A NOT SO "LAME" LAME DUCK SESSION

By Peter J. Kulick

The 111th Congress enacted several sweeping laws, ranging from a controversial health care overhaul to a series of changes to tax laws aimed at international activities of U.S. taxpayers. During the two-year session of the 111th Congress (January 2009 to January 2011), Congress continually grappled with the tax policy question of whether lower tax rates enacted in 2001 and 2003 should be preserved. The conventional wisdom suggested that the 2001 and 2003 rates would, for the most part, be preserved; however, there were divergent policy positions staked out concerning whether *all* rates should be extended—specifically, focusing on tax rates for those in the highest income brackets—and the length of the lower rates should be extended. By the time the mid-term elections approached on Nov. 2, 2010, after prolonged debate, the Democrat majorities in the two chambers of Congress punted on the issue, leaving any prospect for tax relief to be addressed in the lame duck session or the new Congress that convened on Jan. 5, 2011.

As is now well known, the Nov. 2, 2010 election produced historic election results. The Republicans gained an unprecedented 63 seats in the House of Representatives, seizing control of the lower chamber and giving the GOP with a sizable majority. Democrats were able to maintain a slim majority in the Senate, trimmed from a nearly filibuster-proof 60 seat majority, leaving the upper chamber split at 53-47 in favor of the Democrats. The political talking heads all predicted two years of partisan wrangling with the likelihood that very little will be accomplished legislatively.

The political procrastinations speculated that the gridlock would begin early, specifically with the lame duck session of the 111th Congress. The so-called lame duck session is the period when Congress comes back into session in late November until adjourning *sine die* before the new Congress, the 112th Congress, convened on Jan. 5, 2011. After all, with Republicans emboldened by their stunning electoral success, there was a strong probability that Republicans would not be in any mood to compromise on signature issues, such as tax policy. While Democrats would maintain their sizable majorities during the waning days of the 111th Congress, Republicans still could block legislation in the Senate. Republicans held the 40 votes necessary to prevent the Senate from invoking cloture to end debate on legislation.

Something strange happened on the way to the forum. The lame duck session of the 111th Congress ended up being relatively productive. Democrats and Republicans were able to reach a compromise—not without a few days of intense uncertainty as House Democrats balked at an agreement on tax issues reached among Senate Democrats, President Barack Obama and congressional Republicans—to enact important tax legislation. The tax legislation, officially titled the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the 2010 Tax Relief Act), achieved the extension of the 2001 and 2003 tax rates that Republicans had long advocated. The mainstream media primarily focused on the tax rate extension aspects of the 2010 Tax Relief Act. The tax rate extensions in reality are a minor piece of the 2010 Tax Relief Act. The act contains several other tax law provisions that may potentially be beneficial to gaming industry businesses and Indian tribes.

Overview of Tax Provisions in the Act

The 2010 Tax Relief Act contained several changes in the tax law that may be beneficial to gaming industry businesses. A summary of a selection of key business-related tax law changes follows.

Extension of the Research and Development Tax Credit

Sections 41 and 174 of the Internal Revenue Code of 1986 (IRC), as amended, allow businesses engaged in certain research and development activities to claim a credit for qualifying expenditures. The research credit available under the code operates through a complex web of regulations issued under two code sections, both of which use similar language. The research credit allows taxpayers to claim a credit under the IRC Section 38 general business credit for "qualified research expenses."

The research and development credit expired on Dec. 31, 2009. Congress failed to act to extend the research credit, as prior Congresses have regularly done, prior to the expiration of the credit on Dec. 31, 2009. Thus, prior to the enactment of the 2010 Tax Relief Act, qualified research expenses incurred during 2010 could not be used to claim the tax credit. The 2010 Tax Relief Act retroactively extended the research and development credit to Dec. 31, 2011. The extension, therefore, allows businesses to claim a credit for qualified research expenses incurred not only in 2011, but also 2010.

For gaming businesses, particularly gaming equipment manufacturers, the extension of the research and development credit may offer

substantial tax benefits. A recent decision of the United States Tax Court, *TG Missouri Corporation v. Commissioner*, 133 T.C. 12 (Nov. 12, 2009),[1] provides guidance in structuring research activities in order to maximize the credit. In *TG Missouri*, the Tax Court addressed the meaning of the phrase "property of a character subject to the allowance for depreciation." The expenses at issue in *TG Missouri* were certain third-party toolmaker costs related to the construction of production molds, a common practice in the automotive industry and many other industries. The IRS for many years heavily scrutinized the inclusion of certain third-party toolmaker costs within qualified research expenses. To disallow research credits, the IRS had conjured the novel argument that the expenditures attributable to any property that might, in some circumstance, be subject to depreciation were ineligible for research credits even if the owner could not claim such depreciation.

The *TG Missouri* decision has implications beyond just the automotive industry, the industry where *TG Missouri* operates. The decision offers businesses, particularly businesses with extensive research and development activities, the ability to structure their activities in order to maximize the availability of the research credit. Specifically, *TG Missouri* further clarifies that third-party toolmaker costs relating to production molds can qualify for the research credit. As a result, those businesses that were reluctant, following the IRS' assault with respect to this issue, to claim research credits on their property because it may have been theoretically depreciable in the hands of another person, now have clear guidance that the proper analysis focuses solely on whether the property is depreciable in that business' hands.

The extension of the research and development credit, coupled with the guidance from *TG Missouri*, offer gaming businesses planning opportunities for structuring their 2010 and 2011 research activities.

Temporary 100% Bonus Depreciation

The extension of bonus depreciation and establishing a temporary 100 percent bonus depreciation rate is a very attractive incentive included in the 2010 Tax Relief Act. The 100 percent bonus depreciation rate means that a business can currently expense the costs of qualifying property. Under prior law, the bonus depreciation rate was 50 percent, meaning that one-half of the costs of qualifying property could be eligible for current expensing.

To qualify for the 100 percent bonus depreciation, the depreciable property must be placed in service after Sept. 8, 2010 and before Jan. 1, 2012.[2] The definition of "qualified property" is found in Code Section 168(k)(2). Generally, most machinery, equipment, tangible personal property and computer software will constitute "qualified property" for purposes of the bonus depreciation rules. The generous expensing allowance may favor the acquisition of new gaming equipment and other depreciable property in order to gain the benefit of the ability to currently depreciate the cost of such property. Similarly, gaming equipment manufacturers that have delayed the acquisition of new computer equipment, or other depreciable property, may be able to benefit from the generous 100 percent bonus depreciation.

Reduction in Payroll Tax Rates

The 2010 Tax Relief Act has a modest incentive for employees and self-employed individuals through a temporary 2 percent rate reduction on payroll taxes. The Federal Insurance Contribution Act (FICA) taxes are imposed on employers. FICA consists of two separate taxes: (1) the Old Age, Survivors and Disability Insurance (OASDI) tax; and (2) the Medicare Hospital Insurance (HI) tax. FICA taxes are imposed separately on employers and employees. Self-employed individuals pay an alternative tax, which is essentially equal to both the employer and employee portion of the FICA taxes. Prior to enactment of the 2010 Tax Relief Act, the OASDI tax rate for employees was 6.2 percent. For self-employed individuals, the alternative tax rate for employment taxes, prior to enactment of the 2010 Tax Relief Act, was 12.4 percent. Under present law, FICA taxes and self-employment taxes are only imposed on the first $106,800 in wages.

The 2010 Tax Relief Act reduces the OASDI tax rate and the self-employment tax rate. The new OSADI rate under the 2010 Tax Relief Act is 4.2 percent, while the tax rate for employment taxes on self-employed individuals is lowered to 10.4 percent. The rate reduction provides a maximum $2,136 in savings for employees and self-employed individuals, taking into account that wages subject to payroll taxes are capped at $106,800. The temporary rate reduction is effective only for 2011. While the benefit is relatively modest, the rate reduction will offer some relief to individuals.

Tax Law Changes Directed at Indian Country

The 2010 Tax Relief Act contains three changes in the law that are specifically directed at Indian tribes or tribal members. The changes in the tax law specifically applicable to Indian tribes or tribal members are:

• Extending an incentive that shortens the depreciation period for qualified Indian reservation property. In general, property may constitute "qualified Indian reservation property" if the property is subject to the Modified Accelerated Cost Recovery System and is predominantly used in the active conduct of a trade or business on an Indian reservation. The 2010 Tax Relief Act extend the shortened depreciation period for a qualified Indian reservation property that is placed in service prior to Jan. 1, 2012.

• Extension of the Indian employment credit to Dec. 31, 2011. Prior to enactment of the 2010 Tax Relief Act, the tax law granted an Indian employment credit. The credit was available for qualified wages paid to an employee that (1) was a member of an Indian tribe or a spouse of a tribal member, (2) performed substantially all his services on an Indian reservation, and (3) lived on or near the reservation. The credit amount is equal to 20 percent of the first $20,000 in qualified wages paid to the qualified employee.

• Grants an exclusion from gross income for settlement payments made as result of the settlement reached in the *Cobell v. Salazar* class-action lawsuit.

Final Thoughts

The 111th Congress enacted sweeping legislation addressing an array of public policy topics. The 2010 Tax Relief Act, while perhaps the least controversial major measure enacted by the 111th Congress, was one of the last major pieces of legislation enacted. The popular discussion of the 2010 Tax Relief Act has focused on the extension of tax rates established in 2001 and 2003. Behind the surface of the media talking points, the 2010 Tax Relief Act offers several favorable tax incentives for gaming businesses. The incentives may be especially beneficial if economic activity increases over the course of the next two years.

1 *TG Missouri* is a case that litigated with my colleagues Will Elwood and Andrew McLeod.

2 Certain long-production property and aircrafts can qualify for the 100 percent bonus depreciation if placed in service before Jan. 13, 2013.

PETER J. **KULICK**

Peter J. Kulick is a tax and gaming attorney with Dickinson Wright PLLC, which has an international gaming law practice with offices in Michigan, Nashville, Washington, D.C., Toronto and Phoenix. He received his LL.M in tax law from New York University. Kulick may be reached at pkulick@dickinsonwright.com.