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<u>TAX LAW</u>: 2010 Tax Relief Act Has Far-Reaching Consequences

By Ronald A. Feuerstein

On December 17, 2010, President Obama signed into law the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" ("2010 TRA"), major tax legislation that includes, among many other items, an extension of the Bush-era Federal income tax cuts for two years, Federal estate tax relief, a two-year "patch" of the alternative minimum tax ("AMT"), a two percent reduction in employee-paid payroll taxes and self-employment taxes for 2011, new business incentives to invest in machinery and equipment and a host of retroactively re-enacted and extended tax breaks for individuals and businesses.

<u>Some Key Income Tax Provisions</u>

While a listing and discussion of all provisions of the 2010 TRA is beyond the scope of this article, some of the important elements of the new tax package include the following:

- The current, favorable Federal income tax rates will be retained for two years (2011 and 2012), with a top tax of 35% on ordinary income and 15% on qualified dividends and long-term capital gains.

- Employees and self-employed workers get a reduction of two percent in Social Security tax in 2011, bringing the rate down from 6.2% to 4.2% for employees, and from 12.4% to 10.4% for the self-employed.

- A two-year AMT "patch" for 2010 and 2011 provides a modest increase in AMT exemption amounts and allows personal nonrefundable credits to offset AMT, as well as regular Federal income tax.

- Key tax credits for working families that were enacted or expanded in the American Recovery and Reinvestment Act of 2009 are retained. For example, 2010 TRA extends for two years (a) the $1,000 child tax credit (and maintains its expanded refundability) and (b) the American Opportunity Tax Credit for Higher Education and its partial refundability.

- Two limitations on deductions for higher-income taxpayers have been deferred. For 2011 and 2012, higher-income individuals will not be required to reduce their itemized deductions or be subject to a phaseout of personal exemptions.

- Businesses can write off 100% of their new equipment and machinery purchases in the placed-in-service year, effective for property placed in service after September 8, 2010 and through December 31, 2011. For property placed in service in 2012, 2010 TRA provides for 50% additional first-year depreciation.

- Many of the popular tax provisions that expired at the end of 2009 have been retroactively reinstated for 2010 and extended through the end of 2011. Among many others, the retroactively reinstated and extended individual and business provisions include the election to take an itemized deduction for state and local general sales taxes instead of the itemized deduction for state and local income taxes; the $250 above-the-line deduction for certain expenses of elementary and secondary school teachers; and the research credit. The credit for making energy-saving improvements for a home has been extended for one year, through 2011, but stricter rules apply after 2010.

<u>Federal Estate, Gift and Generation-Skipping Taxes</u>

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Other than the preservation of the Federal income tax rates and brackets existing since 2001 for two additional years as above described, the most important aspects of the 2010 TRA as to individuals and families with wealth preservation objectives are the Federal estate, gift and generation skipping tax ("GST") changes enacted.

Higher exemption; highest tax rate reduced. 2010 TRA reduces Federal estate and GST taxes for 2011 and 2012. The exemption (or applicable exclusion) amount has been increased by $1 million to $5 million per person, which is to be indexed after 2011. The highest tax rate has been reduced from 55% to 35%.

Decedents dying in 2010. Taxable estates of persons dying in 2010 can elect to either: (1) be subject to the Federal estate tax (subject to a $5 million exemption and tax rate not exceeding 35%) and the ability to step-up basis, or (2) not be subject to any Federal estate tax, but be subject to certain modified carryover basis rules. In considering this choice, estate fiduciaries will need to calculate which choice produces less combined estate and income tax. However, the calculation of income tax must consider when the estate or heirs will sell assets.

- No matter what election is made, it will have no effect on the GST.
- IRS will determine the time and manner to make the election, which will be revocable only with the consent of IRS.

Gift tax reunified. Under 2010 TRA, for gifts made after 2010, the Federal gift tax exclusion amount is $5 million, with a reunified estate and gift tax rate capped at 35%.

GST. Under 2010 TRA, the GST exemption for persons dying or gifts made in 2010 is $5 million. Consequently, one can allocate up to $5 million in GST exemption to a trust created or funded in 2010. While the GST does apply for 2010, the GST tax rate for 2010 transfers is 0%. For persons dying or gifts made after December 31, 2010, the GST exemption is equal the basic exclusion amount for Federal estate tax purposes ($5 million, as indexed). The GST tax rate for transfers made in 2011 and 2012 is 35%.

Portability of unused exemption. 2010 TRA introduces the concept of "portability" for unused Federal estate and gift tax exemptions between spouses. Under this rule, any exemption remaining unused as of the death of a spouse who dies after December 31, 2010 ("deceased spousal unused exclusion amount") can generally be used by the surviving spouse as additional exemption. The predeceased spousal carryover amount can be used by the surviving spouse for lifetime gifts or transfers at death. In the event a surviving spouse is predeceased by more than one spouse, the amount of unused exclusion available for use by the surviving spouse is limited to the lesser of $5 million or the unused exclusion of the last deceased spouse. It is interesting to note that in order to use a deceased spousal unused exclusion amount, the surviving spouse must make an election on a timely filed Federal estate tax return (including extensions) of the predeceased spouse concerning whom such amount is computed, whether or not the estate of such predeceased spouse otherwise must file a Federal estate tax return. This election may have to be made many years in advance and may often be missed by many estates. It will probably be considered standard practice to file "protectively" even in the case of small estates.

Furthermore, notwithstanding the statute of limitations for assessment of Federal estate and gift tax, the Federal estate tax return of the predeceased spouse may be examined by IRS to determine what it views as the proper deceased spousal unused exclusion amount. Such examination may result in the IRS claiming that the deceased spousal unused exclusion amount is less than that claimed by the estate of the surviving spouse.

Ron Feuerstein is a tax lawyer whose practice includes estate planning, business succession planning and intra-family wealth transfers, as well as income tax planning for businesses. If you would like more details about these provisions or any other aspect of the new law, please do not hesitate to contact Ron Feuerstein at 703-525-4000 ext. 288 or rfeuerstein@beankinney.com.

THE SUBSTANTIALLY PREVAILING PARTY

By James V. Irving

Typically, contract language addressing fee shifting in the case of litigation provides that the non-prevailing party shall pay the substantially prevailing party's reasonable fees and expenses. In Signature Flight Support Corporation v. Landow Aviation Limited Partnership, the court awarded Signature, as the substantially prevailing party, attorney's fees and costs exceeding $1,000,000. What makes this case interesting is that the court declined to award Signature any substantive damages.

Since at least 2006, Signature and Landow were both in business at Washington Dulles Airport, where each provided certain airport concession services for noncommercial aviation businesses. In 2008, Signature sued on the theory that Landow had improperly expanded its services and invaded Signature's business with the Metropolitan Washington Airports Authority in violation of certain obligations contained in their Ground Sublease Agreement. Signature brought a five count Complaint in U.S. District Court for the Eastern District of Virginia for Declaratory Judgment, Breach of Contract, Intentional Interference with Contract, Accounting and Disgorgement, and Permanent Injunction. Landow filed a multi-count counterclaim. Signature claimed actual damages of $4,167,910.00

After a bench trial conducted in August and September 2009, the Honorable James C. Cacheris granted Signature's request for Declaratory Judgment and Injunction, but found for the defendant on the Breach of Contract and Accounting claims, ruling that Signature had failed to prove its damages. The net effect of this decision was that Landow had to discontinue certain business practices but was not obligated to pay Signature any of the more than four million dollars it sought as damages.

Immediately post-trial, Signature filed its application for $1,570,616 in attorney's fees and a Bill of Costs seeking $199,475.06 in costs expended. Ultimately, the Court awarded the Plaintiff attorney's fees in the reduced amount of $1,130,843.60 and costs of $176,577.34, leaving Plaintiff's responsible to pay its attorney the total amount of $462,670.

While Plaintiff's counsel was entitled to claim recovery of its fees because they "successfully established the rights to which it was entitled to under the GSA," Judge Cacheris was plainly concerned about the size of Plaintiff's lawyer's bill, particularly in light of its failure to prove any damages. The governing provision called for an award of "reasonable" attorney's fees and ultimately Cacheris found large parts of the bill to be unreasonable.

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Judge Cacheris reviewed the reasonableness of the bill according to a number of standards, including the time and labor expended, the novelty and difficulty of the questions raised, the skills required to perform the services, the experience, reputation and ability of the attorney, the customary fees and the attorney's expectations, time limitations, and the amount in controversy and results obtained.

In several particulars, the judge found the attorney's work to be "unnecessary, redundant and inappropriate." He also concluded that assigning senior counsel billing at between $475 and $605 per hour to perform "common tasks" demonstrated a "lack of billing judgment," and reduced the fee claim accordingly.

While Landow didn't have to pay a dime to its opponent, they had to pay their own attorney's fees plus $1,307,4290.90 to their opponent's counsel, which must have been a stinging defeat. By achieving success on the Injunction and Declaratory Judgment claim, Signature forced Landow to discontinue it offensive business practices. Although Signature recovered none of their more than $4,000,000 in claimed damages, they still had to pay their counsel the much reduced fee of $462,670.00 for this result.

While contractual fee shifting can greatly reduce costs to the winning party, it can lead to a disastrous result if you lose. However most courts have taken the adjective "reasonable" very seriously, even when the gross numbers seem stratospheric.

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The Ninth Circuit Speaks Out On (and "Clarifies") the First Sale Doctrine

By Alain J. Lapter

One of the bedrock canons of U.S. copyright law is known as the "first sale" doctrine. Under the federal Copyright Act, while the owner of a work is entitled to certain exclusive rights that prohibit others from the unauthorized copying or reproduction the work, the "first sale" doctrine presents an explicit limitation thereof. Specifically, the doctrine permits an individual who attains ownership to a copy of a work to dispose of said copy without first having to obtain permission of the copyright owner. Illustratively, if you lawfully purchase a book from Amazon, you are free to resell the book to a third party without having to obtain permission to do so from the author or publisher. See 15 U.S.C. § 109(a).

Through the years, litigants have battled over what actions are recognized as gaining lawful possession to a copy of a work. Obviously, in many instances copyright owners have sought to limit the rights to dispose of a lawfully attained copy for various reasons, including the loss of control over the work of authorship, the potential erosion of the value of the property and certain moral rights. Rather than a book or novel, imagine a painter who sells an original and one-of-a-kind work of art. While the painter may retain certain moral rights to the work, the painter likely could not prohibit the buyer from reselling the work on the open market. Of course, the buyer's ability to sell lawfully obtained goods without the fear of stall tactics or encumbrances from the work's author is essential.

With this in mind, two recent opinions from the Ninth Circuit have attempted to clarify and demarcate where a buyer could properly invoke the "first sale" doctrine as authorizing the dispossession of a work protected by copyright.

Late last year, the Ninth Circuit held that the transfer of software acquired pursuant to the terms of a "shrink wrap license" was considered a license, rather than a sale. Vernon v. Autodesk, Inc., No. 09-35969, slip op. at 13871-72 (9th Cir. 2010). Factually, Vernon purchased a copy of Autodesk's AutoCAD software product at a garage sale. Vernon, thereafter, proceeded to auction off the product through eBay.com. Autodesk contested the sale arguing that the product was sold under the terms of a "shrink wrap license" which forbade the resale of the software. The Court, reversing the district court's decision, held that the license's language explicitly identified the purchaser of the software as merely a licensee. Furthermore, the licenses transfer restrictions barred the sale or lease of the software. In sum, the Court arguably held that the provisions of the shrink wrap license superseded the wording in § 109(A) because the transfer of the product was not considered a sale, as required under the Act. As a result, the "first sale" doctrine did not apply and the software manufacturer and owner of the copyright could restrict the further sale of the product by the purchaser/licensee.

More recently, the same court got another stab at the question of what constitutes the lawful transfer or sale of copyrighted work, as permitted under the "first sale" doctrine. See UMG Recordings, Inc. v. Troy Augusto, No. 08-55998, slip. op. (9th Cir. 2011). In this case, UMG, a music company, sent promotional CDs to numerous recipients. Most of the CDs included a statement indicating that the CD was property of UMG and was merely licensed to the intended recipient. The language also restricted the recipient from selling or otherwise transferring ownership to the CD.

While not an intended recipient, Augusto managed to acquire numerous CDs, which he then sold on auction through eBay.com. When UMG could not get Augusto's listings pulled, UMG brought this claim against Augusto arguing that the auctioning of the CDs violated the terms of the license and infringed on UMGs exclusive rights under the Copyright Act. In defense, Augusto invoked the "first sale" doctrine stating that UMGs distribution of the CDs amounted to a sale of the products, negating any restrictions in the language of the purported license.

On the heels of an analysis examining UMG's distribution methods of the promotional CDs, the Court held that a license had not been entered into between UMG and the recipients, but rather title to the products were in effect transferred to the recipients. Recognizing the Court's holding in Vernon, where a software manufacturer was able to enter into a licensing arrangement with the purchaser, the Court found that UMG's distribution is not analogous to the extent that the CDs were dispatched without any prior arrangement with the recipients: "UMG dispatched the CDs in a manner that permitted their receipt and retention by the recipients without the recipients accepting the terms of the promotional statements." UMG's distribution of the CDs amounted to a gift or sale of the products within the meaning of § 109(A), and, consequently, the recipients were entitled to use and dispose of the products "in any manner they saw fit."

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Taken together, it is clear that the Ninth Circuit's "first sale" analysis hinges directly on the distribution methods by the copyright holder. While the Court's reasoning is, de facto, heavily subjective with respect to industry standards and the circumstances surrounding the product's distribution, one can arguably extrapolate the following from these cases: the owner of a copyright in a work can restrict the further sale and transfer of the work, notwithstanding the "first sale" doctrine, by 1) distributing the work to known individuals who request such a product and 2) by framing the transfer of the product as a licensing arrangement whereby the recipient is prohibited from sale or transfer of the product. While this notion arguably flies in the face of fundamental copyright principles, the Vernon and UMG decisions will in all likelihood alter the landscape surrounding the distribution and sale of protected works.

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