,000 for a joint return or surviving spouse, $125,000 for a married individual filing a separate return, and $200,000 for all others). For surtax purposes, gross income doesn't include excluded items, such as interest on tax-exempt bonds, veterans' benefits, and excluded gain from the sale of a principal residence. (Tax Planning & Practice Guide ¶ 206 04/01/2010)

Higher threshold for deducting medical expenses. For tax years beginning after Dec. 31, 2012, unreimbursed medical expenses will be deductible by taxpayers under age 65 only to the extent they exceed 10% of adjusted gross income (AGI) for the tax year. (Code Sec. 213(a)) If the taxpayer or his or her spouse has reached age 65 before the close of the tax year, a 7.5% floor applies through 2016 and a 10% floor applies for tax years ending after Dec. 31, 2016. (Code Sec. 213(f)) (Tax Planning & Practice Guide ¶ 208 04/01/2010)

Dollar cap on contributions to health FSAs. For tax years beginning after Dec. 31, 2012, for a health FSA to be a qualified benefit under a cafeteria plan, the maximum amount available for reimbursement of incurred medical expenses of an employee (and dependents and other eligible beneficiaries) under the health FSA for a plan year (or other 12-month coverage period) can't exceed $2,500. (Code Sec. 125(i)) (Code Sec. 213(f)) (Tax Planning & Practice Guide ¶ 210 04/01/2010)

Deduction eliminated for retiree drug coverage. Sponsors of qualified retiree prescription drug plans are eligible for subsidy payments from the Secretary of Health and Human Services (HHS) for a portion of each qualified covered retiree's gross covered prescription drug costs ("qualified retiree prescription drug plan subsidy"). These qualified retiree prescription drug plan subsidies are excludable from the taxpayer's (plan sponsor's) gross income for regular income tax and alternative minimum tax (AMT) purposes. For tax years beginning before 2013, a taxpayer may claim a business deduction for covered retiree prescription drug expenses, even though it excludes qualified retiree prescription drug plan subsidies allocable to those expenses. But for tax years beginning after Dec. 31, 2012, under Code Sec. 139A , the amount otherwise allowable as a deduction for retiree prescription drug expenses will be reduced by the amount of the excludable subsidy payments received. (Tax Planning & Practice Guide ¶ 202 04/01/2010)

Fee on health plans. For each policy year ending after Sept. 30, 2012, each specified health insurance policy and each applicable self-insured health plan will have to pay a fee equal to the product of $2 ($1 for policy years ending during 2013) multiplied by the average number of lives covered under the policy. The issuer of the health insurance policy or the self-insured health plan sponsor is liable for and must pay the fee. (Code Sec. 4375, Code Sec. 4376, and Code Sec. 4377) (Tax Planning & Practice Guide ¶ 212 04/01/2010)

$500,000 compensation deduction limit for health insurance issuers. For tax years beginning after Dec. 31, 2012, for services performed during that year, a covered health insurance provider isn't allowed a compensation deduction for an "applicable individual" (officers, employees, directors, and other workers or service providers such as consultants) in excess of $500,000. (Code Sec. 162(m)(6)(A)) A complex rule may reach compensation attributable to services performed in a tax year beginning after Dec. 31, 2009. (Tax Planning & Practice Guide ¶ 301 04/01/2010)

Excise tax on medical device manufacturers. For sales after Dec. 31, 2012, a 2.3% excise tax applies under Code Sec. 4191 to sales of taxable medical devices intended for humans. The excise tax, paid by the manufacturer, producer, or importer of the device, won't apply to eyeglasses, contact lenses, hearing aids, and any other medical device determined by IRS to be of a type that is generally purchased by the general public at retail for individual use. (Tax Planning & Practice Guide ¶ 306 04/01/2010)

Tax Changes Taking Effect in 2014

Larger employers not offering affordable health insurance coverage must pay penalty. Under Code Sec. 4980H , for months beginning after Dec. 31, 2013, a large employer (generally, one with at least 50 full-time employees) that (1) doesn't offer health care coverage for all its full-time employees, (2) offers minimum essential coverage that is unaffordable (coverage with a premium required to be paid by the employee that is more than 9.5% of the employee's household income, as defined for purposes of certain premium tax credit rules), or (3) offers minimum essential coverage that consists of a plan under which the plan's share of the total allowed cost of benefits is less than 60%, must pay a penalty if any full-time employee is certified to the employer as having purchased

health insurance through a state exchange with respect to which a tax credit or cost-sharing reduction is allowed or paid to the employee. (Tax Planning & Practice Guide ¶ 104 04/01/2010)

Individuals not carrying health insurance face a penalty. For tax years beginning after Dec. 31, 2013, nonexempt U.S. citizens and legal residents must pay a penalty if they do not maintain minimum essential coverage, which includes government sponsored programs (e.g., Medicare, Medicaid, Children's Health Insurance Program), eligible employer-sponsored plans, plans in the individual market, certain grandfathered group health plans and other coverage as recognized by HHS in coordination with IRS. (Code Sec. 5000A) There are a number of exceptions, such as one for certain lower-income individuals. (Tax Planning & Practice Guide ¶ 101 04/01/2010)

Some employers must offer "free choice" vouchers for basic coverage. Effective for periods after Dec. 31, 2013, employers offering minimum essential coverage through an eligible employer-sponsored plan and paying a portion of that coverage must provide qualified employees with a "free choice" voucher whose value can be applied to purchase of a health plan through an Insurance Exchange. (Code Sec. 139D) The employer treats the free choice voucher as an amount for compensation for personal services actually rendered. (Code Sec. 162(a)) Briefly, qualified employees are those who do not participate in the employer sponsored plan; whose required contribution for employer sponsored minimum essential coverage (if they did participate in the plan) exceeds 8%, but does not exceed 9.8% of household income; and whose total household income does not exceed 400% of the poverty line for the family. (Tax Planning & Practice Guide ¶ 105 04/01/2010)

Refundable tax credit for low- or moderate-income families buying certain health insurance. For tax years ending after Dec. 31, 2013, a new refundable tax credit (the "premium assistance credit") under Code Sec. 36B applies to qualifying taxpayers who get health insurance coverage by enrolling in a qualified health plan through a State-established American Health Benefit Exchange. (Tax Planning & Practice Guide ¶ 102 04/01/2010)

"Qualified health plans" may be offered through cafeteria plans by "qualified employers." For tax years beginning after Dec. 31, 2013, a reimbursement (or direct payment) for the premiums for coverage under any "qualified health plan" through a health insurance Exchange is a qualified benefit under a cafeteria plan if the employer is a qualified employer (generally, smaller businesses). (Code Sec. 125(f)(3)(B)) In very broad terms, a qualified health plan is one that meets certain certification requirements, provides "an essential health benefits package," and is offered by an insurer meeting detailed requirements. And a health insurance "Exchange" is a federally supervised marketplace for health insurance policies meeting specific eligibility and benefit criteria, to be made available not later than Jan. 1, 2014, to qualifying individuals and employer groups of graduated sizes. (Tax Planning & Practice Guide ¶ 103 04/01/2010)

New information reporting of employer provided health coverage. For periods beginning after Dec. 31, 2013, new information reporting and related statement obligations apply under Code Sec. 6056 for (1) certain applicable large employers required to offer their full-time employees and their dependents the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan and (2) offering employers (those offering minimum essential coverage to employees and paying any portion of the such coverage, but only if the required employer contribution of any employee exceeds 8% of the employee's wages). (Tax Planning & Practice Guide ¶ 204 04/01/2010)

Excise tax on health insurance providers. For calendar years beginning after Dec. 31, 2013, an annual fee applies to health insurance providers. The aggregate annual flat fee for the industry (e.g., $8 billion for 2014) will be allocated based on a health provider's market share of net premiums written for a U.S. health risk for calendar years beginning after Dec. 31, 2012. The fee will not apply to companies whose net premiums written are $25 million or less. For purposes of the fee, health insurance does not include: coverage only for a specified disease or illness; hospital indemnity or other fixed indemnity insurance; insurance for long-term care; or any Medicare supplemental health insurance. (PPACA Sec. 9010, as amended by HCERA Sec. 10905, as further amended by HCERA Sec. 1406) (Tax Planning & Practice Guide ¶ 307 04/01/2010)

Accelerated estimated tax payments for large corporations. The estimated tax payment due for large corporations (assets of at least $1 billion at the end of the previous tax year) in July, August, or September 2014 is increased from 157.75% to 173.50% of the payment otherwise due, and the amount of the next required installment is appropriately reduced. (HCERA Sec. 1410) (Tax Planning & Practice Guide ¶ 404 04/01/2010)

Tax Change Taking Effect in 2018

Excise tax applies to high-cost employer provided health insurance coverage. For tax years beginning after Dec. 31, 2017, a 40% nondeductible excise tax will be levied on insurance companies and plan administrators for employer-sponsored health coverage to the extent that annual premiums exceed $10,200 for single coverage and $27,500 for family coverage. (Code Sec. 4980I) An additional threshold amount of $1,650 for single coverage and $3,450 for family coverage will apply for retired individuals age 55 and older and for plans that cover employees engaged in high risk professions. (Tax Planning & Practice Guide ¶ 201 04/01/2010)

17. Wife had no survivorship interest in deceased husband's rollover IRA Charles Schwab & Co v. Debickero, Cheryl M. (CA 9 1/22/2010) 105 AFTR 2d ¶ 2010-407

The Ninth Circuit has held that an IRA's named beneficiaries, rather than his wife, were entitled to the IRA funds after his death, even though some of the funds in the IRA had been rolled over from a 401(k) plan subject to ERISA's surviving spouse provisions.

Facts. Wayne Wilson was a participant in the Siemens/GTE's 401(k) plan. After leaving employment with Siemens, Wayne elected in '94 to close his Siemens 401(k) account and take a lump-sum distribution, which he rolled over into an IRA with Smith Barney. Between '95 and '99, Wayne also transferred or rolled over funds from other accounts into the Smith Barney IRA.

Wayne married Katherine Chandler in December of 2000.

In June of 2002, Wayne transferred about half of the funds from the Smith Barney IRA into an IRA opened with Charles Schwab. Despite his marriage to Katherine, Wayne told Schwab that he was divorced, and named his four adult children from a previous marriage as the IRA's primary beneficiaries.

On Aug. 9, 2005, at the age of 65, Wayne died unexpectedly in a flash flood. Katherine claimed that she was entitled to the funds in the Schwab IRA, and Wayne's four children contested her claim, asserting their own right to the IRA funds. Faced with this dispute, Schwab filed an interpleader action naming Katherine and Wayne's children as defendants. Katherine filed a cross-claim against the children, asserting that she was entitled to the funds as Wayne's surviving spouse, under either ERISA or the Code.

The district court granted summary judgment in favor of Wayne's children, rejecting Katherine's argument that ERISA's surviving spouse protections continued to apply even after the 401(k) funds were rolled over into an independently managed IRA. The court also refused to construe the Code as imposing surviving spouse protections, identical to those in ERISA, on IRAs. Katherine appealed to the Ninth Circuit.

Rollover IRAs and ERISA. Katherine's primary claim to automatic surviving spouse benefits was based on ERISA § 205 , which requires that certain plans provide that the surviving spouse of a vested plan participant must receive a qualified survivor annuity when the participant dies. Generally, the survivor annuity requirement does not apply to a 401(k) plan—but only if the plan provides that the nonforfeitable accrued benefit of a deceased participant is payable in full to the participant's surviving spouse (or, if there is no surviving spouse, or if the surviving spouse consents, to a designated beneficiary).

The Ninth Circuit said, however, that ERISA's surviving spouse provisions apply only when an ERISA-qualified plan is involved, While the Siemens 401(k) plan was covered by ERISA, and although Wayne was at one point a participant in that ERISA-covered plan, the court concluded that ERISA ceased to apply when, long before his marriage to Katherine, he terminated his participation in the 401(k) plan and transferred the proceeds to an independent IRA.

Under ERISA § 4(a), ERISA covers only an “employee benefit plan” that is established or maintained by an employer, an employee organization, or both. The Schwab IRA at issue here was established and maintained by Wayne personally, and thus was not covered by ERISA. It was beside the point that the IRA proceeds originated as employee benefits within an ERISA-qualified plan, the court said. An ERISA plan is delineated not in terms of “employee benefits,” but in terms of “employee benefit *plans.”* Only “plans” involve administrative activity subject to employer abuse. Under Labor Reg. 2510.3-2(d)(1), too, IRAs are specifically excluded from ERISA's coverage, as long as the involvement of an employer or employee organization is strictly limited. There was no employer involvement with the Schwab IRA here.

Katherine argued that “properly construed,” ERISA excludes from coverage only self-funded IRAs, and not IRAs containing funds that originated as employer contributions to an ERISA-covered plan. Specifically, she said that one of the criteria for excluding IRAs from ERISA coverage under Labor Reg. 2510.3-2(d)(1) is that “no contributions are made by the employer or employee organization.” According to Katherine, no distinction should be made between *direct* employer contributions to an ERISA-qualified pension plan, and employer contributions to an ERISA-qualified plan that are *rolled over* into an independent IRA. The Ninth Circuit rejected this argument, saying that the reg sets limits on ERISA coverage not based on the ultimate origin of funds contributed to the IRA, but on the degree of an employer's (or employee organization's) involvement in the IRA itself. That is reflected in the reg's reference to an employer's contributions in the present tense: “no employer contributions *are made* by the employer.” Past contributions that were made by a former employer to a different retirement plan (i.e., not the IRA) do not invoke ERISA coverage of the IRA, the court said.

In addition, ERISA § 201(6) specifically excludes IRAs from ERISA's participation and vesting requirements in Part 2 of Title I, which include the joint and survivor annuity requirements at issue here. This exclusion of IRAs applies even for an IRA that *is* covered under ERISA, the court noted.

Rollover IRAs and the Code. Katherine also argued that the Code Sec. 401(a)(11) automatic surviving spouse requirements, which mirror the ERISA requirements, applied to the Schwab IRA. She relied on Code Sec. 408(a)(6), which provides for IRS regs that would establish rules “similar to the rules of Code Sec. 401(a)(9) and the incidental death benefit requirements,” which would apply to the distribution of the entire interest of an individual for whose benefit the IRA is maintained. Katherine read this Code provision as requiring that the incidental death benefit requirements, including the survivor annuity requirements, be incorporated in their entirety to apply to IRAs. The Ninth Circuit disagreed with Katherine's interpretation. In fact, it said that Reg. § 1.408-2(b)(8) specifically leaves the designation of IRA beneficiaries to the individual account holder.

Further, the Code Sec. 401(a)(11) joint and survivor annuity rules address the requirements for a “qualified trust,” which is an employer's plan for the exclusive benefit of its employees. Thus, these rules do not apply to individually established and maintained IRAs, like the Schwab IRA here. IRAs are specifically excluded from the surviving spouse rules in Reg. § 1.401(a)-20, Q&A 3(d).

Thus, the Ninth Circuit affirmed the district court's grant of summary judgment for Wayne's children, as beneficiaries of the Schwab IRA.

RIA observation: The surviving spouse annuity rules in ERISA § 205 do not prevent a participant in a 401(k) plan from withdrawing funds without hindrance from the surviving spouse annuity rules (i.e., without the necessity of the participant's spouse from consenting to the withdrawal). Those rules require that the nonforfeitable accrued benefit be payable to the surviving spouse (or a designated beneficiary if there is no surviving spouse) only *after the participant dies.* A participant who has cashed out of his plan leaves no accrued benefit for a surviving spouse. In this situation, the survivor annuity rules provide no protection for a surviving spouse.

RIA observation: According to the Ninth Circuit, the fact that Wayne and Katherine were not married until several years after Wayne ended his participation was significant to the district court. However, because ERISA does not give a participant's spouse any right to amounts in a 401(k) plan until the participant's death, it should not have mattered whether Wayne closed out his 401(k) account before or after he married Katherine, since he was free to dispose of the amounts distributed from the 401(k) plan as he chose.

18. RIA Special Study: Hiring and Business Stimulus Provisions in the HIRE Act of 2010

The Hiring Incentives to Restore Employment Act (HIRE Act, P.L. 111-147) was signed into law by the President on Mar. 18, 2010, one day after it passed Congress. This Special Study explains how the HIRE Act encourages companies to hire (and retain) unemployed workers by creating an employer “payroll tax holiday” of sorts for hiring unemployed workers in 2010 and an employer tax credit if these new hires are retained for at least one year. It also explains how the Act boosts expensing for 2010 and permits certain bond issuers to elect to receive a payment in lieu of providing a tax credit to the bondholders. For a Special Study on the Act's new anti-offshore tax abuse measures, and other revenue raising provisions, see ¶ 2.

Payroll Tax Holiday in 2010 for Hiring Unemployed Workers

The Federal Insurance Contributions Act (FICA) imposes two taxes, the Old Age, Survivors and Disability Insurance (OASDI) tax and the Medicare Hospital Insurance (HI) tax. These taxes are imposed on employers for wages paid with respect to employment and on employees for wages received with respect to employment. The OASDI tax rate is 6.2% on wages up to an annually-adjusted “wage base” ($106,800 for 2010). The HI tax rate is 1.45% on all wages, regardless of amount. Under pre-Act law, the Social Security payroll tax wasn't forgiven for employers who hired the unemployed.

Employers who hire members of certain targeted groups before Sept. 2011 may claim a work opportunity credit (WOTC) equal to a percentage of up to $6,000 of first-year wages per employee, $12,000 for qualified veterans, and $3,000 for qualified summer youth employees. If the employee is a long-term family assistance recipient, the credit is a percentage of first- and second-year wages, up to $10,000 per employee.

New law. The Act provides relief from the employer share of OASDI taxes for employers that hire unemployed workers. The relief applies to wages paid beginning on Mar. 19, 2010 (the day after the enactment date) and ending on Dec. 31, 2010. (Code Sec. 3111(d), as amended by Act Sec. 101(a))

More specifically, the OASDI tax on employers doesn't apply to wages paid by a qualified employer with respect to employment during the period beginning on Mar. 19, 2010 and ending on Dec. 31, 2010, of any qualified individual for services performed:

... in a trade or business of the qualified employer; or
... for a qualified employer that is tax-exempt under Code Sec. 501(a), in furtherance of the activities related to the purpose or function on which the employer's exemption is based. (Code Sec. 3111(d)(1), as amended by Act Sec. 101(a))

RIA observation: The payroll tax holiday applies only to the 6.2% OASDI portion of the employer's tax. It doesn't apply to the 1.45% Medicare (HI) portion of the employer's tax, nor to any part of the employee's tax. It also doesn't affect the self-employment tax paid by self-employed individuals.

RIA observation: The amount of tax forgiven per employee can't exceed $6,621.60, because the OASDI tax applies to only the first $106,800 of wages paid in 2010 ($106,800 × 6.2% = $6,621.60).

RIA observation: An employee need not work for a minimum number of hours in order for the employer to qualify for the payroll tax holiday.

Qualified employer defined. A qualified employer is any employer other than the U.S., a state, or a political subdivision of a state (i.e., a local government, or an instrumentality). (Code Sec. 3111(d)(2)(A)) However, a public institution of higher education is a qualified employer even though it is a government instrumentality. (Code Sec. 3111(d)(2)(B))

RIA observation: Thus, the payroll tax holiday applies to employers in the private and not-for-profit sectors. It doesn't apply to public-sector employers other than public institutions of higher education.

Qualified individuals defined. A qualified individual is anyone who:

(1) Begins employment with a qualified employer after Feb. 3, 2010, and before Jan. 1, 2011.

RIA observation: Although a qualified employee who begins work after Feb. 3, 2010 can be eligible for the payroll tax holiday, only the employer's portion of OASDI on his wages paid with respect to employment after Mar. 18, 2010 (the enactment date) will be forgiven.

(2) Certifies by signed affidavit, under penalties of perjury, that he hasn'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.

RIA observation: IRS is developing a form employees can use to make the required statement. (IR 2010-33)

(3) Isn't employed to replace another employee of the qualified employer unless that other employee separated from employment voluntarily or for cause.

(4) Isn't related to the qualified employer in a way that would disqualify him for the WOTC under Code Sec. 51(i)(1). (Code Sec. 3111(d)(3))

The Committee Report says an employer may qualify for the payroll tax holiday when it hires an otherwise qualified individual to replace one who was terminated for cause or due to other facts and circumstances, such as where a factory is closed due to lack of demand. When the factory reopens, the payroll tax holiday can be claimed both for rehiring old workers and hiring new workers. However, an employer who terminates an employee without cause in order to claim the payroll tax holiday for hiring the same or another employee doesn't qualify. IR 2010-33 confirms that new hires filling existing positions also qualify if the workers they are replacing left voluntarily or for cause.

RIA observation: Under item (4), above, there's no payroll tax holiday for hiring a relative such as the qualified employer's child or descendant of a child; a stepchild; sibling, stepbrother, or stepsister; parent or stepparent; niece, nephew, uncle or aunt; or in-laws.

If the qualified employer is:

... a corporation, an individual standing in any of the above relationships to anyone who owns, directly or indirectly, more than 50% in value of its outstanding stock, after applying the Code Sec. 267(c) attribution rules, won't qualify.

... a noncorporate entity, an individual standing in any of the above relationships to anyone who owns, directly or indirectly, more than 50% of the capital and profits interests in the entity attribution rules, won't qualify.

... an estate or trust, a grantor, beneficiary, or fiduciary of the estate or trust, or an individual having any of the familial relationships described above to a grantor, beneficiary, or fiduciary of the estate or trust, won't qualify.

An individual unrelated to the qualified employer who is the employer's dependent because he has the same principal place of abode and is a member of the employer's household won't qualify. If the qualified employer is a corporation, an individual who is a dependent of anyone who owns, directly or indirectly, more than 50% in value of the outstanding stock, won't qualify. A dependent of a grantor, beneficiary, or fiduciary of an estate or trust that is a qualified employer won't qualify.

Special rule for first calendar quarter of 2010. The payroll tax holiday doesn't apply for wages paid during the first calendar quarter of 2010. Instead, the amount by which the qualified employer's OASDI tax for wages paid during the first calendar quarter of 2010 would have been reduced if the payroll tax holiday had been in effect for that quarter is treated as a payment against the qualified em-

ployer's OASDI tax for the second calendar quarter of 2010. (Code Sec. 3111(d)(5)(B)) The payment is treated as made on the date when the employer's second-quarter OASDI tax is due.

RIA observation: Most employers report employment taxes quarterly on Form 941 (Employer's Quarterly Federal Tax Return). The rule providing that the payroll tax holiday doesn't apply for wages paid during the first quarter will give IRS time to issue guidance about the payroll tax holiday and will give employers time to adjust their payroll systems accordingly. Employers won't lose out, because the amount of first-quarter wages that would have been forgiven will be allowed as a credit for the second quarter. Indeed, an IRS news release issued on the date the Act was signed into law says that IRS will within the next few weeks be issuing revised employment tax forms for the second quarter of 2010, as well as more detailed guidance on the new provisions. (IR 2010-33)

Election out; coordination of payroll holiday with WOTC. A qualified employer may elect, in the manner that IRS requires, not to have the payroll tax holiday apply. (Code Sec. 3111(d)(4)) Unless the employer elects out of the payroll holiday, wages paid or incurred to a qualified individual won't qualify for the WOTC during the one-year period beginning on the date that the qualified employer hired the individual. (Code Sec. 51(c)(5)) The Committee Report indicates that the election can be made on an employee-by-employee basis.

RIA observation: The WOTC is in many cases more valuable than the payroll tax holiday, especially for low-wage employees, because it is generally 40% of “qualified first-year wages” of up to $6,000, for maximum credit of $2,400 per worker. The payroll tax holiday is equal to 6.2% of wages, and applies only to wages paid through Dec. 31, 2010. However, the WOTC is harder to qualify for, because the employee must be certified by an agency as belonging to a targeted group. The main qualification for payroll tax holiday is that the employee have been unemployed for 60 days, and the employee's affidavit is sufficient for this purpose.

Railroad retirement tax holiday. Effective for compensation paid after Mar. 18, 2010, the Act provides a railroad retirement tax holiday that is similar in many respects to the OASDI tax holiday. (Code Sec. 3221(c), as amended by Act Sec. 101(d))

New Up-to-$1,000 Credit for Each “Retained Worker”

For any tax year ending after Mar. 18, 2010, the Act provides an up-to-$1,000 credit for “retained workers.” (Act Sec. 102) A retained worker is defined as any qualified individual, as defined for purposes of the payroll tax holiday (see above):

(1) who was employed by the taxpayer on any date during the tax year,
(2) who was so employed by the taxpayer for a period of not less than 52 consecutive weeks, *and*
(3) whose wages (as defined in Code Sec. 3401(a)) for that employment during the last 26 weeks of the period (described in item (2) above) equaled at least 80% of the wages for the first 26 weeks of that period. (Act Sec. 102(b))

RIA observation: The definition of wages for withholding purposes in Code Sec. 3401(a) generally includes all remuneration (other than fees paid to a public official) for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash. Thus, compensation that isn't subject to withholding, such as certain fringe benefits, wouldn't be included as wages for purposes of the up-to-$1,000 credit for retained workers. Also, wages paid to certain types of employees that are exempt from income tax withholding under Code Sec. 3401(a) wouldn't qualify as wages for purposes of the up-to-$1,000 credit. The exemptions from withholding provided in Code Sec. 3401(a) include wages paid to certain agricultural labor, domestics working in private homes, certain employees working in foreign countries (if the employer is required to withhold on the wages under foreign law), etc.

Amount of the credit. Under Act Sec. 102(a), for any tax year ending after Mar. 18, 2010, the current year business credit determined under Code Sec. 38(b) for the tax year is *increased*, for each retained worker (as defined above) with respect to which the 52-consecutive-week requirement in (2), above, is *first* satisfied during the tax year, by the *lesser* of:

... $1,000; or
... 6.2% of the wages (as defined for income tax withholding in Code Sec. 3401(a)) paid by the taxpayer to the retained worker during the 52-consecutive-week-period. (Act Sec. 102(a))

RIA observation: If a retained worker's wages during the 52-consecutive-week-period exceed $16,129.03, the increase to the current year business credit for that retained worker will be $1,000.

RIA observation: Since the increase to the current year business credit under the above rules applies in the tax year in which the 52-consecutive-week test is *first* satisfied, the increase to the current year business credit with respect to each retained employee only occurs in one tax year (i.e., the tax year in which the 52-consecutive-week test is first satisfied by a particular employee).

RIA observation: For an employer using the calendar year as its tax year, the increase to the current year business credit will be claimed on the employer's 2011 tax return.

RIA illustration 1: ABC Corp., a taxpayer using the calendar year as its tax year, hires Earl, a retained worker, on Feb. 15, 2010. The 52-consecutive-week requirement is first satisfied in the 2011 tax year if Earl works for ABC until Feb. 14, 2011. His wages for the 52-consecutive-week period are $30,000. In that case, on its 2011 tax return, ABC's current year business credit will be increased by $1,000 for Earl.

RIA observation: Certain fiscal year taxpayers may have to claim the increase to the current year business credit on tax returns for two tax years on an employee-by-employee basis.

RIA illustration 2: The facts are the same as in illustration (1) except that ABC Corp. uses a fiscal year beginning on Dec. 1 and ending on Nov. 30 as its tax year. ABC Corp. also hires Carol (a retained worker) on Dec. 31, 2010, and she is still working for ABC on Dec. 30, 2011. Carol's wages for the 52-consecutive-week-period are $52,000.

The 52-consecutive-week requirement is first satisfied with respect to Earl on Feb. 14, 2011, and with respect to Carol on Dec. 30, 2011. Thus, ABC can claim the $1,000 increase to the current year business credit for Earl on its tax return for the fiscal year ending on Nov. 30, *2011* and the $1,000 increase for Carol on its tax return for the fiscal year ending on Nov. 30, *2012*.

RIA illustration 3: The facts are the same as in illustration (2) except that Earl quits working for ABC on Jan. 30, 2011. Since he only worked for ABC for 50 consecutive weeks, the 52-consecutive-week requirement isn't satisfied for Earl, and ABC can't claim the up-to-$1,000 credit for him.

RIA observation: Presumably, IRS will soon issue a form for claiming the $1,000 increase to the current year business credit for the retention of certain newly hired employees as it has for other employee retention credits such as the Midwestern Disaster Area employee retention credit that is claimed on Form 5884-A and on Form 3800.

RIA caution: An employer will need to keep careful records with respect to each employee hired after Feb. 3, 2010 and before Jan. 1, 2011 so that it can prove that each employee for which it claims the up-to-$1,000 increase to the current year business credit meets the definition of a retained worker.

RIA observation: Presumably, the increase to the current year business credit under Act Sec. 102 occurs *before* the application of any of the limitations under Code Sec. 38(c) that apply to the general business credit as determined under Code Sec. 38(a)(2). Thus, the up to $1,000 increase to the current year business credit is subject to the rules that, under Code Sec. 38, can prevent some taxpayers from enjoying full use of the credit to reduce their tax liabilities in the tax year that the credit is claimed. For example, the increase to the current year business credit under Act Sec. 102 won't be allowed to offset any of a taxpayer's alternative minimum tax (AMT), and will be limited in its offset of a taxpayer's regular income tax.

Carryback limit on the $1,000 increase per retained worker. No portion of the unused business credit under Code Sec. 38 for any tax year that is attributable to the up-to-$1,000 increase in the current year business credit under Act Sec. 102 can be carried to a tax year *beginning* before Mar. 18, 2010. (Act Sec. 102(c))

RIA observation: A one-year carryback generally applies to unused business credits under Code Sec. 39(a)(1). However, Act Sec. 102(c) prevents a taxpayer from carrying back any portion of an unused business credit that is attributable to the up-to-$1,000 increase of the current year business credit to a tax year beginning *before* Mar. 18, 2010. Since a taxpayer using the calendar year as its tax year is only entitled to the up-to-$1,000 increase to the current year business credit in 2011 (see above), the effect of the rule in Act Sec. 102(c) is that a calendar year taxpayer can't carry back any portion of the unused business credit that is attributable to the up-to-$1,000 increase to 2010 (a tax year that began before Mar. 18, 2010). Thus, a calendar year taxpayer isn't allowed the one-year carryback (that would be allowed under Code Sec. 39(a)(1)(A) but for the rule in Act Sec. 102(c)) of any portion of any unused business credit that is attributable to the up-to-$1,000 increase to the current year business credit under Act Sec. 102.

RIA observation: The transitional rule in Act Sec. 102(c) was necessary because the transitional rule in Code Sec. 39(d) (generally providing that no part of any unused current business credit attributable to a component credit can be carried back to any tax year before the first tax year that the component credit was allowable) is limited to the credits *listed* under Code Sec. 38(b)), and the increase to the current year business credit under Act Sec. 102 isn't listed in Code Sec. 38(b).

RIA observation: There are no special *carryforward* provisions that apply to the up-to-$1,000 increase to the current year business credit for retained workers. Thus, presumably, any portion of the general business credit that is attributable to the increase to the current year business credit will be subject to the 20-year carryforward limitations applicable to current year unused business credits.

U.S. possessions. The Act provides comparable rules relating to the application of the up to $1,000 increase to the current year business credit to employers in U.S. possessions. For this purpose, a U.S. possession includes Puerto Rico and the Northern Mariana Islands. (Act Sec. 102(d)(3)(A))

Expensing Limits Boosted For 2010

Generally, taxpayers can elect to treat the cost of any Code Sec. 179 property placed in service during the tax year as an expense which is not chargeable to capital account, and any cost so treated is allowed as a deduction for the tax year in which the section 179 property is placed in service.

For tax years beginning in 2008 and 2009, the maximum amount that could be expensed under Code Sec. 179 was $250,000, and the maximum deductible expense was reduced (i.e., phased out, but not below zero) by the amount by which the cost of Code Sec. 179 property placed in service during tax year 2008 or 2009 exceeded $800,000. The $250,000 and $800,000 amounts were not adjusted for inflation.

Under pre-Act law, for tax years beginning in 2010, the maximum amount that could be expensed under Code Sec. 179 , was $134,000, and the maximum deductible expense had to be reduced (i.e., phased out, but not below zero) by the amount by which the cost of Code Sec. 179 property placed in service during the 2010 tax year exceeded $530,000 (i.e., the beginning-of-phaseout amount). The 2010 amounts reflected statutory inflation adjustments.

For tax years beginning after 2010, the maximum expensing amount under Code Sec. 179 is $25,000, the beginning-of-phaseout amount is $200,000, and neither amount is adjusted for inflation.

Qualifying property for purposes of the Code Sec. 179 expensing election is depreciable tangible personal property purchased for use in the active conduct of a trade or business, including "off-the-shelf" computer software placed in service in tax years beginning before 2011.

New law. For tax years beginning *after 2007 and before 2011,* the Act provides that:

... the dollar limitation on the Code Sec. 179 expensing deduction is $250,000,
... the reduction in the dollar limitation (beginning-of-phaseout amount) starts to take effect when property placed in service in a tax year exceeds $800,000, and
... neither the dollar limitation nor the beginning-of-phaseout amount is adjusted for inflation. (Code Sec. 179(b), as amended by Act Sec. 201(a)).

Additionally, the increase in dollar limitation amounts and no-inflation-adjustment rule for 2008 and 2009 are removed. (Act Sec. 201(a)(3))

Thus, the Act increases for one year (2010) the amount a taxpayer can expense under Code Sec. 179. The maximum amount a taxpayer can expense for a tax year beginning in 2010 is $250,000 of the cost of qualifying property placed in service for that tax year. The $250,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during 2010 exceeds $800,000.

RIA observation: Since the $250,000 and $800,000 limitation amounts and no-inflation-adjustment rule applied under pre-Act law for tax years beginning in 2008 and 2009, the Act both extends those limitation and phaseout amounts to tax years beginning in 2010 and eliminates the inflation-adjustment rule which applied for tax years beginning in 2010 under pre-Act law.

RIA illustration : In 2010, Midcorp, a calendar-year taxpayer, places into service Code Sec. 179 property with a cost of $660,000. It can elect to expense $250,000 of the cost (there's no phaseout because the cost of Code Sec. 179 property placed in service during the year does not exceed $800,000, the beginning-of-phaseout amount for 2010).

RIA observation: For property placed in service in tax years beginning in 2010, the Code Sec. 179 expensing deduction phases out completely only when the cost of the property exceeds $1,050,000 ($800,000 (beginning-of-phaseout amount) + $250,000 (dollar limitation)). This is the same limit that applied under pre-Act law for property placed in service in 2008 or 2009.

Issuers of Certain Tax Credit Bonds Can Elect to Receive Direct Payment In Lieu of a Tax Credit to the Bondholder

As an alternative to traditional tax-exempt bonds, state and local governments may issue qualified tax credit bonds. Qualified tax credit bonds allow the bondholder (i.e., investor) to claim a nonrefundable tax credit in lieu of receiving interest. Qualified tax credit bonds include:

... new clean renewable energy bonds (New CREBs)—i.e., certain bonds issued to finance capital expenditures for qualified renewable energy facilities;
... qualified energy conservation bonds (QECBs)—i.e., certain bonds issued for a "qualified energy conservation purpose" such as initiatives for reducing greenhouse emissions;

... qualified zone academy bonds (QZABs)—i.e., certain bonds issued to finance certain academic programs operated by public schools in cooperation with businesses in economically disadvantaged areas; and
... qualified school construction bonds (QSCBs)—i.e., certain bonds issued to finance the construction, rehabilitation, or repair of, or the acquisition of land for, public school facilities.

Build America Bonds (BABs), which are otherwise tax-exempt bonds issued to finance capital projects for which the issuer (i.e., a state or local government) irrevocably elects to treat as taxable bonds, entitle the holder to a nonrefundable tax credit. For BABs that are "qualified bonds"—certain BABs issued before 2011 for which the issuer irrevocably elects, on or before the issue date of the bonds, to have the refundable tax credit rules of Code Sec. 6431 apply—the issuer may elect to claim a refundable tax credit (the so-called "direct payment" option) in lieu of the tax credit to the bondholder.

New law. For bonds originally issued after Mar. 18, 2010, the Act allows an issuer of New CREBS, QECs, QZABs, or QSCBs to make an irrevocable election on or before the issue date of the bonds to receive a payment in lieu of providing a tax credit to the holder of the bonds. Thus, these "specified tax credit bonds" are treated as "qualified bonds" under Code Sec. 6431, and the issuer is entitled to receive a direct payment from IRS. (Code Sec. 6431(f), as amended by Act Sec. 301(a))

RIA observation: Qualified forestry conservation bonds (another type of tax credit bond) aren't "specified tax credit bonds," qualifying for the direct payment option.

Interest paid to the holder of the bond is includible in the holder's gross income. (Code Sec. 6431(f)(1)(D)) The issuer's direct payment option for qualified tax credit bonds is in lieu of the credit for the holder, and the bondholder can't claim the tax credit that otherwise would be available under the qualified tax credit bond rules. (Code Sec. 6431(f)(1)(E))

For specified tax credit bonds, the amount that IRS will pay to the issuer (or to any person making interest payments on the issuer's behalf) for any interest payment due under the bond is equal to the lesser of:

(1) the amount of interest payable under the bond on that date (Code Sec. 6431(f)(1)(C)(i)), or
(2) the amount of interest that would have been payable under the bond on that date if the interest were determined at the applicable credit rate determined under Code Sec. 54A(b)(3). (Code Sec. 6431(f)(1)(C)(ii))

Thus, the amount of the payment to the issuer of a specified tax credit bond that is a New CREB, QECB, QZAB, or QSCB is a function of the market-determined interest rate on the bond and not a rate set by IRS. (Committee Report)

Under a special rule, for any New CREB or QECB, the amount of the credit determined under Code Sec. 6431(f)(1)(C)(ii) is 70% of the amount otherwise determined, without regard to this rule, Code Sec. 54C(b) (new CREB annual credit is 70% of the amount otherwise allowed), and Code Sec. 54D(b) (QECB annual credit is 70% of the amount otherwise allowed). (Code Sec. 6431(f)(2))

The income tax deduction otherwise allowed to the issuer of a qualified bond that is a New CREB, QECB, QZAB, or QSCB for interest paid on the bond is reduced by the amount of the payment made under Code Sec. 6431 for the interest. (Code Sec. 6431(f)(1)(G))

RIA observation: The issuer of a New CREB, QECB, QZAB, or QSCB that elects the direct payment option for the bond must make regular interest payments to the bond holders. The deduction otherwise allowed to the issuer for these interest payments must be reduced by the amounts the issuer receives from IRS.

New CREBs, QECBs, QZABs, and QSCBs for which the election is made count against the national limitation for such bonds in the same way that they would if no election were made. (Committee Report)

An issuer can elect the direct payment option for qualified bonds that are New CREBs, QECBs, QZABs, or QSCBs even if the bonds aren't issued before 2011. (Code Sec. 6431(f)(1)(B))

RIA observation: However, due to a "zero" national bond volume limitation that is prescribed for both QZABs and QSCBs for years after 2010, they can be issued after 2010 only if unused national bond volume limitations for pre-2011 years can be carried forward. For carryforward for QSCBs, see below.

In a technical correction, the Act also provides that for bonds issued after Feb. 17, 2009—i.e., as if it were originally included in American Recovery and Reinvestment Act §1521—the Code Sec. 54F(e) rule allowing the carryover of unused QSCB limitation by a State or Indian tribal government applies to the 40% of QSCB limitation that is allocated among the largest school districts. It also provides that the limitation amount allocated to a State is to be allocated to QSCBs issuers within the State by the State education

agency (or such other agency as is authorized under State law to make the allocation). (Code Sec. 54F, as amended by Act Sec. 301(b))

19. Hitting the restart button on RMDs in 2010—how taxpayers and their beneficiaries are affected

The federal government's reaction to the stock market crash of 2008 featured a number of tax relief measures, including an unprecedented waiver, for 2009 only, of required minimum distributions (RMDs) from qualified plans and IRAs. Now that the waiver has expired, clients will want to know how their RMDs for 2010 will be affected by the skipped year of payouts. This *Practice Alert* takes a detailed look at the answer, both for taxpayers receiving RMDs from their retirement plan accounts or IRAs, and for taxpayers receiving RMDs from inherited plan accounts or IRAs.

Background on RMDs under Code Sec. 401(a)(9). Employer-provided defined contribution qualified retirement plans, IRAs and individual retirement annuities are subject to the RMD rules. Generally, RMDs must begin by the required beginning date (RBD), which usually is April 1 of the calendar year following the calendar year in which the individual (employee or IRA owner) reaches age 70 1/2. But for employer-provided qualified retirement plans, the RBD for non-5% company owners is delayed to April 1 of the year following the year in which the individual retires. For IRAs and defined contributions plans, the lifetime RMD for each year generally is determined by dividing the account balance as of the end of the prior year by a distribution period carried in a uniform table in the regs. Special rules apply to annuity payments from an insurance contract.

Minimum distributions after the death of the qualified plan participant or IRA owner depend on whether he died before or after his RBD:

> ... If he died on or after his RBD, and designated a nonspouse beneficiary for the account, the IRA balance is paid out over the longer of: (1) the remaining life expectancy of the designated beneficiary, using his attained age in the year immediately following the year of the IRA owner's death, or (2) the remaining life expectancy of the IRA owner, using the owner's attained age in the year of his death. (Reg. § 1.401(a)(9)-5, Q&A 5(a), Q&A 5(c)) In either case, the life expectancy is found in the Single-Life Table at Reg. § 1.401(a)(9)-9, Q&A 1.
> ... If he dies before his RBD, and designated a nonspouse beneficiary for the account, there are two methods for satisfying the after-death RMD rules: (1) Under the five-year method, the individual's entire account must be distributed no later than December 31 of the calendar year containing the fifth anniversary of his death; (Code Sec. 401(a)(9)(B)(ii)) (2) Under the life expectancy method, annual RMDs over the beneficiary's life or over a period not extending beyond his life expectancy, must begin no later than December 31 of the calendar year immediately following the calendar year in which the individual died. (Code Sec. 401(a)(9)(B)(iii); Code Sec. 408(a)(6))

More liberal rules apply if the sole beneficiary of the account is the taxpayer's spouse. For example, the spouse may roll over the decedent's IRA into his or her own IRA, or elect to treat the IRA as the spouse's own IRA.

Failure to take an RMD triggers a 50% excise tax under Code Sec. 4974 , payable by the qualified plan participant or IRA owner or his beneficiary. The tax is imposed during the tax year that begins with or within the calendar year during which the distribution was required. The tax may be waived if the distribution did not occur because of reasonable error and reasonable steps are taken to remedy the violation.

RMD waiver for 2009. Under the Worker, Retiree, and Employer Recovery Act (WRERA, P.L. 111-458), no RMD was required for calendar year 2009 from IRAs and employer-provided qualified retirement plans that are defined contribution plans (within the meaning of Code Sec. 414(i)). (Code Sec. 401(a)(9)(H)) The relief applied both to otherwise-required lifetime distributions to employees and IRA owners and after-death distributions to beneficiaries. The change was made to help taxpayers who otherwise would have been forced to sell depressed-in-value stock or mutual fund shares held by their IRAs or retirement plan accounts in order to make RMDs.

RMDs back on track for 2010. Now that the RMD waiver for 2009 is history, here's a review of the types of taxpayers who are affected by restarted RMDs for 2010, and how.

(1) Taxpayers who attained age 70 1/2 before 2009. The RMD for 2010 for these taxpayers is based on IRA or retirement plan account values as of Dec. 31, 2009, and the life expectancy factor in the Uniform Lifetime Table at Reg. § 1.401(a)(9)-9, Q&A 2. The skipped year of RMDs doesn't affect the method of calculating RMDs for 2010, although it likely will affect the amount (the account value as of the end of 2009 should be larger because of the skipped payouts, and the partial market recovery).

(2) Taxpayers who attained age 70 1/2 in 2009. A taxpayer's RBD is determined without regard to the 2009 temporary waiver rule for RMDs, for purposes of applying the RMD rules after 2009. (Code Sec. 401(a)(9)(H)(ii)(I))

RIA illustration 1: IRA owner Anna Baker attained age 70 1/2 in 2009 and thus her RBD is Apr. 1, 2010. Under pre-WRERA law, the first year for which Anna would have had to take an RMD from her IRA was 2009. Under WRERA, no RMD was required for 2009, and, thus, no distribution for 2009 need be made by Apr. 1, 2010. However, because WRERA did not change the RBD for purposes of determining the RMD for calendar years after 2009, Anna's RMD for 2010 must be made no later than the last day of calendar year 2010.

(3) Taxpayers who attain age 70 1/2 in 2010. The one-year RMD waiver under Code Sec. 401(a)(9)(H) has no effect on these taxpayers. Their RMD for the first distribution calendar year (2010) may be postponed until Apr. 1, 2011. However, taking advantage of this three-month grace period does not absolve the taxpayer from making an RMD for 2011 (the second distribution calendar year) on or before Dec. 31, 2011. (Reg. § 1.401(a)(9)-5, Q&A 1(c))

(4) Beneficiaries using 5-year method. Under the five-year method, where the IRA or qualified retirement account owner died before his RBD, his entire account must be distributed to designated beneficiaries no later than December 31 of the calendar year containing the fifth anniversary of the owner's death. However, under WRERA, the 5-year period is determined without regard to 2009. (Code Sec. 401(a)(9)(B)(ii)) Thus, beneficiaries on a 5-year payout schedule that would have ended with 2009 or a later year were it not for WRERA's RMD waiver, have an extra year, to complete payouts from the inherited account.

(5) Beneficiaries using lifetime payout method Where beneficiaries had begun taking distributions from an inherited retirement account before 2009 via the lifetime distribution method, the RMD for 2010 is based on account values as of Dec. 31, 2009, applying the life expectancy factor in the Single Life Table at Reg. § 1.401(a)(9)-9, Q&A 1, and using the rules at Reg. § 1.401(a)(9)-5, Q&A 5(c)(1). The skipped year of RMDs doesn't affect the method of calculating RMDs for 2010, although it likely will affect the amount (the account value as of the end of 2009 should be larger because of the skipped payouts, and the partial market recovery).

(6) Extended distribution election period for some beneficiaries. A retirement account may allow the owner or beneficiary to choose between a 5-year or lifetime payout, and may specify one or the other payout method if the choice isn't timely made. (Reg. § 1.401(a)(9)-3, Q&A 4(c)) Where the retirement account allows a choice to be made between 5-year and lifetime payouts, it must be made by the earlier of:

> (a) Dec. 31 of the calendar year in which the distribution would have to start in order to meet the lifetime payout rule under Code Sec. 401(a)(9)(B)(iii) and Code Sec. 401(a)(9)(B)(iv) (i.e., for nonspouse beneficiaries, by Dec. 31 of the year following the year of the IRA owner's death), or
> (b) Dec. 31 of the calendar year that includes the fifth anniversary of the IRA owner's death. (Reg. § 1.401(a)(9)-3, Q&A 4(c))

RIA observation: As a practical matter, the choice must be made no later than Dec. 31 of the year following the year in which the account owner died.

The deadline for making the 5-year or lifetime payout election is extended to Dec. 31, 2010, if, in the absence of Code Sec. 401(a)(9)(H), the deadline would have occurred in 2009. (Notice 2009-82, 2009-41 IRB 491, Part V, Q&A 2)

RIA illustration 2: Barbara Yates, a widow, died at age 65 in 2008. The designated beneficiary of her company sponsored defined contribution plan is her daughter, Mary. Barbara's plan allows a designated beneficiary to choose between a five-year or lifetime payout if the account owner dies before required distributions begin. Mary has until Dec. 31, 2010, to elect to receive a lifetime payout from her mother's retirement account (before WRERA, she would have had to make the change no later than Dec. 31, 2009). If she fails to make the election by the end of this year, the balance in her mother's retirement account must be paid out to Mary in full by no later than Dec. 31, 2014.

Similarly, where a participant's spouse is the designated beneficiary, the spouse has until the end of 2010 to make the election if the deadline, in the absence of Code Sec. 401(a)(9)(H), would have been the end of 2009. (Notice 2009-82, 2009-41 IRB 491, Part V, Q&A 2)

(7) Extra year for nonspouse beneficiaries making rollovers from inherited qualified plan accounts to elect life expectancy payout. Under the Pension Protection Act of 2006 (PPA, P.L. 109-280), effective for distributions after 2006, nonspouse beneficiaries of an inherited qualified plan account may make a trustee-to-trustee transfer of part (or all) of the deceased employee's account balance in a qualified plan (or a Code Sec. 403(a), Code Sec. 403(b), or Code Sec. 457 plan) to an IRA (or individual retirement annuity), if the plan permits. The transfer is treated as an eligible rollover distribution for purposes of Code Sec. 402(c), the receiving IRA is treated as an inherited IRA, and the RMD rules of Code Sec. 401(a)(9)(B) apply (except for Code Sec. 401(a)(9)(B)(iv), namely those rules dealing with a spousal beneficiary). (Code Sec. 402(c)(11))

RIA observation: Under Sec. 108(f) of the Worker, Retiree, and Employer Recovery Act of 2008 (WRERA, P.L. 110-458), qualified retirement plans must offer nonspouse beneficiaries the opportunity to roll over an inherited plan account balance to an IRA set up to receive the rollover on the nonspouse beneficiary's behalf, effective for plan years beginning after Dec. 31, 2009. For earlier plan years, plans could, but were not required to, offer nonspouse beneficiaries this rollover option. (See Weekly Alert ¶ 3 12/18/2008 for details.)

Under the "special rule" of Notice 2007-7, 2007-1 CB 395 , Q&A 17(c)(2), if a plan participant died before his RBD, and the 5-year payout rule applies to a benefit under the plan, the nonspouse designated beneficiary making a rollover of the inherited account may determine the RMD using the life expectancy rule in the case of a distribution made before the end of the year following the year of death. After enactment of the Code Sec. 401(a)(9)(H) rule waiving RMDs for 2009, IRS modified this special rule so that if the employee's death occurred in 2008, the nonspouse designated beneficiary has until the end of 2010 to make the direct rollover and use the life expectancy rule. (Notice 2009-82, 2009-41 IRB 491, Part V, Q&A 3)