Year-End Legislation Extends Key Provisions for Businesses, Provides 100 Percent Expensing for Certain Assets and Enacts New Foreign Procurement Excise Tax

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As part of legislation enacted at the end of 2010, the U.S. Congress extended several beneficial tax provisions for businesses, including the research credit, active financing exception under Subpart F and look-through rule for payments between controlled foreign corporations. In addition, the new legislation provides 100 percent expensing for certain assets purchased during the latter part of 2010 and during 2011 that are placed in service prior to January 1, 2012. Finally, as part of legislation providing benefits to 9/11 relief workers, a new excise tax will be imposed on certain procurement payments received by non-U.S. persons under contracts with the U.S. government.

Overview

On December 17, 2010, President Obama signed H.R. 4853, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the 2010 Tax Act), into law. The 2010 Tax Act extends for two years all current individual income and capital gains tax rates, many of which had been set to expire (and thus to increase to prior-law levels) December 31, 2010. In addition, the 2010 Tax Act extends certain expired business tax provisions, including the research credit, the active financing exception under Subpart F and the look-through rule for payments between controlled foreign corporations (CFCs). Previous attempts to extend these expiring provisions languished in Congress. The 2010 Tax Act generally extends the provisions retroactively to the beginning of 2010 and through 2011.

Finally, the 2010 Tax Act extends 50 percent bonus depreciation under section 168(k) of the Internal Revenue Code (the Code) for certain business assets purchased prior to January 1, 2013, that are placed into service prior to that date (or by January 1, 2014, with respect to certain property). Temporary bonus depreciation has been enacted as a stimulus measure several times in recent years. However, the 2010 Tax Act creates an additional incentive by allowing for 100 percent expensing of certain business assets purchased after September 8, 2010, and before January 1, 2012, that are placed into service prior to January 1, 2012 (or by January 1, 2013, with respect to certain property).

On December 23, 2010, President Obama signed H.R. 847, the James Zadroga 9/11 Health and Compensation Act of 2010 (the 9/11 Act), into law. In order to partially offset the costs associated with providing benefits to 9/11 relief workers, the 9/11 Act imposes an excise tax on certain procurement payments received by non-U.S. persons under contracts with the U.S. government.

Expired Provisions

Research Credit—Section 41

In order to encourage research activities, section 41 of the Code provides for a nonrefundable 20 percent credit for certain research expenses. Prior to the enactment of the 2010 Tax Act, the research credit was not available for research expenses paid or incurred after December 31, 2009. Section 731 of the 2010 Tax Act extends the availability of the credit for two years, allowing taxpayers a credit for research expenses paid or incurred on or before December 31, 2011. The 2010 Tax Act does not otherwise alter a taxpayer's ability to qualify for the research credit under section 41.

The Active Financing Exception to Subpart F—Section 954(h)

Under the anti-deferral regime of Subpart F, U.S. shareholders of CFCs are required to immediately take into account passive income of the CFC. Specifically, the foreign personal holding company income (FPHCI) rules of section 954 generally require a U.S. shareholder to immediately include in its income its proportionate share of dividends, interest, royalties, rents and annuities of a CFC in which the U.S. shareholder has a direct or indirect 10 percent or greater interest. In addition, a U.S. shareholder is generally required to immediately include in its income its proportionate share of a CFC's foreign base company services income (FBC Services Income), which is income from services provided by a CFC that are performed outside of the CFC's country of organization for or on behalf of related parties.

Section 954(h) of the Code provides an exception to the FPHCI and FBC Services Income rules for qualified banking or financing income of CFCs engaged in the active conduct of banking, finance or similar businesses. Thus, for example, if a CFC is actively engaged in the business of lending, the interest derived by that CFC with respect to loans may be eligible for the active financing exception under section 954(h), such that the interest does not constitute FPHCI or FBC Services Income and is not subject to immediate taxation in the United States.

Prior to the enactment of the 2010 Tax Act, section 954(h) applied to tax years of the CFC beginning after December 31, 1998, and before January 1, 2010, and to tax years of U.S. shareholders with or within which any such taxable year of the CFC ended. Section 750 of the 2010 Tax Act extends the active financing exception of section 954(h) for two years, through tax years beginning before January 1, 2012.

Look-Through Treatment for Payments Received by a CFC from Related Persons—Section 954(c)(6)

Like section 954(h), section 954(c)(6) provides an exception to the general FPHCI regime of Subpart F that requires a U.S. shareholder of a CFC to immediately take into account passive income of the CFC. Specifically, section 954(c)(6) provides that certain payments (*e.g.*, dividends, interest, rents and royalties) received by a CFC from related persons do not constitute FPHCI provided the payment is not allocable to income of the related persons which is Subpart F income or income effectively connected with the conduct of a trade or business within the United States.

Prior to the enactment of the 2010 Tax Act, section 954(c)(6) applied to tax years of the CFC beginning after December 31, 2005, and before January 1, 2010, and to tax years of U.S. shareholders with or within which such tax years of the CFC ended. Section 751 of the 2010 Tax Act extends the look-through rule of section 954(c)(6) for two years, through tax years beginning before January 1, 2012.

Other Provisions

In addition to the provisions discussed above, Section 731 through 765 of the 2010 Tax Act extended a number of other business tax provisions, including:

- New Markets Tax Credit (section 45D of the Code)—through December 31, 2011
- Deduction for Income Attributable to Domestic Production Activities in Puerto Rico (section 199(d)(8) of the Code)—through tax years beginning before January 1, 2012
- Exemption for Certain Dividends of RICs (section 871(k) of the Code)—through December 31, 2011
- 100% Exclusion of Gain on Certain Small Business Stock (section 1202(a)(4) of the Code)—stock acquired prior to January 1, 2012

Bonus Depreciation and 100 Percent Expensing

The 2010 Tax Act extends the 50 percent bonus depreciation allowable under section 168(k) to “qualified property” purchased prior to January 1, 2013, that is placed into service prior to that date (or before January 1, 2014, with respect to certain property). Prior to enactment of the 2010 Tax Act, section 168(k) applied to qualified property purchased prior to January 1, 2011, that was placed in service prior to that date (or before January 1, 2012, with respect to certain property). Temporary bonus depreciation has been enacted as a stimulus measure several times over the last several years.

Section 168(k)(2) of the Code provides that qualified property generally includes property which has a recovery period of 20 years or less, is computer software (for which a deduction is allowable under section 167), is water utility property or is qualified leasehold improvement property.

In addition to another extension of the 50 percent bonus depreciation under section 168(k), the 2010 Tax Act provides for a 100 percent depreciation deduction for certain business property acquired after September 8, 2010, and before January 1, 2012, that is placed into service prior to January 1, 2012 (or January 1, 2013, with respect to certain property). Specifically, new section 168(k)(5) will allow a taxpayer to expense 100 percent of the cost of qualified property acquired between the dates described above, during the tax year in which such property is placed in service (provided such property is placed in service prior to January 1, 2012 or January 1, 2013, with respect to certain property). For example, assume on September 9, 2010, a calendar year taxpayer acquired qualified property (discussed above) for which the 100 percent expensing allowance of section 168(k)(5) applies, and placed the property into service in its business the same day. The taxpayer would be permitted to expense the entire cost of such property during its 2010 tax year. Provided the property acquired is qualified property and was acquired and placed in service during the appropriate time frame, new section 168(k)(5) does not impose any additional limitations to obtaining the 100 percent depreciation deduction.

Foreign Procurement Excise Tax

To partially offset the cost of providing health benefits and compensation to relief workers of the September 11, 2011, terrorist attacks, the 9/11 Act creates new section 5000C of the Code, which imposes a 2 percent excise tax on any "specified Federal procurement payment" received by a foreign person. A "specified Federal procurement payment" is defined as a payment made pursuant to a contract with the government of the United States for the provision of goods, if such goods are manufactured or produced in any country that is not party to an international procurement agreement with the United States, or the provision of services, if such services are provided in any country which is not a party to an international procurement agreement with the United States.

Conclusion

Businesses should be encouraged by the extension of the favorable provisions described above, and new opportunities for capital investment may arise as a result of the 100 percent expensing provision provided by the Act. However, the temporary nature of these provisions requires taxpayers to consider planning opportunities to maximize the benefits of the provisions in the near term, as well as potentially to live without them.

Further, taxpayers should be aware of the new excise tax imposed on certain payments received by foreign persons under contracts with the U.S. government. The new tax appears to be fairly narrow in scope, but multinational

companies that do significant business with the U.S. government should confirm the tax does not apply in their particular situations.

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