



## **U.S. Tax Reporting Requirements for Uncertain Tax Positions (UTP)**

Earlier this year, the IRS Commissioner announced that the IRS has been taking a hard look at transparency regarding business tax issues, accounting for income taxes, and tax risks for several years. The IRS studied the changes that would need to be made to achieve its objectives of certainty, consistency, and efficiency for both the IRS and the taxpayers.

In January 2010, Announcement 2010-9 was issued, which requires taxpayers to report "uncertain tax positions" (UTP) with their returns. Taxpayers are required to disclose any position for which a tax reserve must be established under the applicable accounting standards. In other words, if the taxpayer believes its tax reporting position is more likely than not correct, the Announcement requires a disclosure on the position. Furthermore, on April 19, 2010, the IRS released the draft Schedule UTP along with draft instructions in Announcement 2010-30. The IRS invites public comment on the draft schedule and instructions. All the comments must be received by June 1, 2010. The schedule and instructions will be finalized after the IRS has received and considered all of the comments regarding the overall proposal and the draft schedule and instructions. The requirement will apply to 2010 tax returns and subsequent tax-return years.

The U.S. federal income tax system relies on taxpayers to make a self-assessment of tax positions and to file the appropriate form that shows the facts upon which tax liability may be determined and assessed. To discharge its obligation to fairly and uniformly administer the tax laws, the IRS must be able to identify quickly and efficiently significant issues (including UTP) underlying the tax return. Existing business tax returns do not currently require that taxpayers identify and explain UTP underlying their returns.

Many business taxpayers are required by FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN48), to identify and quantify UTP taken in the return for financial accounting purposes. If necessary, the taxpayer must record a tax reserve on its books regarding a UTP and also disclose it on its financial statements. The information developed in the course of complying with FIN 48 or other accounting standards is highly relevant to understanding the taxpayer's tax positions and assessing how those positions affect the taxpayer's tax liability. That information would also aid the IRS in focusing its examination resources on returns that contain specific UTP that are of particular interest or of sufficient magnitude to warrant the IRS's inquiry, as well as allowing IRS auditors to identify all of the issues more quickly and efficiently.

According to the Announcement, the IRS is developing a schedule that will require certain filers to provide information about their UTPs that affect their U.S. federal income tax liabilities. This schedule should be filed with the Form 1120, U.S. Corporation Income Tax

Return, or other business tax returns. The schedule will require (i) a concise description of each UTP for which the taxpayer or a related entity has recorded a reserve in its financial statements and (ii) the maximum amount of potential federal tax liability attributable to each UTP that is determined without regard to the taxpayer's risk analysis regarding its likelihood of prevailing on the merits.

The schedule will require a concise description of each UTP in sufficient detail so that the IRS can determine the nature of the issue. The sufficiency of a description will depend on the taxpayer's particular facts and the nature of the underlying transaction. To be sufficient, the description must contain:

1. the Code sections potentially implicated by the position;
2. a description of the taxable year or years to which the position relates;
3. a statement that the position involves an item of income, gain, loss, deduction, or credit against tax;
4. a statement that the position involves a permanent inclusion or exclusion of any item, the timing of that item, or both;
5. a statement as to whether the position involves a determination of the value of any property or right; and
6. a statement as to whether the position involves a computation of basis.

In addition, the schedule will require a taxpayer to specify for each UTP the entire amount of U.S. federal income tax that would be due if the position were disallowed in its entirety on audit. This amount is the maximum tax adjustment for the position reflecting all changes to items of income, gain, loss, deduction, or credit if the position is not sustained.

The IRS intends the new schedule to be filed by a business taxpayer with total assets in excess of \$10 million if the taxpayer has one or more UTPs required to be reported on the new schedule. This includes a taxpayer who prepares financial statements or is included in the financial statements of a related entity.

## COBRA Subsidy Eligibility Period Extended to May 31

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Workers who lose their jobs during April and May may qualify for a 65% subsidy on their COBRA health insurance premiums, according to the IRS. The American Recovery and Reinvestment Act established this subsidy to help workers who lose their jobs as a result of the recession and maintains their employer-sponsored health insurance.

The Continuing Extension Act of 2010, enacted April 15, reinstated the COBRA subsidy, which had expired on March 31. As a result, workers who are involuntarily terminated from employment between September 1, 2008 and May 31, 2010, may be eligible for a 65% subsidy of their COBRA premiums for a period of up to 15 months. In some cases, workers who had their hours reduced with the eventual termination of their jobs may also be eligible for the subsidy.

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Employers must provide COBRA coverage to eligible individuals who pay 35% of the COBRA premium. Employers are reimbursed for the other 65% by claiming a credit for the subsidy on their payroll tax returns, Form 941, Employers Quarterly Federal Tax Return, Form 944, Employer's Annual Federal Tax Return; or Form 943, Employer's Annual Federal Tax Return for Agricultural Employees. Employers must maintain supporting documentation for the claimed credit.

## Tax-Free Employer-Provided Health Coverage Now Available for Children Under Age 27

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As a result of changes made by the recently enacted Affordable Care Act, health coverage provided for an employee's children under 27 years of age is now generally tax-free to the employee, effective March 30, 2010.

The IRS announced that these changes immediately allow employers with cafeteria plans – plans that allow employees to choose from a menu of tax-free benefit options and cash or taxable benefits – to permit employees to begin making pre-tax contributions to pay for this expanded benefit. These changes are explained and further guidance is provided to employers, employees, health insurers, and other interested taxpayers in the IRS Notice 2010-38.

Per IRS Commissioner Doug Shulman, these changes give employers a unique opportunity to offer a worthwhile benefit to their employees. This expanded health care tax benefit applies to various workplace and retiree health plans. It also applies to self-employed individuals who qualify for the self-employed health insurance deduction on their federal income tax returns.

Employees who have children who will not have reached age 27 by the end of the year are eligible for the new tax benefit from March 30, 2010, forward, if the children are already covered under the employer's plan or are added to the employer's plan at any time. For this purpose, a child includes a son, daughter, stepchild, adopted child, or eligible foster child. This new age standard replaces the lower age limits that applied under prior tax law, as well as the requirement that a child generally qualify as a dependent for tax purposes.

The notice says that employers with cafeteria plans may permit employees to immediately make pre-tax salary reduction contributions to provide coverage for children under age 27, even if the cafeteria plan has not yet been amended to cover these individuals. Plan sponsors then have until the end of 2010 to amend their cafeteria plan language to incorporate this change.

In addition to changing the tax rules as described above, the Affordable Care Act also requires plans that provide dependent coverage of children to continue to make the coverage available for an adult child until the child turns age 27. The extended coverage must be provided not later than plan years beginning on or after Sept. 23, 2010. The favorable tax treatment described in the notice applies to that extended coverage.

# Hiring Caregivers and Other Household Employees

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When a household employee is hired, there are some rules of which the employer should be aware of. First, if the worker has control on how the work is done, the worker is not an employee, but rather a self-employed person. A self-employed worker usually provides his or her own tools and offers services to the general public as an independent contractor. For payments made to an independent contractor, if the amount exceeds \$600 in an entire year, a Form 1099-MISC is required to be issued. No income tax or payroll tax is required to withhold in the payments. However, if the worker is determined to be an employee, the employer is required to withhold income and payroll tax on the payments. It does not matter whether the work is full-time or part-time, or whether he or she is hired from a list provided by an agency or association. It also does not matter whether he or she is paid on an hourly, daily, or weekly basis, or by the job.

## **Social Security and Medicare Wages:**

The Social Security and Medicare wage threshold is \$1,700 for 2009 and 2010. If the employer paid cash wages less than \$1,700 to any one household employee during 2009 or 2010, the employer does not have to report and pay Social Security and Medicare taxes on the household employee's wages. Cash wages include wages paid by check, money order, etc. Cash wages do not include the value of food, lodging, clothing, and other noncash items given to the household employee.

## **Federal Unemployment Tax (FUTA):**

Household employers may owe both the federal unemployment tax and a state unemployment tax. Or, they may owe only the federal unemployment tax or only the state unemployment tax.

The FUTA tax is 6.2% of the employee's FUTA wages. However, household employers may be allowed a credit of up to 5.4% against the FUTA tax for state unemployment taxes paid, resulting in a net tax of 0.8%. FUTA tax is not withheld from an employee's wages; household employers must pay it from their own funds. A household employer who pays cash wages to all of his household employees totaling \$1,000 or more in any calendar quarter of 2009 or 2010 must count the first \$7,000 of cash wages paid to each household employee in 2010 as FUTA wages.

The employers can pay taxes on Schedule H with their U.S. federal individual income tax returns. However, the employers should ensure that they pay enough tax during the year to cover both their household employment taxes and their own income taxes. They may pay the additional tax by:

- having more withholdings from their paychecks or retirement benefits; or
- making or increasing estimated tax payments.

### Household Employer's Checklist

When you hire a household employee	You and the employee must complete Form I-9, Employment Eligibility Verification, and retain it in your records; and find out about federal and state tax obligations.
When you pay your household employee	Withhold Social Security and Medicare taxes; withhold federal income tax (this is optional if both the employer and employee agree); make advance payments of the earned income tax credit; decide how to make tax payments; and keep records.
By January 31 of the following year	Get an employer identification number (EIN); give the employee Copies B, C, and 2 of Form W-2, Wage and Tax Statement.
By March 1 of the following year (March 31 if you file Form W-2 electronically)	Send Copy A of Form W-2 to the Social Security Administration (SSA).
By April 15 of the following year	File Schedule H (Form 1040), Household Employment Taxes, with the federal income tax return (Form 1040).

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## California Refunds Can Be Delayed: File Soon

The state budget crisis is not yet fixed, and the state's cash flow is dismal. It is still too early to tell, but it is very likely that the State Controller will delay income tax refunds or issuing IOUs if California lawmakers do not resolve the budget crisis.

Currently, if an individual or fiduciary overpayment is refunded or credited within the later of 45 days after the return is filed, or 45 days after the original due date of the return (determined without regard to extensions), the California Franchise Tax Board (FTB) does not pay interest. This means the state could delay refunds for calendar-year individuals until May 30, 2010, without paying interest. If the state fails to pay individual and fiduciary refunds on or before May 30, 2010, interest accrues at 4% from April 15, 2010, until 30 days prior to the payment issue date. If paid after June 30, it is possible a different interest rate could apply, because the FTB sets the interest rate semi-annually, effective July 1.

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For bank and corporate taxpayers, the refunds must be paid within the later of 90 days after the return is filed, or 90 days after the original due date of the return (determined without regard to extensions). Therefore, for calendar-year banks and corporations, the state could delay refunds until June 15, 2010, without paying interest. For calendar-year banks and corporations, although interest would begin accruing if refunds are not issued on or before June 15, 2010, the current interest rate for corporate overpayment is 0%. This means that the state would not owe any interest on those delayed refunds. Again, the interest rate could be adjusted beginning July 1, 2010, but it could remain at 0%. Interest paid by the state on late refunds is taxable for both federal and state purposes, unlike interest paid on IOUs.

## **IOUs**

If the financial situation becomes truly dire again, the Controller may be forced to issue IOUs. Under current law, a taxpayer may use an IOU to pay taxes to the FTB or the BOE, but other state agencies will not accept them. Last year, when the state issued IOUs, some banks accepted the IOUs as payment or allowed customers to cash them. However, the IRS has stated they will not accept California's IOUs as payment for federal taxes.

## **IOU Interest Income**

According to the FTB, like interest on California municipal bond, interest attributable to state warrants is exempt from California income tax. Thus, for individuals, partnerships, LLCs, estates and trusts, and corporate income tax payers, the interest is tax exempt. However, the interest on state warrants is taxable for corporate franchise tax purposes.

When the last round of IOUs was issued, a secondary market popped up on eBay, craigslist, and other Web sites to sell their IOUs, giving investors an opportunity to purchase the IOUs at a reduced rate. The sale of an IOU results in:

- interest being paid to the purchaser when the IOU is repaid by the state (however, if the purchaser used the IOU to pay a state liability, no interest was paid);
- interest not being taxable for income tax purposes but is taxable for corporate franchise tax purposes;
- buyers having a short-term capital gain on the disposition of the IOU; and
- seller having a short term capital loss, which is a nondeductible personal loss, unless the IOU was issued as payment to a trade or business for goods and services provided.

*See FTB Return Processing Schedule on next page.*

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### FTB return processing schedule

	From February 1 - April 14	April 15 - June 30
<b>If e-filed return and refund to be direct deposited</b> , how long will it take for the refunds to be deposited into taxpayer's account?	On average, 3-5 business days	On average, 3-5 business days
<b>If e-filed return and refund to be mailed</b> , how long will it take for the taxpayer to receive the check?	On average, 5-7 business days	On average, 5-7 business days
<b>If paper filed return and refund to be direct deposited</b> , how long will it take for the funds to be deposited into taxpayer's account?	On average, 23 business days	On average, 26 business days
<b>If paper filed return and refund to be mailed</b> , how long will it take for client to receive the check?	On average, 30 business days	On average, 33 business days
<b>If paper filed return with a check</b> , how long will it take FTB to deposit the check?	On average, 5-7 business days	On average, 5-10 business days

\* It can take the U.S. Post Office up to two weeks to deliver all the April 15 post-marked returns and payments to the FTB. The timeframes above are calculated based on when the FTB physically receives the return/payment. Additionally, returns with errors or requiring additional analysis or review may require additional processing time.

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# California Governor Signed Partial Cancellation of Debt (COD) Income Conformity

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On April 13, 2010, the Governor signed SB 401, which partially conformed California to the federal COD income exclusion for principal residences, as well as numerous other changes enacted since January 1, 2005. While the partial COD conformity is retroactive to taxable years beginning on or after January 1, 2009, most of the other conformity items will not be effective until the 2010 taxable year.

Like the federal exclusion for qualified principal residence debt, the California exclusion will apply to discharges occurring on or after January 1, 2009 and before January 1, 2013. However, here are the California differences:

- qualified principal residence indebtedness may be limited to \$800,000 (\$400,000 for married filing a separate return) instead of the federal \$2 million (\$1 million for married filing a separate return); and
- the maximum cancellation of debt income (COD) exclusion may be further limited to \$500,000 (\$250,000 for taxpayers married filing a separate return).

Some of the other significant conformity provisions, most all of which take effect beginning with the 2010 taxable year, include:

- surviving spouse may exclude up to \$500,000 if sale of principal residence occurs within two years of death of the spouse;
- gain from sale of principal residence attributable to nonqualified use cannot be excluded;
- increased penalty for failure to file partnership and S corporation returns (partial conformity);
- increased minimum penalty for failure to file individual returns;
- waiver of early withdrawal penalty for public safety employees and individuals called to active duty;
- kiddie tax age increase; and inflation indexing for the active participation limitations on traditional IRA contributions.

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