

First steps revisited
Additional tax relief for
businesses and homebuyers



Overview



The House of Representatives on November 5, 2009, approved an unemployment insurance extension bill that allows businesses with net operating losses (NOLs) for 2008 or 2009 to carry back those losses for up to five years, and also extends and modifies the first-time homebuyer credit. The Worker, Homeownership, and Business Assistance Act of 2009, which cleared the Senate a day earlier, was signed into law by President Obama on November 6.

The bill's tax relief provisions are paid for by a delay in the effective date of the worldwide interest allocation election, an increase in the corporate estimated tax payments for certain large taxpayers in the third quarter of 2014, and an increase in the penalty for failure to file a partnership or S corporation return.

This publication outlines the tax provisions in the new legislation and discusses the issues that taxpayers should consider before taking advantage of the important planning opportunities it presents.

Five-year NOL carryback

The loss carryback gives cash-strapped businesses greater flexibility in writing off current losses against past profits by allowing them to carry back NOLs for up to five years (from the current-law two years) for losses incurred in taxable years beginning or ending in either 2008 or 2009 — but not both. Businesses may offset 50 percent of taxable income in the fifth preceding year and 100 percent of taxable income in the remaining four carryback years. If an election is made to carry back an NOL to the fifth year preceding the loss year, the carryback is limited to 50 percent of taxable income. The remaining balance of the NOL generated in the loss year is carried forward to the fourth year preceding the loss year, and so on until the loss is utilized or expired.

The provision also suspends the 90 percent limitation on the use of any alternative tax NOL deduction attributable to carrybacks of the applicable NOL for which an extended carryback period is elected. For purposes of applying the 50 percent taxable income limitation to the carryback of an alternative tax NOL deduction to the fifth preceding taxable year, the limitation is applied separately based on alternative minimum taxable income.

Life insurance companies may elect to increase the present-law carryback period for an applicable loss from operations from three years to four or five years. An applicable loss from operations is the taxpayer's loss from operations for any taxable year beginning or ending in either 2008 or 2009. A 50 percent of taxable income limitation applies to the fifth carryback year.

Unlike the carryback enacted in the American Recovery and Reinvestment Act of 2009 (ARRA, P.L. 111-5), this provision is not limited to small businesses — that is, taxpayers meeting a gross receipts test. The extended carryback provision is available to all taxpayers other than those specifically excluded. Generally, the provision does *not* apply to any taxpayer (or member of the affiliated group) in which the federal government acquired or acquires an equity interest (or warrants or other rights) pursuant to the Emergency Economic Stabilization Act of 2008. The Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation are also excluded.

Small businesses that have already elected to carry back 2008 losses under the ARRA are permitted to carry back losses from 2009.

A taxpayer must make the election by the extended due date for filing the return for the taxpayer's last taxable year beginning in 2009. The election, once made, is irrevocable.

The provision is generally effective for NOLs arising in taxable years ending after December 31, 2007, and beginning before January 1, 2010. The modification to the alternative tax NOL deduction applies to taxable years ending after December 31, 2002. The modification with respect to operating loss deductions of life insurance companies applies to losses from operations arising in taxable years ending after December 31, 2007.

The Joint Committee on Taxation staff estimates the provision would provide \$33.2 billion of immediate tax relief at a net cost of \$10.4 billion over 10 years.

Taxpayer considerations

Before filing an irrevocable election to carry back a 2008 loss to 2003, 2004, 2005, or 2006, taxpayers should think about the impact of such election. Failure to consider all implications of the election could result in potentially unpleasant surprises. In particular, taxpayers should consider both the tax and financial statement impact of the NOL carryback.

Federal tax — Taxpayers should analyze current tax positions in order to optimize the NOL generated in 2008 or 2009 (the loss year). The NOL generated in the loss year can be optimized through an analysis of accounting methods. For 2009, both items that require an accounting method change and those that do not may be considered, while optimizing a loss in 2008 may be achieved solely through analysis of items that do not require an accounting method change.

Foreign tax credits — Multinational companies that choose to take advantage of the extended NOL carryback provision must consider the impact this decision could have on their foreign tax credits (FTCs). FTCs arising in 2005 and beyond may be carried back one year and carried forward 10 years. FTCs arising prior to 2005 were carried back two years and forward five years. However, the American Jobs Creation Act of 2004 (AJCA) extended the carryforward to 10 years for FTCs carried into taxable year 2004. As a result, a company that elects to carry back a 2008 NOL to taxable years 2003, 2004, 2005, or 2006 may reduce its FTC limitation in that year and subsequent

years, displacing FTCs that were previously claimed. The displaced FTCs could affect the actual cash refund received and have an impact on the company's book earnings.

A multinational company that chooses to carry back an NOL should also consider the impact this decision will have on its ability to utilize FTCs in years subsequent to 2008. Future FTC utilization may be affected as a result of recapture accounts (overall foreign loss, separate limitation loss, and overall domestic loss) resulting from the NOL utilization.

Corporate and consolidated returns — Taxpayers should consider the potential impact of stock acquisitions or dispositions and the impact on loss limitation rules, such as section 382, Separate Return Limitation Year (SRLY), and section 172(h) Corporate Equity Reduction Transactions (CERT).

State tax — Taxpayers should understand and navigate the myriad state tax laws. Many states have their own NOL regimes and most do not provide for NOL carrybacks. It remains to be seen whether those states that do follow the federal rules will conform to the new federal five-year carryback provision or decouple from it. Due to state budgetary constraints, it seems likely that many states will not conform to the federal law change.

Financial reporting — Corporate taxpayers should be aware of how the extended carryback will affect their financial statements. Pursuant to Accounting Standards Codification Topic 740, *Income Taxes*, any adjustment to deferred tax liabilities and assets for the effect of a change in tax laws or rates is included in income from continuing operations for the period that includes the enactment date. The enactment date of U.S. federal tax legislation is the date that the president signs the tax bill into law.

Taxpayers that intend to carry back their NOLs beyond the two-year "normal" carryback period should consider:

- Whether an adjustment to an existing valuation allowance to take into account the additional carryback capacity is necessary. (If the loss to be carried back was not previously benefited and instead the related deferred tax asset was offset by a valuation allowance, an adjustment to that valuation allowance will be necessary.)

- The appropriate financial statement disclosures (not just for the period of enactment, but also in periods prior to the enactment as part of the discussion of the potential effects on the company of proposed legislation).

As this would be a change in tax law, any required adjustment to the valuation allowance will be included in income from continuing operations in the period that includes the enactment date.

First-time homebuyer credit

The bill extends the first-time homebuyer tax credit that was included in the ARRA through April 30, 2010, and modifies it to apply to certain current homeowners who buy a new primary residence. The credit was originally slated to expire for purchases after November 30, 2009.

As enacted in the ARRA, a refundable homebuyer tax credit equal to the lesser of \$8,000 or 10 percent of a home's purchase price is available to individuals buying a principal residence for the first time. The credit phased out for individuals with modified adjusted gross income (AGI) during the year of purchase between \$75,000 and \$95,000, and for joint filers with modified AGI between \$150,000 and \$170,000.

The new bill raises the modified AGI phase-out range to between \$125,000 and \$145,000 for individuals, and between \$225,000 and \$245,000 for joint filers.

For homes purchased after December 31, 2008, individuals must repay the credit only if they dispose of or move from their principal residence within 36 months of purchase. Individuals who purchased homes on or before that date must recapture the credit ratably over 15 years (with no interest charge), beginning in the second taxable year after the taxable year in which the home is purchased.

The bill provides that a taxpayer can continue to elect to treat the purchase of a principal residence purchased after December 31, 2008, and before May 1, 2010, as occurring on December 31 of the prior calendar year. Before this change, the election applied only to homes purchased after December 31, 2008, and before December 1, 2009. This election allows the taxpayer to accelerate claiming the credit to a preceding year tax return.

The bill also makes the credit available to any individual who purchases a home before July 1, 2010, provided that a written binding contract is in place before May 1, 2010.

Significant opportunity for long-term residents — The measure provides a significant opportunity for certain individuals who are selling one primary residence and buying another. In the past, these individuals could not qualify for the first-time homebuyer credit. But under the bill, certain long-term resident homebuyers who purchase a new principal residence may be eligible for a credit of up to \$6,500. To qualify, an individual must have used the same principal residence for five consecutive years during the eight-year period ending on the closing date for the purchase of a new principal residence.

For example, a married couple uses their principal residence for 10 years ending on January 31, 2010, the closing date for purchasing a new home. The purchase price of the new home is \$500,000 and the couple's modified AGI for the year of purchase is \$100,000. In this case, the couple would qualify for a refundable credit of \$6,500, whereas under prior law the couple would receive no credit.

The same modified AGI limitations that apply to the first-time homebuyer credit apply here, as well, so homeowners with significantly higher incomes would not qualify for this credit.

District of Columbia homebuyers — First-time homebuyers or long-term residents in the District of Columbia cannot claim both the national first-time homebuyer credit under this bill and the District of Columbia first-time homebuyer credit available under current law for the purchase of a home after December 31, 2008. In this case, only the national credit is allowed.

Military personnel — Finally, the bill provides two carve-outs for military personnel. First, service members who are forced to either sell or cease using their home after December 31, 2008, and within 36 months of purchase, as a result of official extended-duty service would be exempt from having to repay the tax credit. In the case of a home acquired prior to January 1, 2009, which would be subject to the 15-year recapture, repayment of the credit would cease to apply in the taxable year the disposition or cessation occurs or any subsequent taxable year. Second, military personnel serving outside the United States for at least 90 days during the period beginning after December

31, 2008, and ending before May 1, 2010, would be given one additional year to qualify for the credit (i.e., the credit is extended through April 30, 2011).

Errors associated with credit — The bill also makes several changes to expand the definition of mathematical or clerical errors for purposes of administration of the credit by the Internal Revenue Service. For example, in some cases, the IRS can assess additional tax without the issuance of a notice of deficiency that would be typically required. This change applies to returns for taxable years ending on or after April 9, 2008.

Other enhancements made to assist in administration of the credit provide that:

- No credit is allowed unless the buyer (or spouse of buyer) is age 18 or older on the date of purchase;
- The buyer must attach a copy of the settlement statement to the tax return for the year of purchase;
- The definition of purchase excludes property acquired from a person related to the buyer (or buyer's spouse); and
- No credit is allowed to any taxpayer if the taxpayer is a dependent of another taxpayer.

Exclusion for payments related to military base realignment and closure

The American Recovery and Reinvestment Act of 2009 expanded the Department of Defense Homeowner Assistance Program (HAP), which provides payments to certain employees and members of the armed forces to offset the adverse effects on housing values that result from a military base realignment or closure. Payments received under HAP, as in effect on November 11, 2003, are excluded from tax and are also not considered wages for FICA and Medicare tax purposes. The exclusion is limited to the amount that a home's fair market value has declined.

The bill expands the tax exclusion to HAP payments attributable to the ARRA, effective for payments made after February 17, 2009.

Extension of unemployment insurance benefits

The bill extends unemployment insurance benefits for 14 weeks in all 50 states, and for 20 weeks in certain states with high unemployment rates.

Revenue offsets

Delayed effective date of worldwide interest allocation election

The bill further delays the implementation of the worldwide interest allocation election, making it effective for taxable years beginning after December 31, 2017.

The election, which was enacted as part of the American Jobs Creation Act of 2004, would permit taxpayers to take advantage of a liberalized rule for allocating interest expense between U.S. and foreign sources for purposes of determining their foreign tax credit limitation. As enacted in the AJCA, the provision was scheduled to take effect for taxable years beginning after December 31, 2008, but was delayed for two years by the Housing and Economic Recovery Act of 2008.

The bill also eliminates a special phase-in rule enacted under the AJCA that would reduce the amount of the benefit in the first year of the election.

Corporate estimated tax payments

The bill increases the required corporate estimated tax payments factor for corporations with assets of at least \$1 billion by 33 percentage points for payments due in the third quarter of 2014. Corporate estimated tax payments are reduced by a corresponding margin in the following quarter.

Higher penalties for failure to file partnership and S corporation returns

The bill increases the base penalty applied to partnership or S corporation returns for failure to file a return to \$195 per shareholder or partner. The penalty applies for each month (or fraction of a month) that the failure continues, up to a maximum of 12 months for returns required to be filed after December 31, 2008. The higher penalty will apply to returns for taxable years beginning after December 31, 2009.

Mandatory electronic filing by individual return preparers

This provision requires that tax return preparers electronically file individual, estate, and trust returns they prepare unless they reasonably expect to prepare 10 or fewer returns during the calendar year. The Obama administration included a similar legislative proposal in its fiscal 2010 budget, but that proposal has a higher threshold and would apply to preparers who filed more than 100 tax returns. Mandatory electronic filing by return preparers is also supported by IRS oversight and advisory groups as well as the Government Accountability Office.

According to the Treasury Inspector General for Tax Administration, electronic filing of individual tax returns by paid preparers would increase electronic filing by more than 25 percent and reduce IRS processing costs for paper returns.

Legislation is required because under current law the IRS is prohibited from imposing an electronic filing requirement on (1) returns filed by individuals, trusts, or estates, or (2) persons that file fewer than 250 returns during the calendar year. This provision retains the general rule regarding persons who file fewer than 250 returns, but provides an exception for preparers that file more than 10 individual, estate, or trust returns.

The provision will apply to returns filed after December 31, 2010.

FUTA surtax extension

To pay for the extension of unemployment insurance benefits, the bill extends the 0.2 percent FUTA surtax through June 30, 2011.

Next steps

Passage of the expanded NOL carryback resolves an issue that had been a significant source of concern for large businesses since the ARRA was enacted into law earlier this year. But as we approach the end of 2009, Congress has yet to complete work on a number of other legislative initiatives that will create significant risks and opportunities for the business community.

Tax implications of health care reform

Health care reform efforts, which include a significant tax component, have dominated the debate in Congress through the summer and fall. President Obama had originally hoped to see a final bill by October 1. But lawmakers have been treading carefully in the wake of August town-hall debates in which constituents expressed confusion and even anger over some of the proposals currently under consideration.

As this publication goes to press, the House is set to vote on a bill that would be paid for primarily through a surtax on high-income taxpayers, codification of the economic substance doctrine, a limitation on treaty benefits for deductible related-party payments, repeal of the worldwide interest allocation election, a provision making “black liquor” ineligible for the cellulosic biofuel credit, and an excise tax on medical devices.

For their part, Senate leaders are still working behind the scenes to merge separate bills from the two committees with jurisdiction into a single package, and have not set out a precise timeline for bringing legislation to the chamber floor. When a combined bill is introduced, the revenue package is expected to include an excise tax on insurance companies that offer so-called “Cadillac” health care plans, plus other provisions targeting the health care industry, including “fees” on branded drugs, medical devices, and health insurers.

It is currently unclear how these divergent approaches to paying for health care reform will be reconciled when the legislation finally reaches a conference committee. Political necessity and economic realities may force negotiators to scrap some provisions and add new ones as the process moves forward.

Extenders and the estate tax

In addition to health care, lawmakers must confront at least two other separate tax issues before the end of 2009. First is the extension of numerous tax provisions that are set to expire at the end of 2009, including the research and experimentation tax credit, the Subpart F active financing exception and lookthrough treatment for controlled foreign corporations, the New Markets Tax Credit, and tax-free distributions from IRAs for charitable purposes. This action has become an annual event in recent years and usually brings with it other legislation that lawmakers try to have attached to this moving bill.

Given the current deficit projections and concerns by fiscally conservative Democrats as well as Republicans over the current level of government spending, Congress is likely to insist on adhering to pay-as-you-go budget rules to finance most if not all of an extenders package, which will result in taxwriters scouring the Internal Revenue Code for additional revenue raisers.

Second, under current law the estate tax is scheduled to be briefly eliminated in 2010 before coming back in 2011 with a top tax rate of 55 percent and a unified credit exemption amount of \$1 million (the levels in effect before the Bush tax cuts were enacted in 2001). It is widely expected that Congress will address the estate tax rates and exemption in 2009 to avoid a zero-tax year in 2010. President Obama and some lawmakers have proposed extending the estate tax at its 2009 levels — that is, an exemption of \$3.5 million (\$7 million for married couples) and a top rate of up to 45 percent.

Climate change

Another Democratic priority — legislation to address climate change — also remains on the punch list. The House narrowly approved a climate-change bill in late June, but only after intense lobbying by Democratic leadership in an effort to resolve regional differences over nontax issues related to the implementation of a cap-and-trade program. Preoccupation with health care has slowed down work on climate-change legislation in the Senate, however, and the issue could carry over into next year.

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