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'Fiscal Cliff' Legislation Temporarily Extends Key Provisions for Businesses

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As part of legislation enacted in early 2013 to **avert the so-called "fiscal cliff,**" Congress temporarily extended several beneficial tax provisions for businesses, including the research credit, the active financing exception and **look-through rule for certain payments between controlled foreign corporations under Subpart F,** and the reduced built-in gains period for the sale of assets by an S corporation.

Overview

On January 1, 2013, Congress passed the **American Taxpayer Relief Act of 2012 (the 2012 Tax Act) t**o address the tax rate hikes and expiring tax incentives to avert the "fiscal cliff." President Obama signed the legislation into law on January 2, 2013. The 2012 Tax Act makes permanent all current individual income and capital gains and dividend tax rates for those single filers with taxable income of $400,000 or less and for those joint filers with taxable income of $450,000 or less. Absent legislation, rates would have increased beginning January 1, 2013. Thus, with respect to taxable income below the above-described thresholds, the top ordinary income tax rate is 35 percent and the top rate for long-term capital gains and qualified dividend income is 15 percent. However, the 2012 Tax Act provides for a 39.6 percent ordinary income tax rate on taxable income of more than $400,000 for single filers and $450,000 for joint filers. Above these income thresholds, the top rate for long-term capital gains and qualified dividend income is set at 20 percent. In addition, the 2012 Tax Act phases out deductions for personal exemptions and limits the overall amount of itemized deductions for those single filers with adjustable gross income of more than $250,000 and those joint filers with adjustable gross income of more than $300,000. The 2012 Tax Act did not modify the 3.8 percent tax on net investment income enacted as part of the Patient Protection and Affordable Care Act (ObamaCare), which continues to apply to single filers with taxable income of more than $200,000 and joint filers with taxable income of more than $250,000.

Further, the 2012 Tax Act temporarily extends certain expired business tax provisions, including the research credit (with certain modifications, discussed below), the active financing exception and look-through rule for payments between controlled foreign corporations (CFCs) under Subpart F, and the reduced built-in gains period for the sale of assets by an S corporation. The 2012 Tax Act generally extends these provisions retroactively to the beginning of 2012 and through 2013.

Expired Provisions

Research Credit—Section 41

In order to encourage research activities, Section 41 of the **Internal Revenue Code (the Code)** provides for a nonrefundable 20 percent credit for certain research expenses. Prior to the enactment of the 2012 Tax Act, the research credit was not available for research expenses paid or incurred after December 31, 2011. Section 301 of the 2012 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, 2013.

In addition, the 2012 Tax Act modifies certain special rules for calculating the credit allowed by Section 41, including the rules for aggregating expenses contained in Section 41(f)(1) and the rules for allocating expenses between a buyer and seller in connection with acquisitions contained in Section 41(f)(3).

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 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 2012 Tax Act, Section 954(h) applied to tax years of the CFC beginning after December 31, 1998, and before January 1, 2012, and to tax years of U.S. shareholders with or within which any such taxable year of the CFC ended. Section 322 of the 2012 Tax Act extends the active financing exception of Section 954(h) for two years, for tax years beginning on or after January 1, 2012, through tax years beginning before January 1, 2014.

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 that 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 2012 Tax Act, Section 954(c)(6) applied to tax years of the CFC beginning after December 31, 2005, and before January 1, 2012, and to tax years of U.S. shareholders with or within which such tax years of the CFC ended. Section 323 of the 2012 Tax Act extends the look-through rule of Section 954(c)(6) for two years, for tax years beginning on or after January 1, 2012, through tax years beginning before January 1, 2014.

Reduction in S-Corporation Recognition Period for Built-In Gains Tax

Section 1374 imposes a corporate-level tax on S corporations that were formerly C corporations upon the recognition of certain gains by an S corporation upon the disposition of built-in gain property held by the S corporation prior to its conversion from a C corporation. The Section 1374 built-in gains (BIG) tax has generally applied for property sales within a 10-year period from the date of the S conversion. However, for 2009 and 2010 the recognition period was reduced to seven years, and for 2011 the recognition period was reduced to five years.

Section 326 of the 2012 Tax Act extends the five-year recognition period for the application of the Section 1374 BIG tax for two years, 2012 and 2013. In addition, the 2012 Tax Act adds Section 1374(d)(7)(E), which provides that if an S corporation sells an asset and reports the income from the sale under the installment method of Section 453, the treatment of all payments received is attributable to the taxable year in which such sale was made. This provision should be beneficial for S corporations that sell assets during the reduced Section 1374 BIG tax period (2012 and 2013) under an installment sale arrangement.

Other Provisions

In addition to the provisions discussed above, Sections 301–331 of the 2012 Tax Act extended a number of other business tax provisions, including:

- 50 percent bonus depreciation (Section 168(k) of the Code) for property purchased prior to January 1, 2014, that is placed into service prior to that date (or before January 1, 2015, with respect to certain property)
- The immediate expensing of certain depreciable property (Section 179 of the Code) through December 31, 2013
- The new markets tax credit (Section 45D of the Code) through December 31, 2013
- The 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, 2014
- The exemption for certain dividends of regulated investment companies (Section 871(k) of the Code) through December 31, 2013
- The 100 percent exclusion of gain on certain small business stock (Section 1202(a)(4) of the Code) (stock acquired prior to January 1, 2014)

Conclusion

Businesses should be encouraged by the extension of the favorable provisions described above. 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.

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