2014 TAX EXTENDERS LEGISLATION FINALLY APPROVED

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Tags
C.F.C.
Extenders
F.P.H.C.I.
R.I.C.

SUMMARY

On December 19, President Obama signed into law the Tax Increase Prevention Act of 2014 (the "Act"). The Act extended more than 50 expired tax-related provisions through the end of 2014, allowing taxpayers to claim a number of tax deductions, credits, and other benefits for the 2014 tax year. Since the Act does not generally cover 2015 and later years, Congress will have to debate the merits of these many expiring provisions all over again in 2015. Taxpayers are once again faced with making decisions based upon the hope that Congress will act to renew the provisions.

Legislative materials indicate that the 2014 expiration date was based upon budgetary and political concerns. The Act is projected to cost U.S. taxpayers $41.6 billion over 10 years, with no new federal revenue to offset the cost. Half of the cost comes from the $7.6 billion credit for business research and development costs, a $6.4 billion tax break for renewable energy production plants, and a $5.1 billion tax exception that allows financial firms and other businesses to defer U.S. taxes on certain foreign profits.

EXTENDED PROVISIONS

The heart of the Act is the extension of many tax deductions and credits that expired on January 1, 2014. The many tax deductions and credits now effective in 2014 include the following:

- Tax credits for qualified research and development ("R&D") activities would be retroactively extended for one year to amounts paid or accrued through December 31, 2014. The R&D credit is extremely important to the pharmaceutical industry and many other industries.
- The special 50% bonus deprecation deduction allowed for the first year a property is placed in service would be extended for any property placed in service before January 1, 2015.
- Apart from first-year bonus depreciation, I.R.C. §179 allows a business owner to take an immediate deduction for part of the cost of placing property in service. The amount that can be taken as an immediate deduction or expensed had been increased in prior years, but on a temporary basis. The Act extends for 2014 the increased $500,000 maximum expensing amount and also the increased $2 million investment based phase-out amount. If Congress fails to act in 2015, then the maximum expensing amount will drop to $25,000 in 2015 and, likewise, the phase-out amount will drop to $200,000.

- The tax deduction for state and local general sales taxes in lieu of state and local income taxes will also be extended through the 2014 year. This deduction is helpful for people in states with no income tax such as Texas and Florida.

- An individual who wishes to borrow for the purpose of purchasing a residence is often required by the institutional lender to take out private mortgage insurance ("P.M.I.") that will protect the lender if the person fails to repay the loan. The deduction for the cost of P.M.I. has also been extended through the end of 2014.

- Older individuals who may want to use money in their Individual Retirement Accounts to make charitable gifts are generally required to (i) include in their taxable income the amount of the distribution and then (ii) claim a charitable deduction for the gift. The deduction is subject to many limitations and restrictions. To make this process simpler, individuals age 70½ or older are allowed through the end of 2014 to make tax-free distributions of up to $100,000 for charitable contributions.

- U.S. investment funds known as mutual funds are generally classified for tax purposes as Regulated Investment Companies ("R.I.C.'s"). R.I.C.'s and their shareholders were also aided by the Act. One change in particular will benefit foreign investors in R.I.C.'s:

  As background, investors invest their money in a R.I.C. and then get dividends from the R.I.C., which reflect the investor's share of the underlying income of the R.I.C. The R.I.C. is a favorable tax entity since it gets a tax deduction for dividends paid to its shareholders, which can eliminate any corporate level tax on the R.I.C. Dividends paid by the R.I.C. to non-U.S. shareholders are normally treated as corporate dividends that are subject to 30% withholding tax (subject to treaty reduction).

  Previously, foreign investors in a R.I.C. that earns interest income from a bond were at a disadvantage since the dividend was subject to 30% withholding tax, whereas an investor who directly owned the bond (or was a partner in a partnership that owned the bond) may have been exempt from the 30% withholding tax under the portfolio interest exemption. Several years ago, this problem was fixed by allowing the dividend paid by a R.I.C. to a foreign shareholder the same treatment as a payment of interest, if the source of the dividend was interest income received by the R.I.C. The dividend was therefore exempt from 30% withholding tax (assuming the debt is eligible for the portfolio interest exemption).[1] However, this change was not permanent – the provision expired and then was renewed, and the last renewal expired at the end of 2013. The Act extends this special treatment one more year, through the end of 2014, but does not benefit the foreign investor in 2015 or later years.

- Several important law provisions affecting international companies have been extended for 2014:

  For several years, there has been a temporary reprieve from the Subpart F rules for certain active financing companies. The Act makes this exemption

[1] I.R.C. § 871(k)(1)(a).

last through the end of 2014. This extension will help a worldwide operating group of companies that has one non-U.S. corporate affiliate act as the financing center for the group.

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There are several categories of gross income that can generate subpart F income, one category of which is foreign personal holding company income ("F.P.H.C.I."). F.P.H.C.I. generally includes interest; dividends; rents; royalties; the excess of gains over losses on the sale of property which gives rise to such income; and income from derivatives.[2] There are certain exceptions to F.P.H.C.I., including the "same country" exception, which applies to interest and dividends received from related corporations incorporated in the same country as the C.F.C.[3] The §954(c)(6) look-through rule, which first was applicable to taxable years of foreign corporations beginning after December 31, 2005, is a further exception to F.P.H.C.I. for certain payments from a related corporation that is incorporated in a different country than the C.F.C. I.R.C. §954(c)(6) specifically states that:

> Dividends, interest, rents and royalties received or accrued from a [C.F.C.] which is a related person shall not be treated as [F.P.H.C.I.] to the extent attributable or properly allocable…to income of the related person which is neither subpart F income nor income treated as effectively connected with the conduct of a trade or business in the United States.

This rule has now been extended through the end of 2014.

ADDED COSTS FOR NON-COMPLIANCE

Included in the Act are several provisions which are intended to increase the costs of failures to timely pay taxes or timely file tax returns. The Act indexes certain penalties for inflation. Among those covered by this change are the penalties for failures to file a tax return or pay taxes, tax preparer penalties, and penalties for failures to file tax returns relating to partnerships and S corporations.

CONCLUSION

The Act represents a much-needed conclusion to 2014, with legislation extending many beneficial tax provisions through the end of the year. Regrettably, the Act does not allow for certainty with regard to future tax planning. It is hoped that Congress will act sooner in the coming year to alleviate this uncertainty and determine the fate of expiring provisions in tax year 2015 and beyond.

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2 I.R.C. § 954(c)(1).

3 I.R.C. § 954(c)(3).