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The Small Business Jobs Act of 2010

Don't be misled by the title of this new law – the act contains many changes that affect individual taxpayers and large enterprises as well as small businesses.

President Obama signed the Small Business Jobs Act of 2010 into law on Sept. 27, 2010. Take care in applying the law to your situation because the effective dates of the changes vary.

Increase in Section 179 Expensing

Under Section 179, businesses currently are allowed to expense up to $250,000 of the cost of eligible property and equipment placed in service per year.

This benefit is designed for small businesses, so once annual additions of Section 179 property reach $800,000, the deduction is phased out dollar-for-dollar. Thus, the deduction is completely lost once annual additions reach $1,050,000.

For tax years beginning after 2010, the maximum deduction was scheduled to be reduced to $25,000, and the phaseout would begin at $200,000 of property additions.

An important condition of Section 179 is that this election generally cannot create a loss. Thus, businesses without taxable income cannot benefit. If Section 179 depreciation is claimed in excess of taxable income, the excess carries over to subsequent tax years.

New law. For tax years beginning in 2010 and 2011, the maximum Section 179 deduction is *doubled* to $500,000. The available deduction begins to phase out when annual additions reach $2 million (previously $800,000) and is fully phased out at $2.5 million of additions (previously $1,050,000).

Observation. Intended to be a "small business" benefit, the $500,000 deduction is significantly higher than ever before in tax law history.

Observation. The $2 million limit of property additions means some larger businesses may also benefit if they had already placed significant property in service in 2010 and are now eligible for more depreciation than expected. To take the deduction in 2010, property must be placed in service before year-end.

Expensing for Qualifying Real Property

Under current law, real estate is not eligible for Section 179 expensing, regardless of the amount.

New law. For the first time ever, certain qualifying real property can qualify for Section 179 treatment. For tax years beginning in 2010 and 2011 only, up to $250,000 of eligible realty can be expensed under Section 179. Qualifying real property includes:

1. Qualified leasehold improvement property, which is generally business nonresidential real estate leased from unrelated parties
2. Qualified restaurant property, which is generally real estate in which 50 percent or more of the space is used for food preparation and seating for on-premises consumption of prepared meals
3. Qualified retail improvement property, which is interior improvements to a building used for the retail trade of selling goods to the general public

In the case of Section 179 for real estate, no Section 179 expense in excess of taxable income can be carried over to years beginning after 2011.

Other Section 179 Changes

Historically, a Section 179 election, once made, could not be revoked without the consent of the IRS. However, for tax years beginning after 2002 and before 2011, taxpayers could amend a return to change their Section 179 election without IRS approval. The act extends this right through tax years beginning before 2012.

Similarly, off-the-shelf computer software previously qualified as Section 179 property if placed in service through tax years beginning before 2011. The act extends the availability of this deduction for an additional year, through tax years beginning before 2012.

A tax information bulletin to our clients and business associates from:

Extension of Section 168(k) "Bonus" Depreciation

For assets placed in service through Dec. 31, 2009, businesses could expense 50 percent of the cost of qualifying depreciable assets in the year of acquisition. The remaining 50 percent is available for normal depreciation.

Unlike the Section 179 deduction, there is no maximum amount of eligible additions for this benefit. Further, while the Section 179 deduction is limited to taxable income, the deduction under Section 168(k) can create a taxable loss. A fundamental requirement remains that the property must be "new," meaning never before put into use by any taxpayer.

New law. This act restores the Section 168(k) deduction for eligible property placed in service in 2010. Section 168(k) bonus depreciation is not changed from 2009 but simply extended for one additional year.

The maximum Section 168(k) depreciation available for autos and light trucks subject to the luxury auto depreciation rules is $8,000 in addition to the $3,060 first-year cap on these autos for 2010 ($3,160 for light trucks, vans, and sport utility vehicles).

Business vehicles with a gross vehicle weight of 6,000 pounds or more (loaded) are generally exempt from these limitations.

The Section 168(k) extension is generally for property placed in service in 2010 only. However, the law is extended through assets placed in service in 2011 for certain longer-life assets, certain aircraft and certain tangible personal property used to transport people or property.

Temporary Deduction of Health Insurance for Self-Employment Tax

Self-employed persons are subject to both income tax and self-employment tax under the Self-Employment Contributions Act. Self-employment taxes represent both Medicare and Social Security taxes. The self-employed taxpayer may be able to deduct the cost of health insurance against his or her income taxes but not against self-employment taxes.

New law. Effective *only* for the first tax year after Dec. 31, 2009, the deduction for self-employed health insurance is allowed against both income and self-employment taxes.

Information Reporting for Rental Enterprises

Currently, businesses must report the value of certain business transactions to the IRS on Forms 1099. The transactions include payments to attorneys and payments of $600 or more per year to noncorporate service providers and lessors. Failure to file these information reports when required can subject the taxpayer to penalties.

New law. Effective for payments made after Dec. 31, 2010, the list of required information returns is expanded. Now, taxpayers owning rental property must file information reports if they pay $600 or more per year to service providers in their rental activities. Likely rental service expenses would include repairs, maintenance, commissions and legal, accounting and management fees.

Many in Congress believe that this change will help the government find additional revenues that may not be currently reported by these service providers.

Observation. All individual taxpayers (those who file Form 1040) who hold rental property will be subject to these rules. Because Form 1099 information returns are generally required to be filed by Jan. 31, some individuals who typically assemble their tax information later will have considerable difficulty meeting this deadline. Small lessors will be exempt, but that definition will be determined by the IRS.

Increase in Information Return Penalties

Currently, penalties are imposed on information returns based on when the return is filed and whether the information is correct. A correct filing that is filed 30 days or less after the due date is a first-tier penalty.

If the return is correct, but filed more than 30 days late, and filed by Aug. 1, the second-tier penalty applies.

If the return is correct but filed after Aug. 1, the third-tier penalty is due.

Finally, if the failure to file is due to intentional disregard of the requirement, increased penalties without a maximum apply.

Small businesses face reduced maximum penalties if the business has average annual gross receipts over the prior three years of $5 million or less.

Further, other penalties apply for failing to furnish correct statements to payees. The penalty for failing to provide a statement is $50 for each failure, up to an annual maximum of $100,000. If the failure is intentional, the penalty increases under a formula, and the maximum is removed.

New law. The act increases information return penalties, as shown in the chart. Further, the penalties for failure to provide correct statements to payees would also increase as shown below.

	Defined	Current rules	Current rules (small business)	New rule	New rules (small business)
First-tier penalty	Correct, filed within 30 days of deadline	$15 each, maximum of $75,000	$15 each, maximum of $25,000	$30 each, maximum of $250,000	$30 each, maximum of $75,000
Second-tier penalty	Correct, filed after 30 days but before Aug. 1	$30 each, maximum of $150,000	$30 each, maximum of $50,000	$60 each, maximum of $500,000	$60 each, maximum of $200,000
Third-tier penalty	Correct, filed after Aug. 1	$50 each, maximum of $250,000	$50 each, maximum of $100,000	$100 each, maximum of $1,500,000	$100 each, maximum of $500,000
	Intentional disregard of filing requirement	$100 each, no maximum	$100 each, no maximum	$250 each, no maximum	$250 each, no maximum

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Exclusion of 100 Percent of Certain Stock Gain

Previously, Section 1202 provided that the gain on sale of certain small business stock was subject to a 50 percent exclusion, followed by a 28 percent maximum federal tax rate (net tax rate of 14 percent).

The exclusion was capped at the greater of either 10 times stock basis or $10 million. To qualify, the small business stock must meet certain requirements, including being original issue stock of a C corporation with $50 million or less in total assets. The stock must have been held for at least five years.

In the case of stock acquired after Feb. 17, 2009, and before Jan. 1, 2011, the exclusion is increased to 75 percent – for a net tax of 7 percent. If the alternative minimum tax (AMT) applies, the rates differ.

New law. Under the act, qualified small business stock acquired after Sept. 27, 2010, but before Jan. 1, 2011, and held for at least five years is eligible for a 100 percent (previously 75 percent) exclusion for both regular and AMT taxes.

Deduction of Startup Expenses

New businesses can incur so-called startup costs, which represent those costs incurred before the business is open. Up to $5,000 in startup costs can be deducted in the initial year of operation, and any startup expenses in excess are amortized over 15 years.

To the extent that total startup expenses exceed $50,000, the first-year expense of up to $5,000 is reduced. Thus, at $55,000 or more of startup expenses, none can be deducted upfront and the entire amount is amortized over 15 years.

New law. For tax years beginning in 2010, business startup expenses can be deducted upfront up to $10,000 (previously $5,000). The right to the first-year deduction begins to phase out when total startup expenses reach $60,000 (previously $50,000).

S Corporation Built-in Gains Relief

While C corporations pay their own income taxes, S corporations pay no corporate-level tax. Instead, the shareholders pay tax on their pro rata share of corporate income. The result of this structural difference is that S corporations may avoid the potential two levels of tax for dividend-paying C corporations.

C corporations, if expecting a windfall, could decide that they would rather be an S corporation. An existing C corporation can elect to be treated as an S corporation, but gains allocable to prior C corporation years remain subject to corporate-level tax for a certain time, even as an S corporation.

This corporate-level S corporation tax for gains allocable to pre-S years is called "built-in gains." Generally, built-in gains can trigger corporate-level tax for up to 10 years after the conversion to an S corporation. An exception to this rule is that, for taxable years beginning in 2009 or 2010, the built-in gains tax is not imposed if the corporation has already completed year seven of the built-in gains period.

New law. The act grants further relief to the S corporation built-in gains tax period. For tax years beginning in 2011 *only*, no built-in gains tax applies if the fifth period in the built-in gains period preceded the tax year beginning in 2011.

President Obama signed the Small Business Jobs Act of 2010 on Sept. 27.

General Business Credit Changes

Currently, businesses can claim the general business credit to the extent that their regular tax exceeds their alternative minimum tax. If regular tax liability exceeds $25,000, the credit can offset up to 25 percent of the regular tax liability. Excess credits can be carried back for one year and forward up to 20 years.

New law. For certain small taxpayers, the excess credits are eligible for up to a five-year carryback. Also, for certain small businesses, the AMT is deemed to be zero, thereby allowing full use of the credit against their regular tax liability. This will really help those taxpayers claiming the R&D credit.

Eligible small businesses are those that are not publicly traded, with average annual gross receipts over the prior three years of $50 million or less. These provisions are effective for the first taxable year beginning after Dec. 31, 2009.

Penalties for Failure to Disclose Certain "Reportable" Transactions

Some businesses have found that they entered into transactions that were "reportable" under the tax shelter reform efforts of recent years. The businesses may not have known that there was a reporting requirement. Meanwhile, penalties imposed for failure to report may be a multiple of any tax benefit received from the transaction.

New law. Retroactive to penalties assessed after Dec. 31, 2006, the penalty for failure to file reportable transaction disclosures would better follow the economic benefit received.

Mobile Telephones as "Listed" Property

Certain types of business property that are inherently subject to personal use are subject to special business-use documentation requirements with the IRS.

Known as "listed" property, these items include automobiles, certain computers, property of a type generally used for recreation (such as watercraft) and mobile telephones. The deduction for the expenses of these items may be subject to documentation of business use, through logs or other record keeping.

Business groups had complained for many years that the value of any mobile telephone personal use is quite small, and the potential record-keeping burden is administratively impractical. Thus, they had requested that Congress remove mobile telephones from the definition of listed property.

New law. Effective for tax years beginning after Dec. 31, 2009, mobile telephones are no longer considered listed property.

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Retirement Provisions

➤ Effective for taxable years beginning after Dec. 31, 2010, participants in 457 plans can elect to treat their retirement deferrals as Roth contributions. (Thus, there is no deduction for the deferral, but no taxable income when the funds are withdrawn from the retirement plan, if the Roth requirements are met).

➤ Effective on Sept. 27, 2010, participants in 401(k), 403(b), and certain other plans can convert their retirement plan balances to Roth accounts, if allowed by the plan. This creates taxable income on conversion. If this conversion happens in 2010, the conversion is eligible for a special rule whereby 50 percent of the income is reported on the 2011 tax return, and 50 percent on the 2012 tax return.

Other Changes

1. For business taxpayers with long-term contracts accounted for under the percentage completion method, costs of the project are calculated as if Section 168(k) bonus depreciation was not extended. This allows contractors to benefit from the extension of Section 168(k), even if their contracts are not complete that year.
2. Certain reforms are made to the cellulosic biofuels producer credit.
3. For taxable years beginning after Dec. 31, 2010, annuity contracts can be separated into an annuity portion (paid out over a number of years) and a nonannuity portion (deferred into the future).
4. The IRS is required to submit annual reports to Congress on penalties and enforcement actions.
5. Amounts received for guarantee of the debt of foreign persons is subject to U.S. taxation.
6. The estimated tax rules for very large corporations (assets of at least $1 billion) are changed.

This discussion is necessarily brief. Please do not take any action based on this memorandum alone, but use it to initiate a conversation with your tax adviser about how these provisions impact your specific situation.

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This issue of Federal Tax Watch was written by R. Milton Howell, III, CPA, CSEP, Davenport, Marvin, Joyce & Co., L.L.P., the Greensboro, N.C., affiliate of CPAmerica.