MANY TAX CHANGES FOR BUSINESSES AND INVESTORS GO INTO EFFECT IN 2011

Many important tax changes go into effect this year. Most are the result of new rules in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 Tax Relief Act) as well as in six other tax laws enacted in 2008 - 2010, while others are triggered by regulations. This *Hot Topic* reviews recent non-extender, non-indexing changes for businesses and investors.

- ***EFT rules now in place.*** Beginning January 1, 2011, employers must use electronic funds transfer (EFT) to make all Federal tax deposits such as deposits of employment tax, excise tax and corporate income tax. Forms 8109 and 8109-B, Federal Tax Deposit Coupon, cannot be used after December 31, 2010.

- ***E-filing by return preparers.***

  Under the Worker, Homeownership, and Business Assistance Act of 2009, for returns filed after 2010, specified tax return preparers who expect to file more than 10 individual returns must file them electronically. For this purpose, an individual income tax return also includes income tax returns for estates and trusts. In December of 2010, the IRS announced it was phasing in the new e-filing requirement over 2 years. Accordingly, for calendar year 2011, a tax return preparer must file electronically if he expects to file - or if he is a member of a firm which reasonably expects in the aggregate to file - 100 or more individual income tax returns during the year. A hardship waiver is available.

- ***Up-to-$1,000 credit for "retained workers" in 2011.***

  For any tax year ending after March 18, 2010, the Hiring Incentives to Restore Employment Act (HIRE Act,) provides an up-to-$1,000 increase (retention credit) to the general business credit for "retained workers." A retained worker is any qualified individual (as defined for purposes of the employer payroll tax holiday which was in effect for hiring unemployed workers) who makes a proper certification on Form W-11 and:

  (1) who was employed by the taxpayer on any date during the tax year,

  (2) who was employed by the taxpayer for a period of not less than 52 consecutive weeks, *and*

  (3) whose wages for income tax withholding 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.

  The retained worker must have begun employment with a qualified employer after February 3, 2010, and before January 1, 2011.

- ***Shorter S corp built-in gain period.***

  For tax years beginning after December 31, 2010, Small Business Lending Funding Act provided that for S corporation tax years beginning in 2011, no tax is imposed on the net unrecognized built-in gain of an S corporation if the fifth year in the recognition period preceded the 2011 tax year.

- ***New basis and character reporting rules.***

  Under the Emergency Economic Stabilization Act of 2008, generally effective on January 1, 2011, every broker required to file an information return reporting the gross proceeds of a "covered security" must include in the return the customer's adjusted basis in the security and whether any gain or loss with respect to the security is short-term or long-term. A covered security is any specified security acquired on or after the applicable date if the security: (i) was acquired through a transaction in the account in which the security is held, or (ii) was transferred to the account from an account in which the security was a covered security, but only if the broker received a statement regarding the transfer. January 1, 2011, is the applicable date for stock in a corporation (other than stock in a regulated investment company or stock acquired in connection with a dividend reinvestment plan).

  A specified security is: (a) any share of stock in a corporation (including regulated investment company (RIC), or RIC shares), (b) any note, bond, debenture or other evidence of indebtedness, (c) any commodity, or contract or derivative with respect to the commodity, if IRS determines that adjusted basis reporting is appropriate and (d) any other financial instrument with respect to which IRS determines that adjusted basis reporting is appropriate.

- ***Corporate actions that affect stock basis must be reported.***

  Effective January 1, 2011, issuers of specified securities must file a return according to IRS forms or regulations describing any organizational action (e.g., stock split, merger or acquisition) which affects the basis of the specified security, the quantitative effect on the basis of that specified security and any other information required by IRS. The issuer's return (and information to nominees or certificate holders) must be filed within 45 days after the date of the organizational action or, if earlier, by January 15th of the year following the calendar year during which the action occurred. Nominees or certificate holders must (unless IRS waives this requirement) be given a written statement showing (1) the name, address and telephone number of the information contact of the person required to file the return, (2) the information required to be included on the return with respect to the security and (3) any other information required by IRS.

- ***Reporting requirement for payment card and third-party payment transactions.***

  The Housing Assistance Tax Act of 2008, after 2010, generally requires banks to file an information return with IRS reporting the gross amount of credit and debit card

payments a merchant receives during the year, along with the merchant's name, address and TIN. Similar reporting is also required for third party network transactions (e.g., those facilitating online sales).

- ***Information reporting for real estate.***

Under the Small Business Jobs Act of 2010, for payments made after December 31, 2010, except as provided below, solely for purposes of information reporting, a person receiving rental income from real estate will be considered to be engaged in a trade or business of renting property. Thus, recipients of rental income from real estate generally are subject to the same information reporting requirements as taxpayers engaged in a trade or business. In particular, rental income recipients making payments of $600 or more during the tax year to a service provider (such as a plumber, painter or accountant) in the course of earning rental income are required to provide an information return, generally Form 1099-MISC, to IRS and to the service provider.

The rental property expense payment reporting doesn't apply to:

- any individual who receives rental income of not more than a minimal amount, as determined under IRS regulations;

- any individual (including one who is an active member of the uniformed services or an employee of the intelligence community) if substantially all rental income is derived from renting the individual's principal residence (as defined for purpose of the home sale exclusion on a temporary basis;

- any other individual for whom the requirements would cause hardship, as determined under IRS regulations.

- ***Increased information return penalty and failure to furnish payee statement penalty.***

For information returns required to be filed after December 31, 2010, the Small Business Jobs Act of 2010 increases the penalty for failure to file and the penalty for failure to furnish payee statements.

- ***Annual fee on drug manufacturers and importers.***

Under the Patient Protection and Affordable Care Act (PPAC), as amended by the Health Care and Education Reconciliation Act of 2010, for calendar years beginning after December 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. 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.

- ***Multiple foreign tax credit related crackdowns go into effect.***

A number of foreign tax credit related crackdowns in the Education Jobs and Medicaid Assistance Act go into effect this year:

- A matching rule to prevent the separation of creditable foreign taxes from the associated foreign income. If there is a foreign tax credit splitting event with respect to a foreign income tax paid or accrued by the taxpayer, the tax isn't taken into account before the tax year in which the related income is taken into account for U.S. tax purposes under Chapter 1 of the Code by the taxpayer. A similar rule applies if there is a foreign tax credit splitting event with respect to a foreign income tax paid or accrued by a Code Section 902 corporation. There is foreign tax credit splitting if the related income is (or will be) taken into account by a covered person. A covered person means, with respect to any person who pays or accrues a foreign income tax (i.e., the payor) (1) any entity in which the payor holds, directly or indirectly, at least a 10% ownership interest (determined by vote or value); (2) any person which holds, directly or indirectly, at least a 10% ownership interest (determined by vote or value) in the payor; (3) any person related; and, (4) any other person specified by IRS. These new rules apply to: foreign income taxes paid or accrued in tax years beginning after December 31, 2010; and foreign income taxes paid or accrued by a Code Section 902 corporation in tax years beginning on or before December 31, 2010, (and not deemed paid under Code Section 902(a) or Code Section 960), but only for purposes of applying Code Section 902 and Code Section 960 after December 31, 2010.

- In general, for covered asset acquisitions between related parties after December 31, 2010, the disqualified portion of any foreign income tax determined with respect to the income or gain attributable to the relevant foreign assets is (a) not taken into account in determining the foreign tax credit and (b) in the case of a foreign income tax paid by a Code Section 902 corporation, not taken into account for purposes of the deemed paid credit under Code Section 902 or Code Section 960. A covered asset acquisition is: a qualified stock purchase to which Code Section 338 applies; any transaction treated as an acquisition of assets for U.S. purposes and treated as the acquisition of stock of a corporation (or is disregarded) for purposes of the foreign income taxes of the relevant jurisdiction; any acquisition of an interest in a partnership which has an election in effect under Code Section 754; and to the extent provided by IRS, any other similar transaction.

- For tax years beginning after August 10, 2011, a separate foreign tax credit limitation applies for each item that (1) would be treated as derived from sources within the U.S.; (2) would be treated as arising from sources outside the U.S. under a treaty obligation of the U.S.; and (3) the taxpayer chooses the benefits of such treaty. The foreign tax credit limitation rules under Code Section 904(a), Code Section 904(b) and Code Section 904(c); the Code Section 902 deemed paid credit rules; the special rules in Code Section 960 relating to oil and gas income; and the special rules for foreign tax credits under Code Section 960, are applied separately for each item.

- Under the "anti-hopscotch rule," for acquisitions of U.S. property after December 31, 2010, taxpayers can't maximize their foreign tax credits by selectively repatriating income from high-taxed foreign subsidiaries while continuing to defer U.S. tax on income of low-taxed foreign subsidiaries. If there is an amount included in the gross income of a domestic corporation under Code Section 951(a)(1)(B) attributable to the earnings and profits (E&P) of foreign corporation which is a member of a qualified group with respect to the domestic corporation, then the amount of any foreign income tax deemed to have been paid during the tax year by the domestic corporation under Code Section 902 by reason of Code Section 960(a) with respect to such gross income inclusion can't exceed the amount of foreign taxes that would be deemed paid if cash in an amount equal to the amount of the inclusion in gross income were distributed as a series of distributions (determined without regard to any foreign tax which would be imposed on an actual distribution) through the chain of ownership which begins with the foreign corporation and ends with the domestic corporation.

- For acquisitions after August 10, 2011, there's an additional limit on the E&P of a foreign acquiring corporation which may be taken into account in determining the amount (and source) of a distribution which is treated as a dividend in a constructive redemption. The E&P of an acquiring foreign corporation in a Code Section 304(a) related party stock purchase isn't taken into account in determining the amount treated as a dividend under Code Section 304(b)(2)(A), if more than 50% of the dividends arising in connection with the acquisition would neither: (1) be subject to U.S. income tax for the year in which the dividends arise; nor (2) be includible in E&P of a controlled foreign corporation (CFC), as defined in Code Section 957 without regard to Code Section 953©.

- To compute the foreign tax credit limitation, a taxpayer must determine the amount of its taxable income from foreign sources by allocating and apportioning deductions between its U.S. source and foreign source gross income. Special rules apply for allocating and apportioning interest under which all members of a corporate affiliated group are normally treated as a single corporation (the one taxpayer rule), and an allocation is made on the basis of assets rather than gross income. For tax years beginning after August 10, 2011, notwithstanding the general definition of "affiliated group" for purposes of the interest allocation rules, a foreign corporation is treated as a member of the affiliated group if: (1) more than 50% of the gross income of the foreign corporation for the tax year is effectively connected with the conduct of a trade or business within the U.S.; and (2) at least 80% of either the vote or value of all outstanding stock of the foreign corporation is owned directly or indirectly by members of the affiliated group (determined with regard to this new rule).

■ ***80/20 company rules repealed.***

Effective generally for tax years beginning after December 31, 2010, the rule which treats as foreign source all or a portion of any interest paid by a resident alien individual or U.S. corporation which meets the 80/20 test is repealed by the Education Jobs and Medicaid Assistance Act, subject to a grandfathering exception.

This Act also repeals the provision which treats all or a portion of any dividends paid by an 80/20 corporation as exempt from withholding tax, subject to a grandfathering exception.

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