# BUSINESS TAX BREAKS RETROACTIVELY EXTENDED BY THE PROTECTING AMERICANS FROM TAX HIKES ACT

Late on December 18, Congress passed and the President signed into law a bipartisan, bicameral agreement was reached on tax extenders - i.e., the 50 or so temporary tax provisions that are routinely extended by Congress on a one- or two-year basis - and numerous other tax provisions in the "Protecting Americans from Tax Hikes (PATH) Act of 2015" (the Act). As explained in this *Hot Topic*, the Act retroactively extends a host of business tax provisions, some of which are permanently extended (e.g., the research credit, enhanced charitable deductions for contributions of food inventory, the employer wage credit for activated reservists), and others of which are extended through 2019 (e.g., the new markets tax credit) or 2016 (e.g., empowerment zone tax incentives).

## Research Credit Permanently Extended and Made Creditable Against Other Taxes

The research credit equals the sum of: (1) 20% of the excess (if any) of the qualified research expenses for the tax year over a base amount (unless the taxpayer elected an alternative simplified research credit); (2) the university basic research credit (i.e., 20% of the basic research payments); and (3) 20% of the taxpayer's expenditures on qualified energy research undertaken by an energy research consortium.

The base amount is a fixed-base percentage of the taxpayer's average annual gross receipts from a U.S. trade or business, net of returns and allowances, for the 4 tax years before the credit year, and can't be less than 50% of the year's qualified research expenses. The fixed base percentage for a non-startup company is the percentage (not exceeding 16%) that the taxpayer's total qualified research expenses are of total gross receipts for tax years beginning after '83 and before '89. A 3% fixed-base percentage applies for each of the first 5 tax years in which a "startup company" (one with fewer than 3 tax years with both gross receipts and qualified research expenses) has qualified research expenses.

A taxpayer can elect an alternative simplified research credit equal to 14% of the excess of the qualified research expenses for the tax year over 50% of the average qualified research expenses for the three tax years preceding the tax year for which the credit is being determined. If a taxpayer has no qualified research expenses in any one of the three preceding tax years, the alternative simplified research credit is 6% of the qualified research expenses for the tax year for which the credit is being determined.

Under pre-Act law, the research credit didn't apply for amounts paid or accrued after December 31, 2014.

**New law**. The Act retroactively and permanently extends the research credit.

**Recommendation**: Because the extension of the research credit is retroactive to include amounts paid or incurred after December 31, 2014, taxpayers, such as fiscal year corporations that already filed returns for a fiscal year that includes part of 2015, or any other taxpayers that have filed returns for tax years ending after December 31, 2014, should consider filing an amended return to claim a refund for the amount of any additional tax paid because of not claiming amounts now eligible for the credit.

In addition, for tax years that begin after December 31, 2015, eligible small businesses ($50 million or less of gross receipts) may claim the credit against their alternative minimum tax (AMT) liability.

And, for tax years that begin after December 31, 2015, small (less than $5 million of gross receipts) startup businesses may claim up to $250,000 per year of the credit against their employer FICA tax liability.

**Exemption for RIC Interest-Related Dividends and Short-Term Capital Gains Dividends Permanently Extended**

Under pre-Act law, a regulated investment company (RIC) may designate and pay (1) interest-related dividends out of interest that would generally not be taxable when received directly by a nonresident alien individual or foreign corporation, and (2) short-term capital gains dividends out of short-term capital gains. RIC dividends designated as interest-related dividends and short-term capital gains dividends are generally not taxable when received by a nonresident alien individual or foreign corporation and aren't subject to the withholding tax imposed on nonresident alien individuals and foreign corporations.

Under pre-Act law, these provisions didn't apply to dividends with respect to any tax year of a RIC beginning after December 31, 2014.

> **New law.** The Act retroactively and permanently extends the rules exempting from gross basis tax and withholding tax the interest-related dividends and short-term capital gain dividends received from a RIC.

**Treatment of RIC As Qualified Investment Entity Permanently Extended**

Gain from the disposition of a U.S. real property interest (USRPI) by a foreign person is treated as income effectively connected with a U.S. trade or business and is subject to tax and to withholding under the Foreign Investment in Real Property Tax Act (FIRPTA) provisions. A USRPI does not include an interest in a domestically controlled "qualified investment entity".

Under pre-Act law, before January 1, 2015, a RIC that met certain requirements could be treated as a "qualified investment entity".

> **New law.** The Act retroactively and permanently extends the inclusion of a RIC within the definition of a "qualified investment entity."

The change made generally takes effect on January 1, 2015, but the Act doesn't impose a withholding requirement for any payment made before its enactment. A RIC that withheld and remitted tax on distributions made after December 31, 2014 and before the enactment date isn't liable to the distributee for such withheld and remitted amounts.

**Reduction in S Corp Recognition Period for Built-In Gains Tax Permanently Extended**

An S corporation generally is not subject to tax, but instead passes through its income to its

shareholders, who pay tax on their pro-rata shares of the S corporation's income. Where a corporation that was formed as a C corporation elects to become an S corporation (or where an S corporation receives property from a C corporation in a nontaxable carryover basis transfer), the S corporation is taxed at the highest corporate rate (currently 35%) on all gains that were built-in at the time of the election if the gain is recognized during a recognition period.

Under pre-Act law, for S corporation tax years beginning in 2012 and 2013, the recognition period was five years (instead of the generally applicable 10-year period). Thus, the recognition period was the 5-year period beginning with the first day of the first tax year for which the corporation was an S corporation (or beginning with the date of acquisition of assets if the rules applicable to assets acquired from a C corporation applied). If an S corporation disposed of such assets in a tax year beginning in 2012 or 2013 and the disposition occurred more than five years after the first day of the relevant recognition period, gain or loss on the disposition wasn't taken into account in determining the net recognized built-in gain.

> **New law**. The Act retroactively and permanently provides that, for determining the net recognized built-in gain, the recognition period is a 5-year period - the same rule that applied to tax years beginning in 2014.)

### Exclusion of 100% of Gain on Certain Small Business Stock Permanently Extended

A taxpayer may exclude all of the gain on the disposition of qualified small business stock acquired after September 27, 2010, and before January 1, 2015. None of the excluded gain is subject to the alternative minimum tax.

Under pre-Act law, the exclusion was to be limited to 50% of gain for stock acquired after December 31, 2014, and 7% of the excluded gain was to be an alternative minimum tax preference.

> **New law.** The Act retroactively and permanently extends the 100% exclusion and the exception from minimum tax preference treatment.

### Lower Shareholder Basis Adjustment for Charitable Contributions by S Corporations Permanently Extended

Before the Pension Protection Act of 2006 (PPA), if an S corporation contributed money or other property to a charity, each shareholder took into account his pro rata share of the fair market value of the contributed property in determining his own income tax liability. The shareholder reduced his basis in his S stock by the amount of the charitable contribution that flowed through to him. The PPA amended this rule to provide that the amount of a shareholder's basis reduction in S stock by reason of a charitable contribution made by the corporation is equal to his pro rata share of the adjusted basis of the contributed property.

Under pre-Act law, the PPA rule did not apply for contributions made in tax years beginning after December 31, 2014.

> **New law.** The Act retroactively and permanently extends the PPA rule.

**Special Rule for Payments to a Charity From a Controlled Entity Permanently Extended**

For 2006 - 2014, interest, rent, royalties and annuities paid to a tax-exempt organization from a controlled entity are included in the unrelated business taxable income (UBTI) of the tax-exempt organization, to the extent the payment reduced the net unrelated income (or increased any net unrelated loss) of the controlled entity.

For payments made pursuant to a binding written contract in effect on August 17, 2006 (or renewal of such a contract on substantially similar terms), the above rule applies only to the portion of payments received or accrued in a tax year that exceeds the amount of the payment that would have been paid or accrued if the amount of such payment had been determined under the Code. A 20% penalty applies to that excess.

Under pre-Act law, these rules didn't apply to payments received or accrued after December 31, 2014.

> **New law**. The Act retroactively and permanently extends these rules.

**Liberal Rule for Corporation Qualified Conservation Contributions Permanently Extended and Expanded**

A corporation that, for the tax year of the contribution, is a qualified farmer or rancher and whose stock isn't readily tradable on an established securities market at any time during that year may take a deduction for qualified conservation contributions up to 100% of its taxable income, after taking into account other allowable charitable contributions, with a 15-year carryover of such contributions in excess of the applicable limitation.

Under pre-Act law, these rules didn't apply to any contribution made in a tax year beginning after December 31, 2014, and contributions made thereafter by corporations can't exceed 10% of its taxable income, with a 5-year carryover of such contributions in excess of the applicable limitation.

> **New law.** The Act retroactively and permanently extends the 100% limitation on qualified conservation contributions of appreciated real property.

And, for contributions made in tax years beginning after December 31, 2015, the Act provides that Alaska Native Corporations (as defined in the Alaska Native Claims Settlement Act) are allowed to deduct donations of conservation easements up to 100% of taxable income.

**Enhanced Deduction for Food Inventory Permanently Extended and Expanded**

A taxpayer engaged in a trade or business is eligible to claim an enhanced deduction for donations of food inventory. A C corporation's deduction equals the lesser of (a) basis plus half of the property's appreciation, or (b) twice the property's basis, for contributions of food inventory that was apparently wholesome food - i.e., meant for human consumption and meeting certain quality and labeling standards. For a taxpayer other than a C corporation, the aggregate amount of contributions of apparently wholesome food that may be taken into account for the tax year can't exceed 10% of the taxpayer's aggregate net income for that tax

year from all trades or businesses from which those contributions were made for that tax year.

Under pre-Act law, this enhanced charitable deduction didn't apply for contributions after December 31, 2014.

> **New law.** The Act retroactively and permanently extends the apparently wholesome food contribution rules.

In addition, for tax years beginning after December 31, 2015,

- The Act increases the limitation on deductible contributions of food inventory from 10% to 15% of the taxpayer's aggregate net taxable income from all trades or businesses from which such contributions were made adjusted gross income (15% of taxable income in the case of a C corporation) per year.

- The fair market value (FMV) of apparently wholesome food that cannot or will not be sold solely by reason of internal standards of the taxpayer, lack of market or similar circumstances is determined without regard to such internal standards, etc.; FMV is determined by taking into account the price at which the same or substantially the same food items - as to both type and quality - are sold by the taxpayer at the time of the contribution.; and

- Taxpayers who do not account for inventories using full absorption costing and who are not required to capitalize indirect costs under the Code Sec. 263A UNICAP rules may elect to treat the basis of any apparently wholesome food as being equal to 25% of the market value of the food in determining the amount of the charitable contribution deduction.

### Exception for Active Financing Income Permanently Extended

The U.S. parent of a foreign subsidiary engaged in a banking, financing or similar business is eligible for deferral of tax on that subsidiary's earnings if the subsidiary is predominantly engaged in that business and conducts substantial activity with respect to the business. The subsidiary also has to pass an entity level income test to demonstrate that the income is active income and not passive income. Thus, this income from the active conduct of a banking, financing or similar business, or from the conduct of an insurance business (collectively referred to as "active financing income") is excluded from the definition of Subpart F income.

Under pre-Act law, this exception applied for tax years of foreign corporations beginning after December 31, 1998, and before January 1, 2015, and tax years of U.S. shareholders with or within which such tax years of the foreign corporations end.

> **New law**. The Act retroactively and permanently extends the exclusions for active financing income.

### Differential Wage Payment Credit for Employers Permanently Extended and Expanded

Eligible small business employers that pay differential wages - payments to employees for periods that they are called to active duty with the U.S. uniformed services (for more than 30

days) that represent all or part of the wages that they would have otherwise received from the employer - can claim a credit. This differential wage payment credit is equal to 20% of up to $20,000 of differential pay made to an employee during the tax year. An eligible small business employer is one that: (1) employed on average less than 50 employees on business days during the tax year; and (2) under a written plan, provides eligible differential wage payments to each of its qualified employees. A qualified employee is one who has been an employee for the 91-day period immediately preceding the period for which any differential wage payment is made.

Under pre-Act law, the credit was not available for differential wages paid after December 31, 2014.

**New law.** The Act retroactively and permanently extends the credit.

And, for tax years beginning after December 31, 2015, the Act provides that the credit applies to employers of any size (i.e., the less than 50 employee average no longer applies).

**Miscellaneous Other Provisions Permanently Extended**

The Act also retroactively and permanently extends:

- The low-income housing 9% credit rate freeze.
- A provision under which the basic housing allowance of a military member is excluded from income for purposes of determining the individual's qualification as a "low-income tenant" for purposes of the low-income housing tax credit program.

**Work Opportunity Tax Credit Extended Through 2019 and Expanded**

The work opportunity tax credit (WOTC) allows employers who hire members of certain targeted groups to get a credit against income tax of a percentage of first-year wages up to $6,000 per employee ($3,000 for qualified summer youth employees). Where the employee is a long-term family assistance (LTFA) recipient, the WOTC is a percentage of first and second year wages, up to $10,000 per employee. Generally, the percentage of qualifying wages is 40% of first-year wages; it's 25% for employees who have completed at least 120 hours, but less than 400 hours of service for the employer. For LTFA recipients, it includes an additional 50% of qualified second-year wages.

The maximum WOTC for hiring a qualifying veteran generally is $6,000. However, it can be as high as $12,000, $14,000, or $24,000, depending on factors such as whether the veteran has a service-connected disability, the period of his or her unemployment before being hired, and when that period of unemployment occurred relative to the WOTC-eligible hiring date.

Under pre-Act law, wages for purposes of the WOTC didn't include any amount paid or incurred to: veterans or non-veterans who began work after December 31, 2014.

**New law**. The Act retroactively extends the WOTC so that it applies to eligible veterans and non-veterans who begin work for the employer before January 1, 2019.

With respect to individuals who begin work for an employer after December 31, 2015, the credit also applies to employers who hire qualified long-term unemployed individuals (i.e., those who have been unemployed for 27 weeks or more). The credit with respect to such long-term unemployed individuals is 40% of the first $6,000 of wages.

**Look-Through Rule for Payments Between Related CFCs under Foreign Personal Holding Company Income Rules Extended Through 2019**

For tax years beginning before January 1, 2015, dividends, interest, rents, and royalties received by one controlled foreign corporation (CFC) from a related CFC are not treated as foreign personal holding company income (FPHCI) to the extent attributable or properly allocable to non-subpart-F income, or income that was not effectively connected with the conduct of a U.S. trade or business of the payor (look-through treatment).

Under pre-Act law, this look-thru rule applied to tax years of foreign corporations beginning after December 31, 2005, and before January 1, 2015, and to tax years of U.S. shareholders with or within which such tax years of foreign corporations ended.

> **New law**. The Act retroactively extends look-through treatment for related CFCs for two years, to tax years of a foreign corporation before January 1, 2020, and tax years of U.S. shareholders with or within which such tax years of foreign corporations end.

**New Markets Tax Credit Extended Through 2019**

A new markets tax credit applies for qualified equity investments to acquire stock in a community development entity (CDE). The credit is: (1) 5% for the year in which the equity interest is purchased from the CDE and for the first two anniversary dates after the purchase (for a total credit of 15%), plus (2) 6% on each anniversary date thereafter for the following four years (for a total of 24%).

Under pre-Act law, there was a $3.5 billion cap on the maximum annual amount of qualifying equity investments for 2010, 2011, 2012, 2013 and 2014. However, a carryover was allowed where the credit limitation for a calendar year exceeded the aggregate amount allocated for the year, but no amount could be carried over to any calendar year after 2019.

> **New law**. The Act retroactively extends the new markets tax credit through 2019. It provides up to $3.5 billion in qualified equity investments for each calendar year from 2015 through 2019. The carryover period for unused new markets tax credits is extended through 2024.

**Indian Employment Credit Extended Through 2016**

The Indian employment credit is 20% of the excess, if any, of the sum of qualified wages and qualified employee health insurance costs (not in excess of $20,000 per employee) paid or incurred (other than paid under salary reduction arrangements) to qualified employees (enrolled Indian tribe members and their spouses who meet certain requirements) during the tax year, over the sum of these same costs paid or incurred in calendar year 1993.

Under pre-Act law, the credit didn't apply for any tax year beginning after December 31, 2014.

**New law**. The Act retroactively extends the Indian employment credit for two years to tax years beginning before January 1, 2017.

**Domestic Production Activities Deduction Rules for Puerto Rico Extended Through 2016**

Under the Codes domestic production activities deduction, a taxpayer is allowed a deduction from taxable income (or adjusted gross income, in the case of an individual) that is equal to 9% of the lesser of the taxpayer's qualified production activities income (QPAI) or taxable income for the tax year. QPAI is generally domestic production gross receipts (DPGR) reduced by the sum of: (1) the costs of goods sold that are allocable to those receipts; and (2) other expenses, losses or deductions which are properly allocable to those receipts. The amount of the deduction for a tax year is limited to 50% of the wages paid by the taxpayer, and properly allocable to DPGR, during the calendar year that ends in the tax year. Wages paid to bona fide residents of Puerto Rico generally are not included in wages for purposes of computing the wage limitation amount.

A taxpayer has DPGR from: (1) any sale, exchange or other disposition, or any lease, rental or license, of qualifying production property manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the U.S.; (2) any sale, exchange, etc., of qualified films produced by the taxpayer; (3) any sale, exchange or other disposition of electricity, natural gas or potable water produced by the taxpayer in the U.S.; (4) construction activities performed in the U.S.; or (5) engineering or architectural services performed in the U.S. for construction projects located in the U.S.

Under pre-Act law, for the first eight years of a taxpayer beginning after December 31, 2005, and before January 1, 2015, Puerto Rico was included in the term "U.S." in determining DPGR, but only if all of the taxpayer's Puerto Rico-sourced gross receipts were taxable under the federal income tax for individuals or corporations. In computing the 50% wage limitation, the taxpayer was allowed to take into account wages paid to bona fide residents of Puerto Rico for services performed in Puerto Rico.

**New law**. The Act retroactively extends the special domestic production activities rules for Puerto Rico for two years through 2016. Under the Act, these special rules for Puerto Rico apply for the first eleven tax years of a taxpayer beginning after December 31, 2005, and before January 1, 2017.

**Qualified Zone Academy Bond Limitation Extended Through 2016**

Qualified zone academy bonds are qualified tax credit bonds designed to allow low-income populations to save on interest costs associated with public financing school renovations, repairs and teacher training. A taxpayer holding a qualified zone academy bond on the "credit allowance date" is entitled to a credit.

Under pre-Act law, except for carryovers of unused issuance limitations, the national bond volume limitation was $400 million for 2011, 2012, 2013 and 2014.

**New law**. The Act provides that the national bond volume limitation is $400 million per year for 2011 through 2016.

## Empowerment Zone Tax Breaks Extended Through 2016

The designation of an economically depressed census tract as an "Empowerment Zone" renders businesses and individual residents within such a Zone eligible for special tax incentives. Under pre-Act law, Empowerment Zone designations expired on December 31, 2014.

> **New law**. The Act extends for two years, through December 31, 2016, the period for which the designation of an empowerment zone is in effect. Thus, the Act extends for two years the empowerment zone tax incentives, including: the 20% wage credit; liberalized expensing rules ($35,000 extra expensing and the break allowing only 50% of expensing eligible property to be counted for purposes of the investment-based phaseout of expensing); tax-exempt bond financing; and deferral of capital gains tax on sale of qualified assets sold and replaced.

For tax years beginning after December 31, 2014, the Act provides that, in the case of a designation of an empowerment zone, the nomination for which included a termination date of December 31, 2014, termination will not apply with respect to that designation if the entity which made the nomination amends the nomination to provide for a new termination date in such manner as IRS may provide.

For bonds issued after December 31, 2015, employees are allowed to meet the enterprise zone facility bond employment requirement if they are residents of the empowerment zone, an enterprise community, or a qualified low-income community within an applicable nominating jurisdiction.

## Miscellaneous Other Provisions Extended Through 2016

The Act also retroactively extends the following through 2016:

- The railroad track maintenance credit. For expenditures paid or incurred in tax years beginning after December 31, 2015, the credit applies to expenditures for maintaining railroad track owned or leased as of January 1, 2015, (rather than January 1, 2005, as under prior law).
- The mine rescue team training credit.
- The increase to $13.25 (from $10.50) per gallon limit on cover over of rum excise taxes to Puerto Rico and the Virgin Islands.
- The possessions tax credit for American Samoa for two years through 2016.

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