PUBLICATION

Small Business Jobs Act - The Major Tax Provisions

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On September 27, 2010, President Obama signed the Small Business Jobs Acts of 2010 (Act). The Act includes approximately $12 billion of tax cuts targeted at small businesses. The Act also includes several important revenue provisions that are intended to offset the costs of the tax benefits. This Alert summarizes several (but not all) of the major tax and revenue provisions in the Act.

I. Tax Benefits

A. Reduction of S Corporation Holding Period For Built-in Gains Tax. The Act amends Section 1374 of the Internal Revenue Code (Code) dealing with the built-in gains tax. Generally, when a C corporation with appreciated assets converts to an S corporation, a 35 percent corporate-level tax (the built-in gains tax) is recognized if the corporation distributes such assets or liquidates within a ten-year period beginning on the date of the S corporation election. Previous legislation reduced this ten-year holding period to seven years for events triggering the built-in gains tax which occur in 2009 or 2010. The Act further reduces the holding period to five years for distributions or liquidations in 2011.

B. Expansion of Five-Year Carryback of General Business Credits. The Act amends Code Section 39 by expanding the carryback of unused general business credits from one year to a five-year carryback. The five-year carryback is only available to eligible small businesses (ESBs), which are sole proprietorships, partnerships, and non-publicly traded corporations which have averaged $50 million or less in average annual gross receipts over the previous three years. Also with respect to ESBs, the Act provides that all general business credits may be used to offset the impact of the alternative minimum tax (AMT). The provision is effective for credits acquired in tax years following December 31, 2009.

C. Increase in Capital Gain Exclusion on the Sale of Qualified Small Business Stock. Generally, under Code Section 1202, taxpayers who acquire certain qualified small business stock are eligible for a 50 percent gain exclusion upon the sale of such stock, although a portion of the gain is treated as an AMT preference item. Prior legislation increased the gain exclusion to 75 percent for qualified small business stock acquired after February 17, 2009 and prior to January 1, 2011. The Act amends Code Section 1202 to provide that qualified small business stock acquired during the limited time period beginning after the date of enactment (September 27, 2010) and prior to January 1, 2011, is eligible for an increased 100 percent gain exclusion. The Act also provides that any gain resulting from the sale of qualified small business stock acquired during this limited time period will not be treated as an AMT preference item. Qualified small business stock acquired after February 17, 2009 and through the enactment date of the Act is still subject to the 75 percent gain exclusion and a portion of the gain will be treated as an AMT preference item.

In order to qualify for the exclusion, taxpayers must acquire the qualified small business stock at original issue and hold such stock for five years or more. For purposes of this exclusion qualified small business stock is generally defined as the stock of a C corporation which (i) is an active trade or business and (ii) which has gross assets of less than $50 million.

D. Removal of Cellular Phones as Listed Property. The Act amends Code Section 280F to remove cellular phones from the definition of listed property, thereby relieving the substantiation requirement with regard to their use. Under prior law, business use of a cellular phone was required to be substantiated in order to qualify for a business expense deduction under Section 162. The provision is effective for tax years ending after December 31, 2009.

E. Increase and Expansion of Section 179 Expensing. Effective for tax years beginning in 2010 and 2011, the Act amends Code Section 179 by increasing the expense limitation for qualified property placed in service during the taxable year from the current $250,000 to $500,000, subject to a phase-out above a certain amount. That phase-out is also increased by the Act from the current $800,000 of qualifying property placed in service in the taxable year to $2 million.

The Act also temporarily expands the definition of property qualifying as Section 179 property to include qualified real property. Qualified real property is defined to include qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property. This temporary expansion is effective only for tax years beginning in 2010 and 2011 and is allowed for expenses up to $250,000.

F. Extension of Bonus Depreciation. The Act amends Code Section 168 by extending the first year bonus depreciation deduction for qualified property acquired and placed in service during 2010 (or placed in service during 2011 for certain long-lived property and transportation property). The depreciation deduction is equal to 50 percent of the adjusted basis of the qualified property placed in service.

G. Special Rule for Long-Term Contract Accounting. The Act amends Code Section 460(c) by modifying how the percentage of completion method applies to property for which the first year bonus depreciation deduction is taken. Under the Act, the percentage of completion method will treat certain property for which the first year bonus depreciation deduction is taken as if such deduction had not been taken. This special rule applies only to property that (i) has a MACRS recovery period of seven years or less and (ii) is placed in service after December 31, 2009 and prior to January 1, 2011. The amendment is intended to assist businesses that are subject to the percentage of completion method to benefit from the first year bonus depreciation deduction referenced above.

H. Increased Deduction for Start-Up Expenditures. The Act amends Code Section 195 by increasing the deduction for allowable start-up expenditures from $5,000 to $10,000. The Act also increases the phase-out threshold from $50,000 to $60,000 of cumulative start-up expenditures. The provision is effective for tax years beginning after December 31, 2009.

I. Relaxed Penalty for Failure to Disclose Reportable Transaction. The Act amends Code Section 6707A by modifying the penalty calculation for failing to disclose a reportable transaction. A reportable transaction is generally defined as a transaction which the Treasury Secretary has determined must be disclosed because of the potential for tax avoidance. A listed transaction is a reportable transaction which is described and specifically identified in IRS publications. The mandatory penalty for a reportable transaction is generally $10,000 in the case of a natural person and $50,000 for all others (such as corporations). In the case of a listed transaction, the current mandatory penalty is $100,000 in the case of a natural person and $200,000 in the case of all others.

The Act amends Section 6707A so that the amount of the penalty is proportional to the tax savings that were the object of the transaction. The penalty for a reportable transaction will now be equal to 75 percent of the reduction in tax reported on the taxpayer's return as a result of participation in the transaction. A minimum penalty is established in the amount of $5,000 in the case of a natural person and $10,000 in the case of all others. The maximum penalty is capped at the level of the previous mandatory penalties.

This provision is effective for all Section 6707A penalties assessed after December 31, 2006.

J. Temporary Deduction for Health Insurance Costs in Computing Self-Employment Tax. The Act amends Code Section 162 to allow self-employed individuals to deduct the cost of health insurance for themselves, their spouses, and their children who have not attained age 27 (as of the end of the taxable year), for purposes of computing their self-employment tax. This provision is effective only for the 2010 tax year.

II. Revenue Provisions

Congress included a number of revenue provisions in the Act to offset the cost of its tax benefits and spending provisions. The Act's revenue provisions include:

A. Promotion of Retirement Savings.

1. Section 457(b) Plans Can Include Roth Accounts. For tax years beginning in 2011, the Act allows government-sponsored Section 457(b) plans (but not Section 457(b) plans sponsored by tax-exempt organizations such as churches and private schools and colleges) to include qualified Roth contribution programs. Section 401(k) and Section 403(b) plans can currently include qualified Roth contribution programs, which allow participants to make after-tax salary deferral contributions to a "designated Roth account". The participant has to pay income tax on the portion of his or her salary that is contributed to a designated Roth account, but qualified distributions from the account are tax-free.
2. Rollovers to Roth Accounts Permitted. Under the Act, if a Section 401(k), Section 403(b), or government-sponsored Section 457(b) plan includes a qualified Roth contribution program, the plan can allow participants and their surviving spouses to roll over distributions from a plan account that is not a designated Roth account (i.e., an account funded with pre-tax contributions) to a designated Roth account in that plan. Only distributions that are eligible to be rolled over into another tax-deferred account can be transferred to a designated Roth account. This provision is effective for distributions made after September 27, 2010, but will not apply to any distributions from government-sponsored Section 457(b) plans until 2011 when those plans are permitted to include qualified Roth contribution programs.

   The transfer of a distribution into a designated Roth account is taxed as if it was a rollover into a Roth IRA. Thus, transfers to a designated Roth account in 2010 qualify for the special rule that a taxpayer who rolls over a distribution from an eligible retirement plan to a Roth IRA in 2010 will defer the income on the rollover and include the income in equal parts in 2011 and 2012 unless the taxpayer elects to include the income in 2010.
3. Annuitization. Beginning in 2011, the Act allows holders of annuities, endowment or life insurance contracts to elect to receive a portion of the annuity or contract in the form of a stream of annuity payments, while leaving the remainder of the contract to accumulate income on a tax-deferred basis. The Act provides that a portion of an annuity, endowment or life insurance contract that is converted into qualifying annuity payments will be treated as a separate contract for purposes of Code Section 72, with a separate annuity starting date for each converted portion. In order to qualify, the contract must be converted into an annuity that is payable over a period of 10 years or more or over the lives of one or more individuals.

   When a portion of an annuity, endowment, or life insurance contract is converted into a qualifying annuity, the "investment in the contract" (Code Section 72's term for basis) is allocated pro rata between each portion of the contract converted into a qualifying annuity and the portion of the contract not converted into an annuity. The allocation applies for purposes of the rules relating to the exclusion ratio, the determination of the investment in the contract, the expected return, the annuity starting date, and amounts not received as an annuity.

B. New Reporting Requirements and Increased Penalties.

4. Rental Property Expense Payments Subject to Form 1099 Reporting Requirements. Although the Patient Protection and Affordable Health Care Act's expansion of the Form 1099 information reporting requirements continues to generate fierce controversy, Congress further expands Form 1099 requirements in the Act. Beginning in 2011, recipients of rental income from real estate are subjected by the Act to the Form 1099 requirements applicable to a trade or business. With limited exceptions, persons receiving rental income from real estate who pay a total of $600 or more to a service provider in a single year in the course of earning rental income must report the payments to the IRS and the service provider on a Form 1099.
5. Increased Information Return Penalties. The Act increases the penalties under Code Section 6721 on any person who fails to file certain required information returns (including Forms 1098 and 1099) by the due date for the returns. The increased Section 6721 penalties are effective for information returns due on or after January 1, 2011, and will be adjusted to account for inflation for each fifth calendar year beginning after 2012.

   There are three tiers of penalties under Section 6721, based on when a correct information return is filed, with reduced maximum penalties for small businesses (firms with average annual gross receipts for the most recent three taxable years of less than $5 million). The first-tier penalty applies if a correct information return is filed late, but within 30 days following the due date. The second-tier penalty applies if a correct information return is filed more than 30 days following the due date, but by August 1 of the year it is due. The third-tier penalty applies if a correct information return is not filed by August 1 of the year it is due.

   The Act increases the per return and maximum penalties as follows:

   - The first-tier penalty increases from $15 per return to $30 per return, and the calendar year maximum penalty increases from $75,000 to $250,000 (and from $25,000 to $75,000 for small businesses);
   - The second-tier penalty increases from $30 per return to $60 per return, and the calendar year maximum penalty increases from $150,000 to $500,000 (and from $50,000 to $200,000 for small businesses);
   - The third-tier penalty increases from $50 per return to $100 per return, and the calendar year maximum penalty increases from $250,000 to $1.5 million (and from $100,000 to $500,000 for small businesses); and
   - If the failure is due to an intentional disregard of a filing requirement, the penalty increases from $100 per return to $250 per return, with no calendar year maximum.
6. Increased Payee Statement Penalties. The Act amends Code Section 6722 to create a tiered penalty structure similar to Code Section 6721, including reduced maximum penalties for small businesses, for failures to furnish payee statements (such as Forms K-1) when due and for failures to include required information or inclusion of inaccurate information on a payee statement. The changes to the Section 6722 penalties are effective for payee statements due on or after January 1, 2011, and will be adjusted to account for inflation for each fifth calendar year beginning after 2012.
7. Opportunity for Pre-Levy CDP Hearing Not Required for Certain Federal Contractors. After September 27, 2010, the Act allows the IRS to levy on certain payments to federal contractors without giving 30 days notice of its intent to levy and the opportunity to request a collection due process (CDP) hearing during that 30-day period, but the contractor will have the opportunity to request a CDP hearing within a reasonable time following the levy.

C. Other Revenue Provisions.

8. Increased 2015 Quarterly Estimated Tax Payment For Large Corporations. The Act increases the estimated payments due from large corporations (those with assets of $1 billion or greater as determined at the end of the preceding tax year) in July, August, or September of 2015 to 159.25 percent of the tax otherwise due. The next quarterly estimated tax payment will be reduced to reflect the increased payment.
9. Cellulosic Biofuel Producer Credit. The Act modifies the cellulosic biofuel producer credit for fuels sold or used after January 1, 2010 to exclude crude tall oil and other cellulosic biofuels with an acid number of greater than 25.
10. Source Rules for Income on Guarantees. The Act treats as U.S. source income, and thus subjects to possible withholding, those amounts received directly or indirectly:

    - from a U.S. resident or corporation in exchange for a guarantee of the U.S. resident's or corporation's indebtedness; and
    - from a foreign person in exchange for a guarantee of the foreign person's indebtedness if the payments received are connected with income of the foreign person that is effectively connected with the conduct of a U.S. trade or business.

This provision is effective for guarantees issued after September 27, 2010 and is intended to overturn the February 2010 decision by the U.S. Tax Court in *Container Corp. v. Commissioner*.

III. Summary

The purpose of the Act, at least in part, is to encourage and assist small businesses, while at the same time creating retirement enhancement provisions and increasing enforcement in areas such as reporting requirements. The Act's provisions summarized above must be reviewed in detail with your tax advisor so as to determine whether and to what extent such provisions may be applicable to your particular facts and circumstances. Further, and as stated earlier, the Act contains various other provisions which are not summarized in this Alert.

Should you have any questions or otherwise wish to discuss any tax provisions in the Act, please contact an attorney in the Firm's Tax Department.