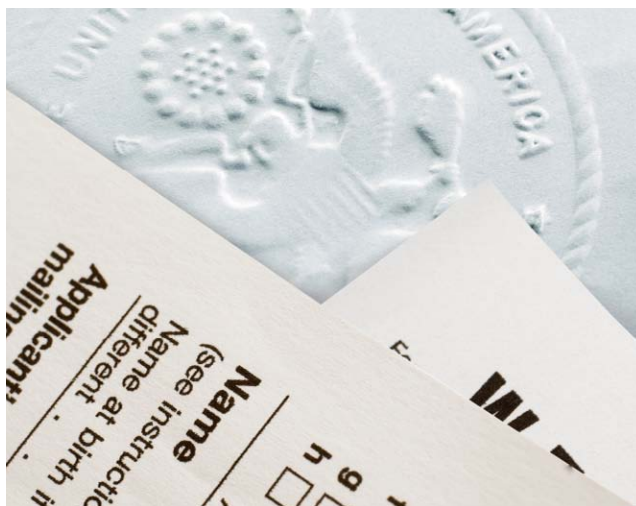




Obama Tax Compromise **APPROVED** by Congress

ON THURSDAY, DECEMBER 16, 2010



The \$858 billion tax deal negotiated by President Obama and Republican leadership was overwhelmingly approved by the Senate on Wednesday, and passed the House Thursday, December 16, 2010, on a 277 to 148 vote.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the Bill):

- Extends for two years the Bush-era income tax rates, the 15 percent rate on capital gains and dividends, and many credits affecting families and children
- Extends jobless benefits for the long-term unemployed until the end of 2011
- Sets the maximum estate tax rate at 35 percent, with an exemption of \$5 million per person, or \$10 million per couple
- Includes an Alternative Minimum Tax (AMT) patch for 2010 and 2011
- Cuts Social Security payroll taxes for employees from 6.2 percent to 4.2 percent for one year
- Provides businesses with 100 percent bonus depreciation for qualified capital expenditures for 2011
- Extends other credits, such as the R&D and new markets tax credits, and includes a variety of energy provisions

The Bill does not provide any offsets to prevent these provisions from expanding the deficit.





INDIVIDUAL Tax Provisions

Extension of Reduced Individual Income Tax Rates

Individual income tax rates will remain at 10, 15, 25, 28 and 35 percent for the 2011 and 2012 tax years. In addition, the repeal of the itemized deduction phase-out and the repeal of the personal exemption phase-out remain in place for the next two years.

Current long-term capital gains and qualified dividend income will continue to be taxed at rates of zero for taxpayers in the 10 and 15 percent brackets and 15 percent for all other tax brackets for 2011 and 2012. Dividends received from a regulated investment company (RIC) or real estate investment trust (REIT) are treated as qualified dividends for purposes of these reduced tax rates.

An Alternative Minimum Tax (AMT) "patch" has been provided for 2010 and 2011. Specifically, the individual AMT exemption amounts for 2010 and 2011, respectively, are:

- \$72,450 and \$74,450 in the case of married individuals filing a joint return and for surviving spouses
- \$47,450 and \$48,450 in the case of other unmarried individuals
- \$36,225 and \$37,225 in the case of married individuals filing separate returns

For both years, individuals are allowed to offset their entire regular and AMT tax liabilities by nonrefundable credits, for example the dependent care credit or the child credit, discussed here:

Employee Payroll Tax Cut

The Bill cuts payroll taxes by 2 percent. Currently, employers and employees must each pay half of the Federal Insurance Contribution Act (FICA) taxes, which in total equal 15.3 percent (12.4 percent in Social Security taxes and 2.9 percent in Medicare Hospital Insurance taxes). Self-employed individuals subject to self-employment tax must pay both the employee and employer portions of the Social Security and Hospital Insurance tax themselves. The Bill reduces the employee portion of the Social Security taxes paid on wages up to \$106,800 for employees and self-employed individuals; thus, the maximum benefit is \$2,136. Importantly, this reduction does not change self-employment net earnings, which is used to determine certain self-employment deductions.

OBSERVATION. In contrast to the payroll tax holiday (under the HIRE Act) and the Making Work Pay credit, which both expire at the end of calendar 2010, this provision does not reduce the employer's share of the Social Security payroll tax and, thus, may not fuel incentives for hiring new workers. In addition, some public employees, who do not pay social security taxes, will not receive the benefit. Also, there is no phase out for higher income individuals, as is the case with the Making Work Pay credit.

Estate Tax

Prior to passage of the Bill, estate and generation-skipping transfer taxes were fully repealed for 2010, and the gift tax rate was lowered to 35 percent, with an exemption of \$1 million. The Bill provides a top tax rate for estate, gift and generation-skipping transfer taxes of 35 percent, with a \$5 million exclusion amount per person (\$10 million per couple). The new rate and exemption amount applies to decedents dying, gifts made, and generation skipping transfers through December 31, 2012, thereby reunifying estate and gift tax, and creating a single graduated rate schedule for both. Also, the \$5 million exemption amount will be indexed for inflation beginning in 2012.

The Bill is effective January 1, 2010. This means that decedents dying after December 31, 2009 and before January 1, 2011, are also subject to the 35 percent top rate and \$5 million exclusion. However, these estates may elect to have the prior law apply. If such an election is made, the estate would not be subject to estate tax, but the basis of assets acquired from the decedent would be determined under the modified carryover basis rules, not the basis step-up rules provided for in the Bill. Once such an election is made, it would be revocable only with the consent of the IRS. For estates of decedents dying after December 31, 2010, the Bill allows any applicable exclusion amount that remains unused to be available for use by the surviving spouse, in addition to the surviving spouse's own exclusion amount.

OBSERVATION. There is an opportunity to make generation-skipping transfers at greatly reduced tax rates between now and December 31, 2010.

Credits and Incentives Affecting Families and Children for Two Years

The Bill extends the \$1,000 Child Tax Credit, allowing the credit to be applied against an individual's regular and AMT liabilities for 2011 and 2012. The credit phases out at \$75,000 AGI for single individuals and heads of households, at \$110,000 for married individuals filing jointly, and at \$55,000 for married individuals filing separately.

The Adoption Credit has been extended, as has the exclusion from income for Employer-Provided Adoption Assistance. For 2011, the credit and exclusion are each \$13,170, per eligible child. For 2012, the credit and exclusion are each reduced to \$12,170.

The Employer Provided Child Care Credit and the Dependent Care Tax Credit have been extended through 2012. The basic standard deduction for a married persons filing jointly remains at twice the deduction for an unmarried single filer. The upper threshold of the 15 percent regular income tax rate bracket for married persons filing jointly remains at twice that of the 15 percent bracket for single unmarried individuals.

The Bill also provides educational incentives for families and students, including exclusions from income of employer-provided education assistance and an interest deduction for student loans. Current maximum contribution amounts to Coverdell Education Savings Accounts are maintained. Government bonds, a percentage of which are issued to finance public school construction, may be issued in amounts up to \$15 million without arbitrage restrictions, and post-secondary education credits remain available for eligible students.

The Bill further extends the election to take an itemized deduction for state and local sales taxes in lieu of the deduction for state income taxes. Tax-free distributions to charity from an Individual Retirement Account (IRA) of up to \$100,000 per taxpayer per taxable year continue to be permitted. The Bill also allows individuals to make charitable transfers during January of 2011 and treat them as if made during 2010.



BUSINESS Tax Provisions

Investment Incentives

Extension of Bonus Depreciation and Temporary 100 Percent Expensing of Certain Assets. The Bill expands, from 50 to 100 percent, additional first-year depreciation of the cost of qualified property placed in service after September 8, 2010, and before January 1, 2012 (January 1, 2013 for property with a useful life of between 10 and 20 years or transportation property). This provision also extends the 50 percent bonus depreciation for qualified property placed in service during 2012 (2013 for property with a useful life of between 10 and 20 years or transportation property). Moreover, qualified property acquired under a written binding contract entered into after December 31, 2007, which property is placed in service within the applicable dates described above is also eligible for the 100 percent bonus depreciation, assuming all other requirements are met. In addition, corporations are permitted to increase the minimum tax credit limitation by the bonus depreciation amount by simply electing to forgo bonus depreciation for property placed in service in 2011 or 2012 ("round two extension property").

OBSERVATION. This change will increase the value of performing a cost segregation analysis on major construction projects to the extent such analysis reclassifies property from 39 year property to a shorter class life.

Two Year Extension of 15-Year Cost Recovery for Qualified Leasehold Improvements, Restaurant Buildings and Improvements and Retail Improvements.

In general, the cost of and leasehold improvements to non-residential real property are depreciated on a straight-line method over 39 years. There is a statutory exception allowing 15-year straight-line recovery for qualified leasehold improvement property placed in service through December 31, 2009. Qualified leasehold improvements are interior improvements made at least three years after the building was placed in service and made pursuant to the lease by the lessee or lessor, but not including enlargement of the building, elevators, escalators, structural components benefitting a common area or the internal structural building framework. A similar 15-year recovery exception exists for the following property placed in service in 2009:

- Qualified restaurant property (building or improvements if more than 50 percent of the square footage is devoted to food preparation and consumption)
- Qualified retail improvement property (interior improvements made at least 3 years after the building was placed in service and open to the general public in the retail trade or business of selling tangible personal property, but not including enlargement of the building, elevators, escalators or the internal structural building framework)

The Bill extends the 15-year recovery period exception for qualified leasehold improvements, restaurant buildings and improvements, and retail improvements for two years to cover property placed in service through December 31, 2011.

Exclusion of small business capital gains.

Generally, non-corporate taxpayers may exclude 50 percent of the gain from the sale of certain small business stock acquired at original issue and held for more than five years. For stock acquired after February 17, 2009 and on or before September 27, 2010, the exclusion is increased to 75 percent. For stock acquired after September 27, 2010 and before January 1, 2011, the exclusion is 100 percent and the AMT preference item attributable for the sale is eliminated.

Qualifying small business stock is from a C corporation with gross assets not exceeding \$50 million (including the proceeds received from the issuance of the stock) and that meets a specific active business requirement. The amount of gain eligible for the exclusion is limited to the greater of 10 times the taxpayer's basis in the stock or \$10 million of gain from the sale of stock in that corporation.

The provision extends the 100 percent exclusion of the gain from the sale of qualifying small business stock if the stock is acquired before January 1, 2012 and is held for more than five years.

One Year Extension of Increased Small Business Expensing. For taxable years beginning in 2012, a taxpayer may expense up to \$125,000 of the cost of qualifying property placed in service for the year. This \$125,000 amount must be reduced by the cost of qualifying property placed in service during the taxable year in excess of \$500,000. The section 179 expensing provisions are also extended to apply to off-the-shelf software, but not to

qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property placed in service after 2011. Absent this extension, the expense amount would have reverted to \$25,000 and the investment limit to \$200,000.

Tax Credits

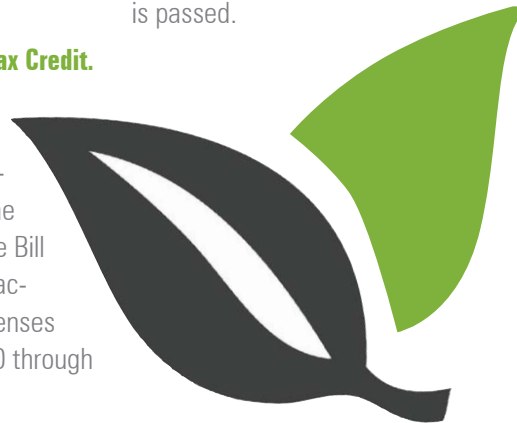
Two Year Extension of the Research Tax Credit.

The research tax credit was allowed to expire on December 31, 2009 for the 14th time, creating significant uncertainty and effectively increasing the cost of performing R&D in the US. The Bill extends the research tax credit retroactively to cover qualified research expenses paid or incurred from January 1, 2010 through December 31, 2011.

OBSERVATION. There is strong bi-partisan support building to make the research credit permanent, but the cost will make it very difficult to move forward until the government can find a way to reduce the deficit.

New Markets Tax Credit. Section 45D of the Internal Revenue Code (the Code) provides a new markets tax credit for qualified equity investments made to acquire stock in a corporation, or a capital interest in a partnership, that is a qualified community development entity (CDE). An investor (either the original purchaser or a subsequent holder) is allowed a 5 percent credit for the year in which the equity interest is purchased and for each of the following two years, and a 6 percent credit for each of the following four years. The provision extends the New Markets Tax Credit through 2011, permitting up to \$3.5 billion in qualified equity investments for each of the 2010 and 2011 calendar years. The provision also extends for two years, through 2016, the carryover period for unused New Markets Tax Credits.

OBSERVATION. The New Markets Tax Credit allows the federal government to use tax credits to encourage significant private investment in businesses in low-income communities. This program has been extremely popular. The U.S. Department of Treasury has said that they are already prepared to announce 2010 recipients once this legislation is passed.



Energy Provisions

Biodiesel and Renewable Diesel. The Code provides an income tax credit for biodiesel fuels that is the sum of three credits: the Biodiesel Mixture Credit (\$1.00/gallon), the Biodiesel Credit (\$1.00/gallon), and the Small Agri-biodiesel Producer Credit (\$0.10/gallon). The credit for biodiesel and renewable diesel has been extended for two additional years (through December 31, 2011).

One year Extension of the ARRA Section 1603 Grant in Lieu of Credit for Specified Energy Property. The Bill extends the popular grant in lieu of credit program, which was a highlight of the 2009 stimulus package and has helped fund a large number of renewable energy projects that would not otherwise have been possible. This program has also been responsible for substantial job creation in the wind, solar, biomass and other renewable energy industries. The provision extends through 2011 the period in which construction must begin on a qualified facility in order to be eligible for the program.

Alcohol Fuels Credit (including ethanol).

Code sections 40, 6426 and 6427(e) provide per-gallon tax incentives for the sale, use and production of alcohol fuel and alcohol fuel mixtures. The incentives generally expire by the end of 2010, except for cellulosic biofuel, for which an incentive is available until the end of 2012. The Section 40 Alcohol Fuels Credit consists of four components: the Alcohol Mixture Credit (\$0.45/gallon for ethanol and \$.60/gallon for other alcohols), the Alcohol Credit (\$0.45/gallon for ethanol and \$.60/gallon for other alcohols), the Small Ethanol Producer Credit (additional \$0.10/gallon), and the Cellulosic Biofuel Producer Credit (\$1.01/gallon). The Bill extends through December 31, 2011, the present-law income tax credit for alcohol fuels (other than the Cellulosic Biofuel Producer Credit). Like the Biodiesel Fuels Credit, the Alcohol Credit is a very valuable credit that is necessary to keep this industry viable given that comprehensive energy legislation is not likely to pass in the next Congress.

ALTERNATIVE FUELS CREDIT. The Code provides two per-gallon excise tax credits with respect to alternative fuel: the Alternative Fuel Credit (\$0.50/gallon) and the Alternative Fuel Mixture Credit (\$0.50/gallon). The Bill extends these credits for two years (through December 31, 2011). It excludes fuel (including lignin, wood residues, or spent pulping liquors) derived from the production of paper or pulp.

OBSERVATION. The Bill does not extend this credit to black liquor (liquid fuel derived from a pulp or paper manufacturing process). Using this credit for black liquor has been controversial because black liquor has long been produced without any tax incentive. Ending the availability of the credit to paper producers was a priority of the Obama administration.

Extension of expensing of environmental remediation costs. Currently, taxpayers may elect to treat expenditures paid or incurred before January 1, 2010, in connection with the abatement or control of hazardous substances at a qualified contaminated site as deductible in the year paid or incurred, rather than charging to the capital account. The deduction applies for regular tax and AMT purposes. The Bill extends the present expensing treatment to expenditures paid or incurred before January 1, 2012.



International Provisions

Active financing exception. The Bill extends for two years (for taxable years beginning before 2012) the present-law temporary exceptions from subpart F foreign personal holding company income, foreign base company services income, and insurance income for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business.

Look-through treatment of payments between related CFCs under foreign PHC rules. Subpart F requires US shareholders with at least 10 percent ownership in a controlled foreign corporation (CFC) to recognize certain CFC

income on a current basis for US tax purposes, regardless of whether the income is distributed to the shareholders. One category of Subpart F income is foreign personal holding company income, which generally includes dividends, interest, rents, and royalties, among other types of income.

However, under the "look-through rule," dividends, interest, rents, and royalties received by one CFC from a related CFC are not treated as foreign personal holding company income to the extent attributable or properly allocable to income of the payor that is not subpart F income. The look-through rule expired after December 31, 2009. The provision extends the application of the look-through rule, to taxable years of foreign corporations beginning before January 1, 2012, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations.

FINAL OBSERVATION

While the Bill contains something for everyone, it fails to include a repeal of new Form 1099 requirements or an extension of the Build America Bonds Program. Both programs may be included in future, and it is hoped that, notwithstanding its many critics, the Bill may lay the groundwork for more comprehensive tax reform by the next election.

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