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SPURRING INVESTMENT: TAX PROVISIONS IN THE 2010 SMALL BUSINESS JOBS ACT

On September 27, 2010, President Obama signed the Small Business Jobs and Credit Act of 2010 (the "Act"). While the primary goal of the Act was to create the Small Business Lending Fund, it also amends the Internal Revenue Code ("IRC") to provide tax incentives for small business job creation. According to the United States Senate Committee on Finance, the Act will provide small businesses with $12 billion in tax cuts. Unfortunately, these tax breaks come at a cost, and the Act also includes some potentially unfavorable revenue raising provisions. Some of the more notable tax changes, including the revenue raising provisions, are outlined below.

1. *Increase of Section 179 Expensing and Expansion to Certain Real Property*. The Act extends the liberalized expensing rules for purchases of business machinery and equipment and expands those rules to make certain real property eligible for expensing. In general, the expensing rules allow businesses to take a current deduction for qualifying property, rather than recovering those costs through depreciation. Under pre-Act law, qualifying property was limited to depreciable tangible personal property purchased for use in the active conduct of a trade or business. The Act expands the definition to included "qualified real property," which is generally defined as qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property. For tax years beginning in 2010 and 2011, qualifying businesses have the option to currently deduct up to $500,000 under IRC § 179. However, the deduction for qualified real property is limited to $250,000 of the $500,000 amount. In addition, the $500,000 deduction is decreased, dollar-for-dollar, for purchases in excess of $2,000,000.

2. *Extension of Bonus Depreciation*. Before the Act, IRC § 168(k) allowed taxpayers to claim a 50% "bonus" depreciation allowance for most qualified property that was placed in service before January 1, 2010. The Act extends the first-year "bonus" depreciation for one additional year, allowing taxpayers the deduction if the qualifying property is acquired and placed in service before January 1, 2011.

3. *Increased Deduction for Start-up Expenditures*. Currently, a taxpayer may elect to deduct certain start-up expenditures of a trade or business on the return for the tax year in which the trade or business began. The Act now allows taxpayers to deduct up to $10,000 in trade or business start-up expenditures for 2010. However, the amount that businesses can deduct is reduced dollar-for-dollar by the amount by which the start-up expenditures exceeded $60,000. Previously, the limit on these deductions was capped at $5,000, subject to a $50,000 phase-out threshold.

4. *S Corp Holding Period*. A business originally formed as a C corporation, which later elects to be taxed as an S corporation, may be subject to built-in gains tax on gains that were "built-in" at the time of the corporation's S election. Under Pre-Act law, the built-in gain tax applied if the gains were recognized during the ten-year, or some cases seven-year, period following the S election. The Act temporarily shortens that period to five years, if the fifth tax year following the S election precedes the tax year beginning in 2011.

5. *General Business Credit Carried Back Five Years*. Generally, a business's unused general business credits can be carried back to offset taxes paid in the previous year and carried forward for twenty years, to offset future tax liabilities. Beginning in 2010, the Act allows eligible small businesses to carry back unused general business credits for five years. Eligible small businesses are sole proprietorships, partnerships, and non-publicly traded corporations with $50 million or less in average annual gross receipts for the prior three years.

6. *100% Exclusion of Small Business Capital Gains*. Ordinarily, individual taxpayers can exclude from taxable income 50% of their gain on the sale of qualified small business stock ("QSBS") held for at least five years. This percentage exclusion was temporarily increased to 75% for stock acquired after February 17, 2009 and before January 1, 2011. However, under the Act, the amount of the exclusion is temporarily increased again to 100% of the gain for the sale of QSBS that is acquired after September 27, 2010 and held for

more than five years. The Act also eliminates the AMT preference item attributable to such sales. Consequently, a taxpayer who acquires QSBS after September 27, 2010 and before January 1, 2011, and holds the stock for five years, will have no regular tax or AMT imposed on the sale of the QSBS.

7. *Major Modification of the Reportable Transaction Penalty*. IRC § 6707A imposes a penalty on any person who fails to include on any return or statement any information regarding a "reportable transaction." Reportable transactions are those identified by the IRS as having a potential for tax avoidance or evasion. Included within the definition of reportable transactions is a listed transaction. A listed transaction is a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the IRS as a tax avoidance transaction. Before the Act, the penalty for the failure to report a reportable transaction was $10,000 in the case of a natural person and $50,000 for other taxpayers and the penalty for failure to report a listed transaction was $100,000 in the case of a natural person and $200,000 for other taxpayers. For penalties assessed after December 31, 2006, the Act completely replaced the IRC § 6707A penalty structure and makes the penalty proportionate to the tax savings generated by the reportable or listed transaction. Under the Act, the penalty is set at 75% of the tax savings received. The Act also sets both minimum and maximum penalty amounts. The minimum penalty is $10,000 for corporations and $5,000 individuals, and the maximum penalty is $200,000 for corporations and $100,000 for individuals.

8. *Deductibility of Health Insurance for Purposes of Calculating Self-Employment Tax*. Under pre-Act law, a self-employed individual's health insurance costs were deductible for income tax purposes but not for self-employment tax purposes. The Act allows self-employed individual's to deduct the cost of health insurance incurred in 2010 for themselves and their family members in calculating their 2010 self-employment tax.

9. *Removal of Cellular Phones as "Listed Property"*. At the present time, taxpayers are not allowed a deduction for "listed property" unless the taxpayer substantiates, by adequate records or other sufficient evidence, the (i) amount of the expense or other item; (ii) use of the property and the business purpose of the expense or other item; and (iii) business relationship to the taxpayer of persons using the property. Before the Act, cell phones were "listed property," meaning the above-listed recordkeeping requirements limited or prevented many taxpayers from taking annual depreciation deductions for cell phones. The Act now "delists" cell phones for taxable years beginning after December 31, 2009, which means that their cost can be deducted or depreciated like other business property, without the need to adhere to the aforementioned recordkeeping requirements.

10. *Required Information Reporting for Rental Property Expense Payments*. The Act requires persons receiving rental income from real property to file information returns with the IRS and service providers reporting payments of $600 or more during the year for rental property expenses. In general, there is an exception for individuals renting their principal residence, including active members of the military, from the reporting requirements. This provision is estimated to raise $2.5 billion over ten years.

11. *Increased Penalty for Failure to File Information Returns*. The Act increases penalties for the failure to timely file information returns with the IRS and to payees. For returns required to be filed after 2010, the Act doubles the basic per return penalty amount and increases the maximum limits dramatically. This provision is estimated to raise $421 million over ten years.

Please be advised that this newsletter only provides brief descriptions of tax information of general interest and that any tax information contained herein was not intended and cannot be used for the purpose of: (1) avoiding penalties that may be imposed by the Internal Revenue Service; or (2) supporting, promoting, or marketing any transaction(s) or matter(s) addressed herein.

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