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AN ALERT FROM THE BDO FEDERAL TAX PRACTICE

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FEDERAL TAX

SUBJECT

SMALL BUSINESS JOBS ACT PROVIDES ADDITIONAL INVESTMENT INCENTIVES AND SMALL BUSINESS TAX RELIEF

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SUMMARY

On September 27, 2010, President Obama signed the Small Business Jobs Act of 2010, Pub. L. No. 111-240 (the "Act"). The Act provides several tax incentives for business investment or access to capital, and makes other modifications primarily affecting small businesses. The tax incentives are temporary, primarily affecting 2010 and 2011 taxable years. Several revenue offsets have also been enacted. This Tax Alert provides a brief summary of the principal provisions of the Act.

SMALL BUSINESS RELIEF

Bonus Depreciation Allowance

A bonus depreciation allowance had previously applied to certain property placed in service in 2008 and 2009. In order to qualify for bonus depreciation, the property must be (a) property to which the modified accelerated cost recovery system applies, with a recovery period of 20 years or less, (b) water utility property, (c) most computer software, or (d) qualified leasehold improvement property. Certain other qualifications and limitations apply to this special allowance. The first-year allowance is 50 percent of the basis of qualifying property, with the remaining 50 percent being depreciated under generally applicable rules. Taxpayers may elect not to claim bonus depreciation on a class-by-class basis. The Act extends the allowance to property placed in service in 2010 (or 2011 for certain longer-lived and transportation property).

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Congress did not extend one provision that had been closely associated with the bonus depreciation provision. Under this provision, a corporation with certain old alternative minimum tax ("AMT") or research and development credits could elect to forgo bonus depreciation and convert a portion of these old credits to refundable credits. This provision expired for property placed in service after December 31, 2009.

Additional First-Year Expensing

Business taxpayers may elect to deduct the cost of certain fixed assets placed in service during the taxable year under the section 179 "expensing" provisions. For 2010, the allowance is limited to $250,000, but the limitation is phased out to the extent that the cost of qualifying property placed in service during the year exceeds $800,000. Most depreciable tangible personal property acquired for use in a trade or business is qualifying property for purposes of section 179 and, for taxable years beginning before 2011, off-the-shelf computer software is also qualifying property.

The Act doubles the section 179 limitation for taxable years beginning in 2010 and 2011, and more than doubles the phase-out threshold. Thus, for these years, the section 179 election may apply to the first $500,000 of qualifying property placed in service in each year, but the limitation is phased out to the extent that the cost of qualifying property placed in service during the year exceeds $2 million. In addition, for the first time and for the same two taxable years, a taxpayer may elect to deduct the first $250,000 of the cost of certain real property, *i.e.*, qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property. The dollar limitations for real property acquisitions are not separate from the dollar limitations for all section 179 property. Thus, the deduction for tangible personal property will be limited to the excess of $500,000 (or the taxpayer's phased-down limitation) over the amount of real property that is deducted for the taxable year.

Congress had previously shortened the recovery period for these three types of real property—qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property—to 15 years. However, these provisions applied only to property placed in service before January 1, 2010. Thus, if the first-year expensing is not elected or does not apply to property placed in service after 2009, regular depreciation rules for real property will apply.

S Corporation Built-in Gains Tax Relief

An S corporation that has converted from C corporation status or has acquired assets in a nonrecognition transaction from a C corporation may be subject to a corporate-level built-in gains tax if it sells assets or recognizes certain types of income during a ten-year recognition period. This tax is in addition to any tax that may be imposed on the shareholders of the corporation under normal flow-through principles applicable to S corporations. Legislation enacted in early 2009 provided temporary relief from this tax for certain S corporations. Under this rule, for taxable years beginning in 2009 or 2010, the tax would not be imposed if the seventh taxable year in the recognition period had been completed before the taxable year in which the built-in gain is recognized.

The Act extends and further relaxes these rules for taxable years of S corporations beginning in 2011. Under the Act, for the 2011 taxable year only, the tax would not be imposed if five years of the recognition period had been completed before the taxable year in which the built-in gain is recognized. Note that the five-year rule under the Act requires that 60 months of the recognition period must have elapsed before the beginning of the taxable year in which the recognized built-in gain would be taken into account.

Exclusion of Gain on Certain Small Business Stock

Tax legislation enacted in 1993 permitted an individual to exclude 50 percent (in most cases) of any gain from the sale of certain small business stock acquired at original issue and held for at least five years. The maximum amount of gain eligible for exclusion is the greater of ten times the taxpayer's basis in the stock or $10 million. However, because of the combined effect of the special tax rates applicable to such gains and the application of the AMT to the excluded portion of the gain, the overall effective tax rate is not significantly lower than the maximum rate of tax generally applicable to the long-term capital gains of individuals.

The Act provides an effective tax exemption for gains from the sale of stock issued after the date of enactment and before January 1, 2011 (subject to the quantitative limitations described in the preceding paragraph). The effective exemption is achieved through the allowance of a 100-percent exclusion of the gain and the elimination of the AMT preference for the excluded gain. As a result, neither the regular tax nor the AMT will apply to such gains.

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General Business Credits of Eligible Small Businesses

The Code provides for a variety of "general business credits" which allow taxpayers a dollar-for-dollar reduction in their tax liability, subject to applicable limitations. With certain exceptions, such credits may not reduce a taxpayer's tax liability below the "tentative minimum tax" of the taxpayer, a key determinant of the taxpayer's liability (if any) for the AMT. To the extent that the credits available to a taxpayer for a taxable year exceed the applicable limitation, the excess credits may be carried back one taxable year and carried forward 20 taxable years.

The Act provides two relief provisions for eligible small businesses, which are defined as taxpayers with average annual gross receipts not exceeding $50 million for the three immediately preceding taxable years. Certain special rules are provided for businesses conducted by S corporations and partnerships, for sole proprietorships, and for aggregating the gross receipts of certain related taxpayers.

Under the first relief provision, in the case of the eligible small business taxpayer's first taxable year beginning after December 31, 2009, the general business credits may be carried back for five taxable years. Under the second relief provision, for the same taxpayers and for the same single taxable year, the general business credits are effectively permitted to offset both regular tax and AMT liability.

Bonus Depreciation and Long-Term Contract Accounting

Taxpayers subject to the long-term contract method of accounting must generally use the percentage-of-completion method to determine their taxable income from such contracts. In order to determine the percentage of completion for tax purposes, affected taxpayers must use a "cost-to-cost" comparison, by determining the total contract costs incurred before the end of the taxable year and by estimating the total costs for the entire contract. Because depreciation is among the costs to be taken into consideration, the use of bonus depreciation has the effect of overstating the percentage of completion in the early years of a long-term contract. The Act provides that, in the case of property with a recovery period of seven years or less that is placed in service during the calendar year 2010, taxpayers may compute the percentage of completion as if bonus depreciation had not been enacted.

Increased Deduction for Start-up Expenditures

The Code generally requires start-up expenditures to be capitalized. Start-up expenditures are those that would be deductible as trade or business expenses if the trade or business activities had begun. However, once the trade or business begins, a taxpayer may elect to deduct the first $5,000 of start-up expenditures and to amortize any remaining expenditures over a 15-year period. The deductible portion of the start-up expenditures is phased down to the extent that the total of such expenditures exceeds $50,000. Under applicable regulations, the election to deduct and amortize is deemed to have been made unless the taxpayer affirmatively elects to capitalize such expenditures.

For taxable years beginning in 2010, the Act increases the deductible portion of start-up expenditures from $5,000 to $10,000, and increases the phase-out threshold from $50,000 to $60,000.

Health Insurance Premiums and the Self-Employment Tax

Self-employed individuals, including partners in partnerships and certain shareholder-employees of S corporations, may claim an "above-the-line" deduction for the cost of health insurance for themselves and their spouses, dependents, and any children who have not attained the age of 27 at the end of the taxable year. Certain other limitations apply to this deduction. Self-employed individuals are also subject to a tax on their net earnings from self-employment. The hospital insurance portion of this tax applies to all earnings from self employment, while the other component of this tax only applies to a limited amount of earnings from self-employment ($106,800 in 2010, reduced by the amount of wages subject to the FICA tax for the same year). The self-employment tax does not apply to wages received by a shareholder-employee of an S corporation, nor does it apply to the shareholder's share of income from the S corporation.

For the taxpayer's first taxable year beginning after December 31, 2009, taxpayers are allowed a deduction, in computing their net earnings from self employment, for their self-employed health insurance premiums paid during the year. For taxpayers whose net earnings from self employment exceed the FICA wage base of $106,800, the deduction will produce only a 2.9% tax benefit, but for those taxpayers whose net self-employment earnings are below this amount (or would be reduced below this amount by the deduction for health insurance premiums), the deduction could produce a tax benefit of up to 15.3%.

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Cellular Telephones as Listed Property

Cellular telephones had been included in a class of "listed property" subject to special substantiation requirements and depreciation provisions. Listed property also included passenger automobiles, other property used as a means of transportation, any property of a type generally used for purposes of entertainment, recreation, or amusement, or any computer or peripheral equipment. Listed property is thought to have greater potential for mixed personal and business use than other types of property.

No deduction is allowed for listed property unless the taxpayer provides adequate substantiation of the expense and business usage of the property. In addition, depreciation of listed property is computed under the alternative depreciation system if the business-use percentage does not exceed 50 percent for the taxable year that the property is placed in service.

For taxable years ending after December 31, 2009, cellular telephones are removed from the definition of listed property and thus are no longer subject to the substantiation and special depreciation rules.

REVENUE PROVISIONS

The Act also contains a number of revenue-raising provisions in order the make the Act revenue neutral over the relevant five- and ten-year budget windows. However, unlike the tax-relief provisions, which are mostly temporary, the revenue-raising provisions are mostly permanent. The principal revenue-raising provisions are as follows, and are generally effective beginning in 2011, unless noted:

- Extension of the Form 1099 information-reporting requirements to payments made by recipients of rental income to a service provider;
- Increase in penalties for the failure to timely furnish correct information returns (payee statements);
- Allow participants in government section 457 plans to treat elective deferrals as Roth contributions;
- Allow rollovers from elective deferral plans to Roth designated accounts (effective for distributions made after September 27, 2010);
- Permit partial annuitization of a nonqualified annuity contract;
- Modify the source rules of sections 861 and 862 to address income from guarantees issued after September 27, 2010; and
- Increase the amount of estimated taxes otherwise required to be paid by certain large corporations in July, August, or September 2015.

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