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Tax provisions in the Small Business Jobs Act of 2010: summary and practical advice

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On September 27, 2010, President Obama signed the Small Business Jobs Act of 2010 (the "SBJA"), which was passed by Congress on September 23rd. The primary provisions of the SBJA are summarized below, with practical advice following each summary as appropriate. The subheadings below are:

- Provisions that will help businesses reduce their tax liabilities or raise cash quickly
- Structuring investments in companies
- Miscellaneous tax breaks
- Revenue-raisers

Provisions that will help businesses reduce their tax liabilities or raise cash quickly

1. Extension of bonus depreciation

"Bonus Depreciation", allowing 50% of otherwise depreciable property to be written off currently, is extended to items placed in service in 2010. In general, this rule applies to property that has a "recovery period" of 20 years or less, except that it also applies to certain improvements to leasehold real estate and certain other properties. The SBJA makes simple date changes to the existing provisions that provided for "bonus depreciation" in 2009, so the same rules that applied in 2009 should apply in 2010 as well. Bonus depreciation is also extended to 2011 for property with a recovery period of 10 years or longer, and certain transportation property (including private aircraft). The bonus depreciation benefit applies both for regular tax purposes and alternative minimum tax (AMT) purposes.

Bonus depreciation will also be allowed to contractors utilizing the percentage of completion method. Contractors can now benefit from bonus depreciation even if they do not complete their contract during the same year, effective for property placed in service after 2009.

The first-year business automobile write-off is increased by $8,000 (i.e., to $11,060 for autos and $11,160 for light trucks or vans) for new vehicles that are acquired and placed in service in 2010.

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Practical advice. The new bonus depreciation provision is a windfall, because it applies to all of 2010, not just the balance of the year. It also creates an extra write-off for all businesses, large or small. In addition, all businesses should consider accelerating their purchases to qualify for the valuable bonus depreciation benefits.

Due to the retroactive effect, to the beginning of 2010, taxpayers should consider gathering the information on qualifying investments now in order to reduce their fourth quarter estimated tax payments. (This advice also applies to the next two provisions discussed below, which are also retroactive.)

2. Five-year carryback of general business credits of eligible small business and AMT relief

Previously, unused general business credits could only be carried back one year and carried forward 20. The SBJA extends the one-year carryback period for eligible small business credits to five years. An eligible small business generally would be defined as a corporation, the stock of which is not publicly traded, a partnership, or a sole proprietorship whose average gross receipts over the three preceding years did not exceed $50 million. A partner or a partnership and shareholder of an S corporation would have to satisfy the same gross receipts test.

Previously, under the AMT, taxpayers generally could only claim allowable general business credits against their regular tax liability, and only to the extent that their regular tax liability exceeded their AMT liability. The SBJA now allows eligible small businesses to use all types of general business credits under section 38(b) to offset their AMT in tax years beginning in 2010.

The above changes are effective for credits determined in the taxpayer's first year beginning after 2009.

Practical advice. The Internal Revenue Code (the "Code") provides a series of business tax credits for projects that the government desires to encourage. These include low-income housing, renewable energy facilities, rehabilitation of historic buildings, and "new markets" projects (i.e., development in poorer communities). In general, for every dollar an investor puts into these favored kinds of projects, it can reduce its tax liability by a dollar or more. Of course, in the past couple of years, relatively few companies have had profits and, therefore, tax liability, that they might offset with these credits. This new provision is intended to make these credits more useful, by providing smaller companies the ability to carry back their 2010 tax credits as far as five years, when they might have tax liability that would benefit from the credits.

While a very worthy goal, this provision provides precious little real tax benefit. First, it mostly provides a limited windfall, because it applies to credits arising in 2010, which will mostly include credits arising from investments made in prior years, as well as the first nine months of 2010, all of which pre-date the new carryback. Second, it does not encourage much in the way of new projects, for the same reason. Finally, the new provision applies only to relatively "small businesses" which have generally not been in the tax credit marketplace previously. These businesses may not be able to develop sufficient understanding of tax credit products to make decisions about whether to invest in this very short amount of time.

Other credits covered include the Research and Development Tax Credit, Work Opportunity Tax Credit, and Employer-provided Child Care Credit. Many companies may qualify for the later two credits and should plan for claiming the benefit of this windfall.

The AMT relief will be a major benefit to many qualifying taxpayers.

3. Expansion of section 179 expensing

The SBJA aims to help small businesses quickly recover the cost of certain capital expenses by amending section 179. The amendments to section 179 double the immediate deduction for amounts spent on otherwise depreciable property that is placed into service in 2010 and 2011. The new cap is up to $500,000, increased from $250,000, which applied to 2008 and 2009. These deductions phase out as a taxpayer spends more than $2,000,000 in 2010 or 2011, up from the $800,000 limit applicable for 2008 and 2009. For 2012, the law reverts to the pre-2008 level of a $25,000 deduction, phasing out when expenditures exceed $200,000.

The SBJA extends the treatment of computer software as section 179 property to computer software placed in service in a tax year beginning before 2012 (from 2011 under current law).

While section 179 typically applies to personal property, the SBJA extends the provision to apply to certain leasehold improvements to real estate, and to certain retail and restaurant real estate. The maximum amount with respect to real property that may be expensed would be $250,000. Taxpayers could also elect to exclude real property from the definition of section 179 property.

These amendments to section 179 apply to property placed into service at any time in 2010, not just the portion of the year remaining after the enactment of the SBJA.

Practical advice. Virtually all small businesses and many mid-sized businesses that do not need to invest in expensive equipment will be able to take advantage of this expensing provision. The deduction will not completely phase out until the cost of expensing-eligible property exceeds $2,500,000. While the effective date means that much of the benefit will be in the form a windfall, qualifying businesses should consider accelerating their purchases to qualify for the benefit.

Any carryover of an expensing deduction for qualified real property placed in service in 2010 can only be used in 2011. There is no carryover for an unused expensing deduction for qualified real property placed in service in 2011. Accordingly, if a taxpayer may be able to accelerate placing property in service in 2010 and not wait until 2011, and believes that the expensing deduction for the amount attributable to that property will be subject to carryover due to a section 179 limitation, the taxpayer should consider placing the property in service in 2010, allowing for a carryover of the unused deduction to 2011.

4. Boosted deduction for start-up expenditures

For taxable years beginning in 2010, the SBJA increases the amount of deductible start-up expenditures under section 195 from $5,000 to $10,000. In addition, the deduction phase out threshold is increased from $50,000 to $60,000. The amount that a business can deduct is reduced (but not below zero) by the amount by which start-up expenditures exceed this $60,000 threshold. The provision is effective for tax years beginning after 2009.

5. Removal of cell phones and similar equipment from listed property

The SBJA removes cell phones and other similar telecommunications equipment from being classified as "listed property" for purposes of section 274 of the Code. The deduction for ordinary and necessary business expenses is disallowed for "listed property" unless the use of the property is substantiated by detailed evidence. The disallowance included the expense of employers providing cell phones and other mobile communications devices to employees, as well as paying for their cell phone and data plans. Similarly, employees who received cell phones and similar equipment from their employers must include the fair market value of the portion of personal usage of the cell phone in their gross income. The removal of cell phones and similar equipment from listed property eliminates the burdensome documentation requirements. The provision's effective date is tax years ending after 2009.

Practical advice. For the employer to qualify for the business deduction and employees to avoid income on all of the calls on cell phones and other mobile communications equipment treated as listed property, employees technically were required to track each outgoing and incoming call as business or personal. This was obviously not practical, and few companies had a policy to satisfy those requirements.

A footnote in the Joint Committee on Taxation description of the SBJA, sets forth the following: "The provision does not affect Treasury's authority to determine the appropriate characterization of cell phones as a working condition fringe benefit under section 132(d) or that the personal use of such devices that are provided primarily for business purposes may constitute a de minimis fringe benefit, the value of which is so small as to make accounting for it administratively impracticable, under section 132(e)." The only condition stated here is that the cell phone be used "primarily for business purposes."

The IRS Commissioner recently encouraged Congress both to remove cell phones and other mobile devices from the definition of listed property under section 280(F) *and* to treat an employee's personal use of an employer-provided mobile devices as a de minimis fringe benefit. In the SBJA, Congress did the latter, but not the former. Given the above statement in the legislative history, and the IRS Commissioner's prior statements on this topic, it appears that Treasury and the IRS may issue new rules that would, in effect, treat the provision of cell phones and similar equipment as a tax-free de minimis fringe benefit. This would certainly be welcome news to employers, who seek to avoid burdensome and unworkable rules to determine what is and is not personal use of cell phones and similar equipment. The statutory change does not address the situation of employers paying for employees' cell phones and their voice and data plans.

Structuring investments in companies

1. Temporary exclusion of capital gains tax on investments in small business stock

The SBJA amends section 1202 of the Code to provide for a 100% exclusion of gain on a sale or exchange of qualified small business stock that is acquired after September 27, 2010, and before 2011. In addition, no portion of the gain would be a preference item under the alternative minimum tax (AMT). Accordingly, no regular tax or AMT would be imposed on the sale of such stock held at least five years.

Practical advice. Due to the various limitations imposed under section 1202 and the benefits of operating as a tax partnership, it has not always been practical to utilize section 1202's 50% (and 75%) exclusion. Now, given the complete elimination of tax on gain if stock is issued

prior to 2011, and the anticipated increases in tax rates, investors and start-up companies should take a closer look at intentionally trying to fall within this provision prior to the end of this year.

Due to the manner in which the rules previously worked, gain from the sale of qualified small business stock generally was taxed at effective rates of 14% under the regular tax and 14.98% under the AMT for sales prior to January 1, 2011. As a result of a recent statutory change, the effective rates for stock acquired after February 17, 2009, and before January 1, 2011, would be taxed at an effective rate of 7% under the regular tax and 12.88% under the AMT.

The problem with this exclusion provision has been the various requirements, which still must be met. For stock to be qualified as small business stock: (1) the stock must be acquired by the taxpayer at its original issue in exchange for money or other property (not including stock), or as compensation for services provided to the issuing corporation; (2) the corporation, at the time the stock is issued, may not have gross assets exceeding $50 million (including the proceeds of the newly issued stock); (3) the corporation must be and remain a C Corporation during substantially all of the taxpayer's holding period; and (4) certain businesses are excluded and certain active business requirements must be met during substantially all of the taxpayer's holding period (i.e., 80% or more of all assets must be used in the active conduct of a qualified trade or business). To qualify for the exclusion, the stock must be held at least five years. Excludible gain may not exceed the greater of (1) ten times the taxpayer's basis in stock issued by the corporation or (2) $10 million.

Stock acquired after 2011 would revert to the 50% exclusion, with an AMT preference (i.e., under current tax rates, 14% under the regular tax and 14.98% under the AMT).

2. Temporary reduction in recognition period for S Corporation built-in gains tax

Under section 1374 of the Code, S Corporations may be subject to tax at the maximum corporate rate (currently 35%) on built-in gain that arose prior to a C Corporation's conversion to an S Corporation, which must be recognized by the S corporation during a set period beginning with the first day of the first taxable year for which the S election is in effect. This same tax is imposed on built-in gain attributable to property received by an S Corporation from a C Corporation in a carryover basis transaction. Previous recent legislation shortened the period for removing this tax from the tenth taxable year to the seventh taxable year after the S Corporation election is in effect for taxable years beginning in 2009 and 2010. The SBJA further reduces the tax-free period to five years for taxable years beginning in 2011. This provision is effective for taxable years beginning after December 31, 2010.

Practical advice. For the 2009 and 2010 tax years, the recognition period is seven years. For 2011, a five-year period applies. S corporations that are considering selling assets that may be subject to the built-in gains tax might consider delaying the sale of assets until the 2011 tax year if the tax can be avoided as a result of the five-year rule.

Any C corporation that otherwise qualifies for S corporation status should always be considering converting to an S corporation. For one, absent a built-in gains tax discussed above, on a sale of the corporation's assets, the S corporation will be subject to only one level of tax, compared to a double-tax for a C corporation. A purchaser typically will pay top-dollar only for a purchase of assets (or purchase of stock treated as a purchase of assets for tax purposes) due to the purchaser's increased depreciation and amortization deductions. The built-in gains recognition period may not be any shorter than five years for a long time.

Accordingly, C corporations and their tax advisors should reconsider converting to S corporation status in early 2011.

Miscellaneous tax benefits

1. Temporary deduction for health insurance costs in computing self-employment income

Generally, in determining adjusted gross income for purposes of calculating income tax, self-employed individuals are permitted a deduction for the cost of health insurance for themselves and their spouses, dependents, and children who have not yet reached age 27. The Self-Employment Contributions Act ("SECA") imposes a two part tax on the net earnings from self-employment of self-employed individuals. Unlike for income tax purposes, the calculation of net income for SECA tax purposes does not permit a deduction for the cost of health insurance. The SBJA amends section 162(l) of the Code and allows for a deduction against earnings for the cost of health insurance for self-employed individuals and their spouses, dependents, and children who have not yet reached age 27 for purposes of SECA taxes. The provision is effective for the first taxable year beginning after 2009.

2. Permit partial annuitization of nonqualified annuity contracts

Currently, annuity holders who want to convert only a portion of an annuity into a current income stream must exchange the annuity for two separate annuities. The SBJA amends section 72 of the Code to permit some of the assets in an annuity, endowment, or life insurance contract (other than plans qualified under section 401(a), plans described in section 403(a), section 403(b) tax-deferred annuities, or individual retirement plans) to be annuitized while keeping other assets in the contract, provided that the annuitization period is for ten years or more, or is for the lives of one individual or more. The provision dictates that the investment in the contract (the basis) is allocated on a pro rata basis between (i) the portion the holder receives as an annuity and (ii) the portion from which amounts are not received as an annuity.

This allocation is to be used for purposes of the exclusion ratio (the ratio used to determine how much of a payment is taxable), the determination of the investment in the contract (the basis), the expected return, the annuity starting date and amounts not received as an annuity. The SBJA does not intend to change the present-law treatment of amounts received with respect to plans qualified under section 401(a), plans described in section 403(a), section 403(b) tax-deferred annuities, or individual retirement plans. The provision will apply to annuity income received in taxable years beginning after 2010.

3. Limitation on penalty for failure to disclose reportable transactions.

Section 6707A imposes a penalty on any person who fails to include any information regarding a "reportable transaction" on any return or statement. Reportable transactions are those identified by the IRS as having a potential for tax avoidance or evasion. Prior to the SBJA, the penalty for failure to report reportable transactions was $10,000 in the case of a natural person and $50,000 for others ($100,000 and $200,000, respectively, for so-called listed transactions, which the IRS has identified as abusive). Under the SBJA, the amount of the penalty with respect to any reportable transaction is 75% of the decrease in tax shown on the return as a result of the transaction (or which would have resulted from the transaction if it were respected for federal tax purposes). However, this 75% penalty cannot exceed the previous thresholds described above.

There are also minimum penalties: The amount of the penalty for any transaction for any tax year cannot be less than $5,000 for a natural person and $10,000 for any other person. The SBJA rules apply for penalties assessed after December 31, 2006.

Practical advice. The SBJA dramatically lowers the section 6707A penalties. The previous penalty regime was viewed as unfair, particularly when applied to partners of partnerships or shareholders of S corporations that had small interests and did not participate in planning and executing the reportable or listed transaction. Because the changes are retroactive, taxpayers who have already paid a section 6707A penalty should consider filing a refund claim.

Revenue-raisers

1. Information reporting required for rental property expense payments

The SBJA makes recipients of rental income from real estate subject to the same reporting requirements as taxpayers engaged in a trade or business. For payments made after December 31, 2010, the new law requires rental income recipients that make payments of $600 or more to a service provider, in the course of earning rental income, to file information returns with the IRS and the service providers with whom they work. The SBJA provides exceptions to this increased reporting requirement for individuals renting their principal residences on a temporary basis (including active members of the military), taxpayers who receive only minimal amounts of rental income, and those for whom the reporting requirement would create a hardship.

Practical advice. While there are some exceptions, many landlords will now be required to issue a Form 1099 (typically a Form 1099-MISC) to service providers such as contractors, painters, plumbers, gardeners, and electricians, not to mention accountants and attorneys.

2. Time for payment of corporate estimated taxes

The required corporate estimated tax payments due in July, August, and September 2015 for corporations with assets of at least $1 billion would be increased by 36 percentage points to 159.25% of the payment otherwise due.

3. Increase in information return penalties

The SBJA increases the penalty for failing to timely file correct information returns (such as Forms 1099 and W-2) with the IRS, as well as the related penalty for failing to timely furnish correct payee statements. In general, the penalty for each reporting failure is increased from $50 to $100, with the maximum annual combined penalty for unintentional failures increasing from $350,000 to $3 million. In addition, the minimum penalty for each reporting failure due to intentional disregard of the reporting requirements would increase from $100 to $150. The provision applies to information returns required to be filed on or after January 1, 2011.

4. Source rules for income on guarantees

The SBJA amends sections 861, 862 and 864 of the Code to provide sourcing rules for income from guarantees. Previously, the source of such income was not specified in the Code but was determined based on Tax Court case law. The SBJA legislatively overrides such case law. Under the new section 861(a)(9), income from sources within the United States includes amounts received, whether directly or indirectly, from a noncorporate resident (other than

foreign partnerships) or a domestic corporation for the provision of a guarantee of indebtedness of such person. This includes amounts paid, for example, by a foreign corporation if the cost of the guarantee fee is passed on to a domestic subsidiary. The new section 861 also includes amounts received from a foreign person, directly or indirectly, for the provision of a guarantee of indebtedness of that foreign person if the payments received are connected with the income of such foreign person which is effectively connected with the conduct of a trade or business.

Conversely, under the new section 862, amounts received from a foreign person, directly or indirectly, for the provision of a guarantee of such person's indebtedness are treated as foreign source income if they are not from sources within the U.S. (as determined under section 861(a)(9)). Payments received from foreign partnerships are U.S. source income if the amounts received are connected with income that is effectively connected with the conduct of a U.S. trade or business. These provisions apply to guarantees issued after September 27, 2010.

The Joint Committee on Taxation description of the SBJA stated that no inference is intended with respect to the source of income received with respect to guarantees issued before the date of enactment.

For more information on this issue or any tax matter, please contact your Nixon Peabody attorney or:

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