

Tax Alert: Winter 2009/2010

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PENNSYLVANIA TAX UPDATE

Due to the changes in the economy, business environment, and state tax revenue, it is wise to review your state income tax planning strategies. States and their courts continue to push the envelope when it comes to the age old issue of nexus and the physical presence standard. The next step in the evolution of nexus from a state's perspective is the creation of a "substantial economic presence" test. This test examines the level of an out-of-state business activity directed into the state and whether the business has sales sourced to the state under traditional income apportionment statutes.

Pennsylvania passed its long-awaited 2009/2010 budget in October. Notable tax provisions include the following:

Capital Stock & Franchise Tax ("CSF") Phase-Out Deferred

The CSF tax rate for calendar year 2009 was rolled-back to the 2008 rate of 2.89 mills. Previously this rate was slated to drop to 1.89 mills for 2009. Additionally, the phase-out of the CSF tax was delayed. The 2010 and 2011 rate will continue at 2.89 mills, with a decrease to 1.89 mills in 2012 and 0.89 mills in 2013. The CSF is now set to be eliminated in 2014.

Corporate Net Income Tax ("CNI") Net Loss Cap Increased

The CNI net loss carryforward cap is increased to the higher of \$3 million or 15% of Pennsylvania taxable income for taxable years beginning after December 31, 2008, and to the higher of \$3 million or 20% of Pennsylvania taxable income for taxable years beginning after December 31, 2009. Previously the cap was \$3 million or 12.5% of taxable income.

CNI Apportionment Factor Changes

The CNI apportionment formula is modified to increase the relative weighting of the Sales Factor from 70% to 83% for taxable years beginning after December 31, 2008, and to 90% for taxable years beginning after December 31, 2009.

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FEDERAL TAX UPDATE

Service Issues Guidance on Cancellation of Debt Income Deferral

The enactment of IRC section 108(i), within The American Recovery and Reinvestment Tax Act of 2009 ("The Act"), provided flexibility for companies looking to reduce or otherwise restructure existing debt by significantly deferring the impact of cancellation of debt (COD) income occurring as a result of cancellation, reacquisition, or modification of certain debts occurring in 2009 and 2010. The deferred COD income is then recognized ratably over the five-year tax period beginning in the fifth taxable year following a 2009 reacquisition and in the fourth taxable year following a 2010 reacquisition. While the enactment of IRC section 108(i) was welcome guidance to businesses, the statute itself left many questions unanswered as to the application of the law.

New Opportunities Available for Automatic Method Changes

The IRS has issued Rev. Proc. 2009-39, which modifies Rev. Proc. 2008-52 by adding additional automatic method changes, including noteworthy changes for items such as non-incidental materials and supplies, deductible repair and maintenance costs, tenant construction allowances (not subject to section 110), dispositions of structural components of a building and tangible personal property, debt issuance costs, the ratable accrual method for real property taxes, and LIFO pool splits and partial terminations. Rev. Proc. 2009-39 generally applies to Forms 3115 filed on or after Aug. 27, 2009 for tax years ending on or after Dec. 31, 2008. Taxpayers should familiarize themselves with the expanded automatic consent provisions to determine whether opportunities exist to file automatic method changes or convert a pending non-automatic method change to an automatic method change.

Energy Grant Program Offers Windfall for Renewable Energy Companies

On July 9, the Department of Treasury in conjunction with the Department of Energy released awaited guidance related to the renewable energy grant program. For many companies in the renewable energy industry, this guidance comes at an opportune time given the slow economic progress of the past year and the tight capital markets. At this point in time, Treasury has indicated that upwards of \$3 billion in funds is available under the grant program. Effectively, the grant program serves to reimburse applicants for costs incurred on qualifying projects, rather than as an upfront financing solution.

Proposed Changes Affect "Check-the-Box" Strategies of Partnerships, LLCs and S Corporations

U.S. individual owners of interests in partnerships, LLCs and S corporations generally cannot claim foreign tax credits for taxes paid by a foreign subsidiary unless an election is made to treat the foreign subsidiary as a flow-through entity. This so-called "check-the-box" election effectively causes the foreign subsidiary to be treated, for U.S. income tax purposes, as either a foreign branch or a foreign partnership depending on the number of shareholders. As such, foreign taxes (as well as start-up losses, net income, and gains) flow through to the U.S. owners, who may then claim foreign tax credits. Despite this benefit, a check-the-box election is not always the best course of action because it precludes U.S. tax deferral and the receipt of qualifying dividend income from a foreign subsidiary (taxable at capital gain rates). Accordingly, the value of foreign tax credits availed via a check-the-box election must be compared with the potential benefits lost as a result of such election.

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The Obama administration has proposed to reform tax deferral and the qualifying dividend income regime will sunset for tax years beginning after Dec. 31, 2010. In anticipation, prudent taxpayers are revisiting check-the-box strategies and implementing appropriate transition plans, giving due consideration to regulatory limitations, tax rate differentials, the impact of foreign net operating losses, and the tax consequences of the election itself.

Electronic Filing Requirements for Form 5500 Q&A

On Nov. 16, 2007, the Department of Labor (DOL), IRS and Pension Benefit Guaranty Corporation (PBGC) published final annual reporting regulations regarding the new electronic filing requirements for Form 5500. Beginning with the 2009 plan year, the DOL requires retirement plans and welfare plans to file their annual reports (Form 5500) electronically using their EFAST2 system. The transformation from paper filing to electronic filing will result in significant changes in procedures.

The EFAST2 system is effective for plan years beginning on or after Jan. 1, 2009. Plans will be able to commence filing electronically on Jan. 1, 2010. Any plan which has a 5500 due before Jan. 1, 2010 will have an automatic extension until 90 days following the date on which the Form 5500 is available for filing electronically. The date is March 31, 2010, unless the DOL changes the date on which electronic filing will be available.

Must all retirement plans file electronically?

With the exception of a plan covering the sole owner (and his/her spouse) or partners in a partnership (and their spouses) and no employees ("owner only plan"), all plans, including retirement, welfare and 403(b) plans, will need to file their 5500s electronically. Owner only plans will file a paper copy of the 5500-EZ with the IRS. However, owner only plans that do not hold employer stock or real estate may elect to file a Form 5500-SF (short form) electronically with the DOL.

How does a plan sponsor obtain electronic signature credentials?

To file electronically, a plan sponsor must obtain electronic signature credentials. The plan sponsor will go to a DOL website (IREG) and enter certain personal information. The IREG website will be available on Jan. 1, 2010. The plan sponsor then will receive an email with a link to a website where he or she will receive the credentials (signer ID and PIN code). The credentials are personal to the individual obtaining the credentials. If a plan sponsor grants signature authority to several of its officers, each officer will need to obtain his/her own credentials in order to sign the Form 5500.

May a Third Party Administration firm or financial institution obtain signer credentials on behalf of its clients?

No. Every individual who signs a Form 5500 or schedule must obtain his/her own signer credentials. Furthermore, the government limits one set of credentials per email address. When an individual obtains his/her signer credentials, the individual must certify to the government that he/she will not share the credentials with anyone, including a TPA or financial institution.

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INTERNATIONAL TAX UPDATE

Export Incentives Remain Available – It's Time to Revisit

Companies can still take advantage of tax benefits from their export profits. The Interest Charge Domestic International Sales Corporation (IC-DISC) offers a permanent tax savings of up to 20 percent of the tax otherwise due on export profits. The time to take advantage of the benefit is running short. First, the IC-DISC benefit is not available to taxpayers until the required structure is organized. Second, the reduced tax rates on certain dividends derive a share of the benefit and the rate that sunsets, is Dec. 2010. Now is the time to reassess while the benefit is still available.

WORKER, HOMEOWNERSHIP, AND BUSINESS ASSISTANCE ACT OF 2009

On November 6, 2009, the Worker, Homeownership, and Business Assistance Act of 2009 (the Act) was signed into law by President Obama. The new law, which extended unemployment compensation benefits, also included several tax changes. This alert briefly summarizes some of the major tax changes.

First-Time Homebuyer Credit

Extension - The first-time homebuyer credit was scheduled to expire after November 30, 2009. The Act provides a new expiration date of April 30, 2010. In addition, if a taxpayer enters into a binding contract before May 1, 2010, to close on the purchase of a principal residence before July 1, 2010, the credit will be treated as not expiring until July 1, 2010.

Election - To accelerate claims for the credit, the Act allows taxpayers to elect to treat the purchase of a principal residence in 2009 or before the new deadline in 2010 as made on December 31st of the calendar year preceding the purchase.

Non-first-time Buyers - Effective for purchases after November 6, 2009, the credit is no longer restricted to first-time homebuyers. The Act treats as a first-time homebuyer an individual who has owned and used the same residence as his or her principal residence for any five-consecutive year period during the previous eight-year period, ending with the date on which the new residence is purchased. Non-first-time homebuyers will benefit from the credit but at a reduced amount. Their maximum credit will be \$6,500 rather than \$8,000 (\$3,250 for married taxpayers filing separately rather than \$4,000).

Income Threshold - Previously, the first-time homebuyer credit phased out for single individuals with modified adjusted gross income (MAGI) between \$75,000 and \$95,000 and for married couples filing joint returns with MAGI between \$150,000 and \$170,000. The Act raised the start of the phase-out for single individuals to \$125,000 and the start of the phase-out for married couples filing joint returns to \$225,000.

Repayment - For principal residences purchased in 2009 and 2010, there is generally no requirement to repay the first-time homebuyer credit. However, a taxpayer may have to repay the credit if the residence ceases to be his or her principal residence with 36 months from the date of purchase.

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Purchase Price - For the first time, a ceiling on eligibility has been set for the credit based on the purchase price of the principal residence. No credit is allowed if the purchase price of the principal residence exceeds \$800,000. This cap only applies to purchases after the date of enactment, which was November 6, 2009.

NOL Carryback

The American Recovery and Reinvestment Act of 2009 allowed small businesses (average gross receipts of \$15 million or less) to elect to carry back net operating losses (NOLs) from 2008 for three, four or five years rather than the standard two years. The Act provides a similar election to all U.S. businesses of every size to carry back NOLs up to five years, but with a 50 % income limit on NOL offsets in the fifth year.

The new, expanded election is available for NOLs incurred in either 2008 or 2009, but not for both years. However, an eligible small business that elected under the 2009 Recovery Act to carry back 2008 NOLs may make the election for an additional year, enabling the qualified small business to carry back NOLs from both 2008 & 2009 for up to five years. The Act also suspends the 90% income limitation on the use of NOLs for determining alternative minimum tax (AMT) for an extended carryback year.

Electronic Filing

The Act requires individual, estate or trust returns prepared by paid preparers after December 31, 2010 to be filed electronically with limited exceptions.

Penalties

The Act increases the penalties for failure to timely file a partnership or S corporation return. The penalty will increase from \$89 to \$195, per partner or shareholder, effective for returns for tax years beginning after December 31, 2009.

FUTA Surtax

For many years, the Federal Unemployment Tax Act (FUTA) has imposed a 6.2% tax rate on the first \$7,000 of each employee's wages. That 6.2% rate is due to a .2% "temporary" surtax. The Act extends the surtax through June 30, 2011. The total FUTA tax on employers, therefore, continues to be 6.2%.

