



Issue No. 2010-5

True Alert

December 20, 2010

2010 Tax Relief Act Enacted

On December 17, 2010, President Obama signed “The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010” (the “2010 Tax Act”). While most of the 2010 Tax Act provisions are directed towards individuals and estates, there are a few important provisions for business as well.

Expansion and Extension of Bonus Depreciation

The most important provision for business is the expansion and extension of bonus depreciation.

In general, the costs for purchasing property, plant, and equipment (“PP&E”) must be capitalized and recovered over time according to prescribed depreciation schedules. Depreciation for tax purposes begins when the property is placed in service (*i.e.*, when it is in a condition and state of readiness and available for a specifically assigned function).

For property placed in service in 2008-10, the law allowed an additional 50 percent of the cost to be recovered in the first year (“bonus depreciation”). Bonus depreciation is allowed for both regular tax and alternative minimum tax purposes, although it is not allowed in computing earnings and profits. In order to qualify for bonus depreciation, the property generally must meet all of the following requirements:

- It must be depreciable property with a recovery period of 20 years or less, water utility property, computer software, or certain qualified leasehold improvements;
- The original use of the property must commence with the taxpayer after December 31, 2007;
- The taxpayer must purchase the property within the applicable time period; and



- The property must be placed in service after December 31, 2007, and before January 1, 2011.

Various special rules applied to leased property, certain transportation property, property with a production period exceeding one year and a cost of greater than \$1 million, binding written contracts, and the research credit.

The 2010 Tax Act not only extends the placed-in-service period through December 31, 2012, but allows *the entire cost* of property placed in service after September 8, 2010, and before January 1, 2012, to be recovered in that year. Thus, businesses will be able to write off 100 percent of the cost of PP&E placed in service in 2011 (or a portion of 2010), and 50 percent additional depreciation will apply again for property placed in service in 2012. The requirements for qualification and the special rules generally stay the same under the new law.

Example 1: Assume that in 2011, a taxpayer purchased new depreciable property and placed it in service. The property's cost is \$1,000,000, and it is five-year property subject to the half-year convention. The full \$1,000,000 cost is allowed as a depreciation deduction in 2011. The adjusted basis of the property after 2011 will be \$0.

Example 2: The facts are the same as in Example 1 except that the property is purchased and placed in service in 2012. The amount of additional first-year depreciation allowed is \$500,000. The remaining \$500,000 of the cost of the property is depreciable under the rules applicable to five-year property. Thus, 20 percent, or \$100,000 is also allowed as a depreciation deduction in 2012. The total depreciation deduction allowed with respect to the property in 2012 is \$600,000. The remaining \$400,000 adjusted basis of the property is recovered through otherwise applicable depreciation rules.

The expansion of bonus depreciation is a huge benefit to American business—about \$110 billion over two years. If they haven't already done so, businesses should review their capital spending plans and revise them to obtain maximum benefit from this generous provision.

Temporary Extension of Research Credit

The research credit under section 41 of the Code expired after December 31, 2009. The 2010 Tax Act extends the research credit for two years, through December 31, 2011. Thus, the credit is retroactively eligible for research costs incurred during 2010.

Expensing of Environmental Remediation

Taxpayers may elect to treat certain environmental remediation expenses paid or incurred before January 1, 2010, that would otherwise be chargeable to capital account as deductible in the year paid or incurred. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a

qualified contaminated site (generally, any business or investment property certified by the appropriate State agency to be an area at or on which there has been a release or disposal of a hazardous substance). The 2010 Tax Act extends the expensing for two years to include expenditures paid or incurred before January 1, 2012.

Subpart F Exception for Active Financing Income

A 10-percent-or-greater U.S. shareholder of a controlled foreign corporation (“CFC”) is subject to current U.S. tax on certain income earned by the CFC even if such income is not distributed to the shareholders. Subpart F income subject to current tax includes interest and dividend income. There are, however, exceptions for income derived in the active conduct of a banking, financing, or similar business, as a securities dealer, or in the conduct of an insurance business (“active financing income”) during taxable years before 2010.

The 2010 Tax Act extends the exception for active financing income for two years, for tax years beginning before 2012.

Subpart F Look-Through Rule

Under the “look-through rule,” interest, dividends, rents, and royalties received by one CFC from a related CFC are not treated as currently taxable to the extent attributable or properly allocable to income of the payor that is neither Subpart F income nor treated as effectively-connected income. The look-through rule applies to taxable years of foreign corporations beginning before January 1, 2010.

The 2010 Tax Act extends the look-through rule for two years to taxable years of foreign corporations beginning before January 1, 2012.

Temporary Extension of 15-Year Straight-Line Cost Recovery for Certain Qualified Improvements

The cost of nonresidential real property is generally recovered using the straight-line method of depreciation over 39 years. Leasehold improvements to nonresidential real property already placed in service is generally depreciated using the same 39-year, straight-line method. Certain eligible improvements placed in service on or before December 31, 2009, however, were eligible for a 15-year straight-line recovery period. Eligible improvements included:

- Any improvement to an interior portion of a building that is nonresidential real property, provided that the improvement is made under or pursuant to a lease of that portion of the property occupied exclusively by the lessee, and the improvement is placed in service more than three years after the date the building was first placed in service. Expenditures attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building are not qualified.

- Qualified restaurant property, which is any building if more than 50 percent of its square footage is devoted to the preparation of, and seating for on-premises consumption of prepared meals.
- Qualified retail improvement property, which is any improvement to an interior portion of nonresidential real property if such portion is open to the general public and is used in the retail trade or business of selling tangible personal property to the general public, and such improvement is placed in service more than three years after the building was first placed in service. Expenditures attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building are not qualified.

The 2010 Tax Act extends eligibility for 15-year straight-line depreciation for these types of eligible improvements to property placed in service on or before December 31, 2011.

Enhanced Charitable Deductions for Contributions of Certain Property

A taxpayer's deduction for charitable contributions of inventory is limited to the lesser of the taxpayer's basis (typically, cost) or the fair market value. Under a special provision, any taxpayer engaged in a trade or business can claim an enhanced deduction equal to the lesser of (i) basis plus 50% of the items appreciation, or (ii) two time basis, for donations of (A) food inventory, (B) book inventory donated to public schools, or (C) computer inventory for educational purposes. These enhanced deductions do not apply to contributions of food, books, or computers made after December 31, 2009.

The 2010 Tax Act extends the enhanced deduction for charitable contributions of food, book, or computer inventory to contributions made before January 1, 2012.

Small Business Provisions

The 2010 Tax Act also contains several provisions that apply specifically to small businesses.

Increased Small Business Expensing. A taxpayer that invests in certain qualifying property may elect under section 179 of the Code to deduct (or "expense") the cost of qualifying property, rather than recover it through depreciation deductions. For 2010 and 2011, the maximum amount that a taxpayer may expense is \$500,000, reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$2,000,000. "Qualifying property" includes off-the-shelf computer software and up to \$250,000 of qualified leasehold improvement property. The amount that can be expensed cannot exceed the taxable income derived from the active conduct of a trade or business. For taxable years after 2011, the maximum amount that may be expensed is \$25,000, reduced by the amount by which the cost of qualifying property exceeds \$200,000.

Under the 2010 Tax Act, for taxable years beginning in 2012, the maximum amount a taxpayer may expense is \$125,000, reduced by the amount by which the cost of qualifying property exceeds \$500,000. For taxable years beginning in 2013 and thereafter, the amounts are \$25,000 and \$200,000. Off-the-shelf computer software will continue to qualify, although leasehold improvement property will not.

Exclusion of Gain on Certain Small Business Stock. Individuals generally may exclude 50 percent of the gain from the sale of certain small business stock acquired at original issue and held for at least five years. For qualified small business stock acquired after February 17, 2009, and on or before September 27, 2010, the exclusion was increased to 75 percent, while qualified small business stock acquired after September 27, 2010, and before January 1, 2011, was 100 percent. The 2010 Tax Act extends the 100-percent exclusion for one year to stock acquired before January 1, 2012.

Basis Adjustment to Stock of S Corporations Making Charitable Contributions of Property. Shareholders of an S corporation reduce the basis in their stock by the amount of the charitable contribution. For contributions of property made in taxable years before January 1, 2010, the amount of the reduction is the shareholder's pro rata share of the adjusted basis of the contributed property; for taxable years beginning after December 31, 2009, the amount of the reduction is the pro rata share of the fair market value of the contributed property. The 2010 Tax Act extends the adjusted basis rule for two years to contributions made in taxable years beginning before January 1, 2012.

Wage Credit for Active-Duty Military. Some employers voluntarily pay employees called to active duty with the armed forces of the United States the difference between the compensation the employer would have paid the employee during the period of military service less the amount of pay received by the employee from the military ("differential pay"). Eligible small business employers are allowed to take a credit against their income tax in an amount equal to 20 percent of the differential pay for amounts paid after June 17, 2008, and before January 1, 2010. The 2010 Tax Act extends the availability of the credit to amounts paid before January 1, 2012.

Energy Extensions

The 2010 Tax Act extended various energy incentive provisions:

- The biodiesel fuels income and excise tax credits and payment provisions for biodiesel and renewable diesel are extended for two additional years, through December 31, 2011.
- The placed-in-service period for certain new refined coal facilities is extended through December 31, 2011.

- The new energy-efficient home credit is extended to homes purchased before January 1, 2012.
- Excise tax credits for alternative fuels and alternative fuel mixtures are extended for two years, through December 31, 2011.
- Credits, incentives, and duties related to the use of alcohol as fuel are extended through December 31, 2011.
- The energy-efficient appliance credit is extended for one additional year, for appliances manufactured in 2011.
- The credit for installation of qualified clean-fuel vehicle refueling property is extended through 2011.

Other Extensions

The 2010 Tax Act also extended various tax incentives through 2011 for empowerment zones, Gulf Opportunity Zones, renewal communities, investments in the District of Columbia, the work opportunity credit, qualified zone academy bonds, domestic production activities in Puerto Rico, mine rescue and safety, railroad track maintenance, and motorsports racetrack property.

Please contact us if you would like more details about any of these changes or any other aspect of the new law.

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