

July 1, 2010

2010 and Beyond: Significant Tax Changes Affecting Individual and Corporate Taxpayers – a Sensiba San Filippo Summary

Over the past year, as the U.S. has moved out of the Great Recession, there have been tax provisions within the recent health care and business incentive legislation that are highly impactful for individuals and businesses. The cumulative effect of this legislation, combined with the expiration of significant items of tax legislation from the Bush Administration and other legislation moving through Congress, is dramatic. For many individual high-bracket taxpayers, in particular, there will be a sharply increasing effective federal tax rate in 2011 and a second sharp increase in effective tax rates again in 2013.

The following **Sensiba San Filippo** Summary provides perspective on what we believe to be the more significant of these upcoming tax changes so that, in the second half of 2010 and into 2011 and beyond, informed individuals and businesses can plan and act accordingly. We will address pertinent provisions of the **Health Care Act** and **HIRE Act** (key items of legislation which have become law in 2010), tax provisions carried over from the Bush Administration that are scheduled to expire at the end of 2010, certain additional items of federal legislation (likely to be enacted) and certain California considerations. As appropriate, we will also indicate where the current Administration stands on proposed legislation.

It should be noted that this summary does not address:

- (i) tax or business credit changes viewed to be of less significance to SSF's client base of high net worth individuals, closely held companies, technology companies and venture firms;
- (ii) international tax considerations, many of which are very pertinent to our client base but which are better addressed on a client-by-client basis, or
- (iii) the lapsing of the estate tax, which, at this writing, is under discussion in Congress but with no particular direction.



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This summary focuses on these key areas (effective dates in parenthesis):

Individual Taxpayers

- Upward adjustments to highest individual marginal tax rates (1/1/2011)
- Upward adjustments to individual capital gain and dividend tax rates (1/1/2011)
- Reduction in tax benefits for individuals relative to itemized deductions (1/1/2011)
- Additional “Medicare” tax on investment income of “high income” individuals (1/1/2013)
- Additional “Medicare” tax on wages and self-employment income of “high income” individuals (1/1/2013)
- Ordinary income taxation of carried interest (proposed legislation)
- Taxation of Qualified Small Business Stock (proposed legislation)

Business Taxpayers

- Small employer health insurance credit (2010)
- Payroll tax holiday (2/4/2010)
- Changes for specific businesses
 - Extension of favorable equipment expensing rules (2010)
 - Excise tax on device manufacturers of medical devices (1/1/2013)
 - Tax credit (or grant) for investments in a “qualified therapeutic discovery project” (6/18/10 – application available)

California State Legislation

- Conformity to federal law
- New hire credit
- Sales and use tax reporting and electronic filing



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Individual Taxpayers

Upward adjustments to highest marginal tax rates

Current law: The highest individual income tax rate is 35%.

Adjustment as of January 1, 2011: The highest marginal rate will be increased by 4.6% to 39.6% and the second highest rate will be increased by 3% to 36%.

Based on the expiration of tax rate cuts enacted during the Bush Administration, beginning in 2011,

- (i) the highest marginal tax rate (applicable to taxable incomes over \$373,650 for married taxpayers filing jointly, indexed for inflation for 2011 and each year thereafter) would be increased from 35% to 39.6%. and
- (ii) the next highest marginal tax rate (applicable to taxable incomes of \$250,000 less the standard deduction and two personal exemptions for married taxpayers filing jointly, indexed for inflation from 2009) would be increased from 33% to 35%.

[SSF Comment: It is viewed as almost certain that the anticipated increase in the highest marginal rates for ordinary income will, in fact, be in place on January 1, 2011. Therefore, as appropriate and consistent with overall financial objectives, it would be prudent to consider the acceleration of ordinary income events into 2010 and deferral of deductions into 2011 prior to the anticipated increase in the highest marginal tax rates.]



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Upward adjustments to individual capital gain and dividend tax rates

Current law: The maximum long term capital gain and “qualified” dividends tax rate is 15%.

Adjustment as of January 1, 2011: Again, based on the expiration of tax rate cuts enacted during the Bush Administration, the following rate adjustments are scheduled to take effect:

Capital gain tax rates: The highest marginal rate on long-term capital gain is scheduled to increase to 20%.

Dividend tax rates: The lower rate for “qualified dividends” is set to expire, and all dividends will be taxed at ordinary income rates (i.e., at a highest marginal rate of 39.6%).

[SSF Comment: It is also viewed as almost certain that the anticipated increase in the highest marginal rate on long-term capital gain will be in place on January 1, 2011. Therefore, it would be prudent for individuals with appreciated assets who may be contemplating the eventual sale of such assets to consider the sale of all or a portion of such assets during the remaining months of 2010, as appropriate and consistent with their overall financial objectives.]



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Reduction in tax benefits for individuals relative to itemized deductions – the “deduction reduction”

Current law: For higher income individual taxpayers, otherwise allowable itemized deductions (other than certain of such deductions, such as medical deductions, which have their own limitations, and other such deductions, for which there may be other or no limitations), are reduced if their adjusted gross income exceeds a particular level of adjusted gross income (the “floor” -- that is indexed annually for inflation), but not by more than 80% of the total itemized deductions,. As another result of Bush Administration tax cuts, that reduction in the benefit of itemized deductions was gradually phased out so that, in 2010, the reduction is completely eliminated (i.e., there is no such phase-out in 2010).

Reduction in benefit as of January 1, 2011: The full itemized deduction reduction of 3% of adjusted gross income that exceeds the “floor” (but not by more than 80% of such deductions), is scheduled to be reinstated (due to the scheduled expiration of the Bush Administration tax changes).

* The adjusted gross income “floor” for 2010, if it were applicable, would have been \$167,100 for married taxpayers filing jointly.



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Additional “Medicare” tax on investment income of “high income” individuals

Current law: None.

Beginning January 1, 2013: For married taxpayers filing jointly with adjusted gross income (“AGI”) above \$250,000 (not indexed for inflation), a 3.8% tax will be imposed on “net investment income” to the extent the total “net investment income” plus AGI exceeds the \$250,000 threshold amount. For purposes of this additional tax, “net investment income” consists of the sum of:

- (i) the total gross income from interest, dividends, annuities, royalties and rents (other than gross income from a trade or business in which the taxpayer actively participates),
- (ii) other gross income from a passive activity, and
- (iii) net gains from the sale of property (other than property held in a trade or business in which the taxpayer actively participates), less deductions attributable to such gross income or net gain.

And a gain from the sale of property includes the gain on the sale of a personal residence, not including the exempted (from tax) portion of such gain. Additionally, gain from a sale of an interest in a partnership or S corporation is “net investment income” only to the extent that such gain is attributable to property held by the entity which is not involved in an active trade or business.

[SSF Comment: While this tax, which was part of the amendment to the 2010 Health Care Act, does not arise until 2013, it certainly will be a meaningful obligation to those who are affected by it and, in conjunction with the highest marginal rate increase of 4.6% applicable two years earlier (in 2011), packs quite a one-two punch in terms of higher marginal rates when it applies (i.e., a combined increase of 8.4% beginning in 2013).]



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Additional “Medicare” tax on wages and self-employment income of “high income” individuals

Current law: A Medicare tax is imposed (i) at a 1.45% rate on all wages, regardless of amount, and (ii) at a 2.9% rate on all self-employment income, also regardless of amount. With respect to the tax on self-employment income, of which the 2.9% tax is a portion, an income tax deduction is allowed for one-half of the amount of self-employment taxes.

Beginning January 1, 2013:

Regarding wages: As part of the 2010 Health Care Act, an additional 0.9% Medicare tax will be imposed on taxpayers with wages received in excess of \$250,000 (not indexed for inflation) for married taxpayers filing jointly. Therefore, above that threshold amount of wages, the total Medicare tax will increase from 1.45% to 2.35%.

Regarding self-employment income: Likewise, an additional 0.9% Medicare tax will be imposed on taxpayers with self-employment income in excess of \$250,000 (not indexed for inflation) for married taxpayers filing jointly. Therefore, above that threshold amount of self-employment income, the total Medicare tax will increase from 2.9% to 3.8%.

This additional Medicare tax is also additional to (and not to be confused with) the other 3.8% Medicare tax on net investment income (described above).

Additional considerations with respect to this tax:

1. The employer is required to withhold the additional 0.9% tax only as to an employee’s wages in excess of \$200,000.
2. The income (AGI) reduction for one-half of self-employment taxes will not take into account this additional 0.9% Medicare tax.



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Ordinary Income Taxation of “Carried Interest”

Current Law: The “carried interest” (profits interest) allocable to an investment partnership’s general partner is taxed at capital gain rates, and is not treated as self-employment income. The distribution of marketable securities to partners in an investment partnership is not a taxable event.

Anticipated Law: As of the date of this Summary, the Chairmen of the House Ways & Means Committee and the Senate Finance Committee had presented, and the House of Representatives had passed, a bill which would tax 50% (in 2011 and 2012) and 75% (in 2013 and thereafter) of the “carried interest” allocable to the general partner of an investment services partnership, as well as gain on the disposition of carried interest partnership interests, as ordinary income rather capital gain. The proposed legislation would also deem the ordinary income portion of the carried interest to be subject to the uncapped Medicare tax on “high income individuals” of 2.9% (plus an additional 0.9%, or 3.8%, beginning in 2013 as described above). The remaining portion of such carried interest (50% in 2011 and 2012, and 25% in 2013 and thereafter) would continue to be treated as a distributive share of the partnership’s income (and would be capital gain or dividend or interest income).

The proposed legislation would also treat the time of the distribution of assets to the distributee general partners pursuant to the carried interest as a taxable event rather than the time at which such distributed assets are actually sold by the general partner. And, also importantly, the allocations of gain that may be received by general partners in connection with the relinquishment of management fees (in many venture and private equity partnerships) would also be ordinary income.



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[SSF Comment: At the time this Summary was produced, passage of the carried interest bill was expected, although:

- (i) the 75% ordinary income treatment beginning in 2013 was reported as being possibly renegotiated to 65% in an effort to generate sufficient votes for Senate passage,
- (ii) a five-year holding period was being discussed as a possible requirement for capital gain treatment, and
- (iii) certain Senate members were reported to be balking at supporting the legislation due to deep-seated concerns about the possible unfavorable impact on job creation of a dramatically increased tax on investment partnership general partners, particularly in the venture, real estate and energy industries.

The cumulative effect of this legislation, if passed, is dramatic on investment partnership general partners who often labor for up to a decade and more to realize the profit interests, if any, in high risk areas such as venture capital investment. For example, the highest bracket general partner relative to a 2009 allocation of \$200,000 of carried interest reflected in a distribution and sale of long-term capital gain marketable securities would have had a federal tax liability of \$30,000 (and \$40,000 under the higher capital gain rates anticipated beginning in 2011 as described above). An identical allocation

- (i) in 2011 would result in a federal tax liability of \$59,600 (not including regular self-employment tax) and,
- (ii) in 2013 would result in a federal tax liability of \$69,400 plus \$5,700 of additional Medicare tax on net investment income plus \$1,350 of additional self-employment tax, for a total of \$76,450 (not including regular self-employment tax).

The numbers speak for themselves and, specifically as to the large venture capital component of the SSF client base, there are serious and well-founded concerns regarding this strong tax disincentive for engaging in venture fund sponsorship at the general partner level and what could be a corresponding negative impact on job creation.]



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Taxation of Qualified Small Business Stock (“QSBS”)

Current law: If a 5-year holding period and a number of other challenging requirements and limitations are met, taxpayers other than corporations can exclude from taxation, for QSBS acquired between February 17, 2009 and December 31, 2010, 75% of gain on the sale of such QSBS; for acquisitions outside that range of dates, the exclusion from gain is 50%. The non-excluded portion of the gain is taxed at a special (high) rate of 28%. If the taxpayer is subject to the Alternative Minimum Tax (“AMT”), for sale transactions through 2010, 7% of the excluded gain is a tax preference item. For sales after December 31, 2010, the AMT preference is scheduled to increase to 28% of the excluded gain for QSBS acquired after December 31, 2000.

Proposed legislation: A House bill introduced by the Chairman of the House Ways & Means Committee, and supported by the Obama Administration, would increase the amount of the exclusion from taxation to 100% for QSBS acquired after March 15, 2010 and by December 31, 2011, and would also eliminate any such gain for such acquisitions as a tax preference item for AMT purposes.

California implications: California’s QSBS statute does not conform to the federal law with regard to the increase in the percentage (from 50% to 75%) of the gain exclusion for the sale of QSBS acquired after February 17, 2009. Two additional California requirements have routinely been utilized by the California Franchise Tax Board in its challenges to the assertion of QSBS status:

1. At least 80% of the corporation’s payroll must be in California at the date of issuance of the QSBS.
2. At least 80% (by value) of the assets of the corporation must have been used in the active conduct of a qualified trade or business in California subsequent to the issuance of the QSBS.



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Business Taxpayers

Small employer health insurance credit

Current Law: None

Beginning in 2010: The Health Care Act includes an employer tax credit for the employer's payment of employee health insurance expenses of relatively small businesses (those employing no more than 25 of what are defined as full-time equivalent employees) whose average employee is relatively low paid. For 2010 through 2013, the credit is calculated by multiplying by 35% the amount of employer insurance payments (adjusted by reference to government published typical insurance rates) and then reducing the credit ratably by (i) the number of employees beyond ten and (ii) the amount by which the average wages per employee exceeds \$25,000. The credit is initially available for each of the tax years from 2010 through 2013. The credit is also available for 2014 and 2015 if the employer acquires insurance coverage for its employees through a state exchange.

[SSF Comment: The upshot of this calculation is that the credit will be of limited utility; there will be few SSF clients who qualify for its benefits as the credit applies only to quite small companies whose average employees are relatively low paid – a relatively rare set of circumstances in the high cost Bay Area.]



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Payroll tax holiday

Current Law: None.

New Law (applicable to new employees hired beginning February 4, 2010): The HIRE Act includes a payroll tax “holiday” under which no federal social security tax is required to be paid by an employer relative to an employee who meets three requirements and who commences his/her employment with the employer between February 4, 2010 and December 31, 2010, for wages paid beginning March 19, 2010 through December 31, 2010. The employee must

- (i) be unemployed for more that 40 hours during the 60-day period prior to commencement of the employment,
- (ii) not be hired to replace another employee unless that individual left employment voluntarily or for cause, and
- (iii) not be related to the employer.

The expense avoidance of the payroll tax holiday could be meaningful (up to a maximum of \$6,622 per employee, reduced by the benefit of what would have been a tax deduction attributable to a payment of the payroll tax). Also, in circumstances where the hiring of an individual who is part of a certain “targeted group” could enable an employer to claim either Work Opportunity Credit for such hiring (equal to a percentage of first year wages) or the payroll tax “holiday”, the employer can either utilize the payroll tax “holiday” or elect out of that, choosing the Work Opportunity Credit in its place.



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Changes for specific businesses

Extension of favorable equipment expensing rules

Current Law: Generally, taxpayers can elect to treat the cost of any qualified property (Code Section 179 property) placed in service during the tax year as an expense, allowable as a tax deduction for such year. Qualifying property for purposes of the expensing election is depreciable tangible personal property purchased for use in the active conduct of a trade or business, including “off-the-shelf” computer software, placed in service in tax years beginning before 2011.

New Law: Beginning in 2010, the maximum amount a taxpayer can expense for a tax year beginning in 2010 is \$250,000, which amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during 2010 exceeds \$800,000. The \$250,000 and \$800,000 amounts are not adjusted for inflation with respect to tax years following 2010.

Excise tax on manufacturers’ sales of medical devices

Current Law: None.

New Law: Beginning January 1, 2013, pursuant to the Health Care Act, the sale of a “taxable medical device” by the manufacturer, producer or importer of the device will be subject to an excise tax equal to 2.3% of the price for which the device is sold. Excluded from the definition of a “taxable medical device” are devices that are generally purchased by the general public at retail for individual use, such as eyeglasses, contact lenses and hearing aids. It is expected that the IRS will publish a list of medical devices that it considers to be of the type that are generally purchased by the general public at retail for individual use, so that it is more clear as to what types of devices are exempt from the excise tax. Also, there is no exemption from the tax for what are known as Class I devices (as defined by the Food and Drug Administration) that are used with high frequency in hospitals and physician offices, including such items as tongue depressors, elastic bandages, and examination gloves.



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Tax credit (or grant) for investments in a “qualified therapeutic discovery project”

Current Law: None

New Law: Under the Health Care Act, a new and limited program is created to provide grants or tax credits to biotech or biopharma companies with no more than 250 employees who apply to the Treasury (application materials became available beginning June 18, 2010, and a completed application must be postmarked by July 21, 2010). The grant or tax credit for taxable years beginning in 2009 or 2010 (only) would be in an amount equal to 50% of the company’s “qualified investment” for such taxable year with respect to a “qualifying therapeutic discovery project”. The qualified investment cannot include compensation for certain high-salaried employees, building costs and other expenses that are not viewed as directly supportive of the project. The project itself must be designed to

- (i) treat or prevent diseases or conditions by conducting pre-clinical trials and clinical studies, and carrying out research protocols relative to pharmaceutical development,
- (ii) diagnose diseases or conditions, or
- (iii) develop a product, process or technology to further the delivery of therapeutics.

The selection criteria will also take into consideration the likelihood of preventing, diagnosing or treating diseases, including cancer, reducing health care cost, and creating jobs and US competitiveness in the life sciences. A grant will not be taxable income. The total amount of credits/grants to be issued in connection with this program is limited to \$1 billion.



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California State Legislation

Conformity to federal law: The extent to which California tax laws conform to federal tax laws is always a relatively complicated matter, for which the services of an SSF tax professional can be beneficial. However, at least at present, it can be said that California does not conform to any of the changes (including those set forth above) in the 2010 Health Care Act and the 2010 HIRE Act, both of which are significant items of federal legislation.

New hire tax credit: For 2009 and 2010, California employers that began either of those years with 20 or fewer employees will be able to claim a \$3,000 income tax credit for each new, fulltime employee they hire. A maximum of \$400 million in tax credits is available, and the credits will be issued on a first-come, first-served basis. There is little demand for the credit thus far – as of June 12, 2010, only \$26.4 million in credits had been claimed by 3,385 employers. Credit use is updated weekly on the Franchise Tax Board's website: www.ftb.ca.gov/businesses/New_Jobs_Credit.shtml.

Sales and use tax reporting and electronic filing: The California State Board of Equalization ("BOE") is taking meaningful steps to adhere to the state legislature's 2009 initiative to enhance the level of compliance with respect to requirements relative to the filing of California use tax returns. The BOE has been sending notices to use tax registrants demanding the filing of California returns and the payment of use tax obligations. It has also mailed use tax registration information to individuals and businesses whose 2007 federal returns set forth revenue from a business or rental property of \$100,000 or more. Use tax returns for 2009 were due April 15, 2010. Your tax professional should be consulted to provide direction relative to what the BOE's stepped up enforcement of California use tax obligations means to you.

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