

TAXVIEW

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FEDERAL Research Tax Credit Extended and Sweetened

Once again, Congress has breathed new life into the politically popular Research Tax Credit, which expired December 31, 2005. The extension was contained in The Tax Relief and Health Care Act of 2006. The politically popular Research Tax Credit was extended retroactively for qualified expenses incurred after December 31, 2005 but before January 1, 2008.



The Research Tax Credit extension goes a step further than the old credit, adding a third method for calculating the credit and sweetening another existing option for calculating it. Now, in addition to the regular research credit and the alternative incremental research credit, taxpayers will want to examine whether they should use the new alternative simplified research credit.

Reexamine Your Eligibility

Many taxpayers who in the past may have assumed that they couldn't utilize the research tax credit should take another look in light of the new third option for computing the credit. The regular research credit relies on research spending in the 1984-1988 time frame in order to calculate the credit. Using this base period limited the use of the credit for many taxpayers, especially high tech and pharmaceutical companies that have seen their sales increase faster than qualified research expenditures. The new method allows companies to base the credit on their incremental research spending over the prior three years. With this change, these companies may qualify for a bigger research credit using this method. In addition to growth companies, the alternative simplified research credit method could be valuable for companies that have engaged in multiple acquisitions, mergers, or divestitures in recent years or that repatriated significant amounts of dividends from foreign affiliates. The alternative simplified research credit is 12% if qualified expenses exceed 50% of the average qualified research expenses for the previous three tax years.

New Effective Rates

The new law also increases the rates of the alternative incremental research credit for taxable years beginning after December 31, 2006. For tax years beginning after December 31, 2006, the new rates on the tax credits are:

- 3% (an increase from 2.65%) for qualified research expenses exceeding 1% to 1.5% of the company's average gross receipts for the previous four years.
- 4% (instead of 3.2%) for qualified expenses exceeding 1.5% to 2% of average gross receipts for the previous four years.

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- 5% (an increase from 3.75%) to the extent qualified research expenses exceed 2% of average gross receipts for the previous four years.

Companies will need to decide which method for computing the Research Tax Credit works most effectively for them. Companies whose ability to claim the credit was limited by higher research spending in prior years will find the alternative simplified method especially appealing.

Determine Which Credit Is Appropriate

In determining whether to use the alternative simplified research credit or the alternative incremental research credit instead of the regular credit, taxpayers should examine their future sales, research spending and investment plans. Once the taxpayer elects to use either the alternative simplified research credit or the alternative incremental research credit, the selection cannot be revoked in future years without a Private Letter Ruling from the Secretary of the Treasury.

Taxpayers have not heard the last word on the Research Tax Credit. While Congress and the Bush Administration extended the credit and enabled more companies to claim it, the extension is only for two years, retroactive to the earlier expiration at the end of 2005. The Congress will consider yet another extension of the Research Tax Credit during 2008, a Presidential election year.

For more information, please contact Peter Orfanakos at porfanakos@gellerco.com.

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STATE

New York State Adopts Combined Reporting Law

One man's tax loophole is another's tax incentive. It all depends on your perspective. That's certainly the case in New York State, where Governor Eliot Spitzer pushed the state legislature to adopt the so-called "combined" approach to corporate taxes (used by 17 other states including California and Illinois), in order to close a budget gap that has been estimated at \$1.6 billion.



In the past, many states like New York treated each subsidiary or affiliate corporation in a related family of corporations as a separate entity, filing separate tax returns. The problem with this is that the state can lose a significant amount of tax revenue when corporations transfer income among related corporations or out of the state to a lower-tax state.

Leveling the Playing Field for Businesses

Under combined reporting, a corporate family files a single tax return covering income from all subsidiaries. The income gets apportioned among the states based on the locations of all property, payroll and sales, thereby ending income-shifting between subsidiaries. With combined reporting, corporations cannot structure transactions, such as transferring royalty and dividend income and interest expenses, between affiliates in various states to avoid tax. Combined reporting would also level the playing field for small- and medium-sized businesses operating only in New York State that shoulder a proportionately higher share of corporate taxes because they lack the opportunity to shift income to other jurisdictions.

A crucial part of the debate was the so-called "third requirement" for combined reporting. In the past, a company could only be required to file under combined reporting if three tests were met. The first was common ownership, and the second was unity of operations. In addition to these two fairly straightforward tests was a third test: substantial inter-company transactions that distort the profit or loss of a business. Until now, if a company could prove that substantial inter-company transactions are arm's-length and not on favored terms, then the company cannot be compelled to file a combined return. Spitzer's new budget law removes that provision so that combined reporting is required regardless of the terms of any inter-company transactions. By removing the inter-company transaction test, New York State has eliminated a potential source of disagreement over interpretation of who must file a combined return.

Effects of the Change

The New York State combined reporting changes were signed into law as part of the budget passed

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April 1, 2007, retroactively taking effect for tax years beginning January 1, 2007. To remove some of the sting of combined reporting, Governor Spitzer and the Legislature enacted \$150 million of targeted tax cuts for manufacturers. First, the overall tax on manufacturing income was reduced to 6.5% from 7.5%. Secondly, the alternative minimum tax, which Spitzer said affects manufacturers disproportionately, was cut to 1.5% from 2.5%.

The combined taxation approach will cost New York business taxpayers \$215 million annually, according to the State Budget Division. On the other hand, corporate income tax revenues have fallen steadily from just under 1.4% of New York State tax revenue in 1977 to approximately 0.75% today, according to a February 2007 report by the Fiscal Policy Institute.

Other Changes

There are other important changes to note in relation to this new law. The first involves the Single Sales Factor: Implementation of the single receipts factor has been moved up by one year. Specifically, for tax years beginning January 1, 2007, the sales factor constitutes 100% of the business allocation percentage for purposes of allocating net income under the corporate tax.

Secondly, a change has been made to the S Corp Election. For tax years beginning January 1, 2007, certain New York corporations that are federal S corporations will be required to elect New York S corporation status as well.

New York State corporate taxpayers aren't the only ones who are facing combined reporting legislation: Newly-elected Massachusetts Governor Deval Patrick has proposed that the Bay State adopt the combined approach as well.

For more information, please contact Carolyn Makuen at cmakuen@gellerco.com.

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INDIVIDUAL

529 College Tuition Plans Come of Age

The “529 Plan” has now graduated to become a permanent fixture in college-saving plans. Last year, Congress and the Administration dropped a Sunset provision that had scheduled the popular college tuition programs for expiration in 2010. Instead, they made the 529 Plan (a reference to its section in the Internal Revenue Code legally known as a Qualified Tuition Plan) permanent. There are two types of qualified tuition programs.

With the prepaid program, contributions and earnings are used to purchase tuition credits for a designated beneficiary. On the other hand, the savings account plans are accounts set up specifically to pay for qualified higher education expenses of a beneficiary.



529 Plans Offer Numerous Benefits

A 529 College Savings Plan is a state-sponsored, tax-advantaged savings plan that can help families and individuals save for higher education expenses. Contributions on behalf of a beneficiary can grow until they reach \$200,000 or \$300,000, depending on the state. These plans offer a number of benefits:

- Parents and guardians retain complete control over disbursement of 529 funds, unlike Uniform Gift to Minors Act accounts which become the property of the student upon reaching the age of majority, either 18 or 21 years of age depending on the state in which the account was opened.
- Contributions sometimes up to \$300,000 per account are allowed. The contributions allowed are regulated at the state level and therefore vary from state to state.
- The contributor is not subject to any adjusted gross income limitations.
- Savings grow tax deferred.
- Qualified tuition programs can be used at most accredited colleges and universities in the U.S. and at many colleges abroad.
- Withdrawals are federal income tax-free when used for qualified education expenses. Qualified expenses include tuition, fees, eligible room and board, books, supplies and required equipment for attendance at a higher education institution.
- In addition to the federal tax benefit, many states offer a state income tax deduction for contributions to their plans as well as state income tax-free withdrawals for qualified expenses.
- Unlike money for some other college savings vehicles, the account owner maintains control over all of the funds in the 529 College Savings Account.
- Savings can be invested in a variety of investment vehicles, most often through mutual funds offered by leading money managers such as Vanguard and Fidelity.

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- Money in 529 accounts can be tapped for other purposes in cases of emergency. However, a 10% tax penalty is due on top of income taxes.
- If the child doesn't want to go to college, the account can be rolled over to another family member without adverse tax consequences.
- If the child gets a scholarship, any unused money can be withdrawn without paying any penalty (just the tax).

The Tax-Free Gift of Education

Parents, grandparents or other relatives can contribute as much as \$60,000 in a single year (five times the normal exclusion of \$12,000 per year) for each beneficiary without incurring the federal gift tax as long as they don't make any other contributions or gifts to the beneficiary for four more years.

Married persons filing jointly can give up to \$120,000 in a single year without being subject to the gift tax. The contribution is considered a completed gift and is excluded from the contributor's estate. However, if the donor makes the five year election and dies before the close of the five-year period, the donor must include the portion of such contribution allocable to the period after the date of death of the donor.

While 529 plans offer a great tax-advantaged way to save for college, if the donor chooses a plan that invests in the stock market, the account will be subject to the same risks as any other market investment (i.e. it has the potential to lose money). Therefore, donors need to pick investment options carefully, with a particular eye on fees and loads. Lastly, donors should be aware that contributions to a qualified tuition program are not deductible for federal income tax purposes.

For more information, please contact Sherry Reisch at sreisch@gellerco.com.