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Small Business Jobs Act – An Overview of Its Tax Incentives and Revenue Raisers

On September 27, 2010 President Obama signed the Small Business Jobs Act of 2010 (the Act). The following is a brief summary of the some of the Act's tax incentives, as well as some of the offsetting revenue raisers:

Tax Incentives:

1. **Increased Business Expensing.** Under pre-Act law, taxpayers could expense up to $250,000 of qualifying property (generally, machinery, equipment and certain computer software) placed in service in tax years beginning in 2010. This annual expense was reduced to the extent the cumulative cost of qualifying property placed in service during the tax year exceeded $800,000. Pursuant to the Act, for tax years beginning in 2010 and 2011, the $250,000 and $800,000 limitations are increased to $500,000 and $1 million, respectively. In addition, the Act broadens the definition of qualifying property to include qualified real property, which includes qualified leasehold improvement, qualified restaurant and qualified retail improvement property.

2. **Extension of Bonus Depreciation.** Businesses are typically allowed to deduct the costs of capital expenditures over time according to various depreciation schedules. In 2008 and 2009 businesses were allowed to deduct 50 percent of the cost of eligible property (generally, tangible personal property with recovery periods of 20

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years or less, public utility property, computer software or qualified leasehold improvement property) in the year of acquisition. The Act extends the first-year 50-percent write-off for eligible property placed in service during 2010 (as well as during 2011 for aircraft and certain long-term-production-period property).

3. **100-Percent Exclusion of Gain From Sale of Small Business Stock.** Under pre-Act law, noncorporate taxpayers could exclude 50 percent of their gain on the sale of qualified small business stock (generally, stock of a corporation that (i) has gross assets not in excess of $50 million and (ii) has an active business) held for at least five years. Under the 2009 Recovery Act, the percentage exclusion was increased to 75 percent for stock acquired after February 17, 2009 and before January 1, 2011. Pursuant to the Act, the exclusion is increased to 100 percent for qualified small business stock acquired by a noncorporate taxpayer after September 27, 2010 and before January 1, 2011, provided such stock is held for more than five years. In addition, the Act eliminates the alternative minimum tax preference item attributable to the sale.

4. **Reduced Holding Period Required for S Corporations.** Historically, a C corporation converting to an S corporation would be required to hold its appreciated assets for 10 years following its conversion in order to avoid a 35-percent corporate level tax imposed on the built-in gain. The 2009 Recovery Act reduced the 10-year holding period to seven for taxable years beginning in 2009 and 2010 provided that the seventh taxable year of the holding period preceded the 2009 and 2010 tax years. Pursuant to the Act, for tax years beginning in 2011 only, the holding period is reduced to five years if the S corporation's conversion occurred prior to January 1, 2006.

5. **Increase in the Deduction for Start-Up Expenditures.** For tax years beginning in 2010 only, the Act temporarily increases the existing $5,000 limit on the deduction for start-up expenditures to $10,000. This deduction is subject to being phased-out to the extent the cumulative start-up expenditures exceed $60,000 (previously, the phase-out threshold was $50,000).

6. **Increased Carryback of General Business Credits of Eligible Small Businesses.**

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Generally, a business' general business credits can be carried back to offset taxes in the previous year, and the remaining amount can be carried forward for a period of 20 years. Under the Act, for the first tax year of a taxpayer beginning in 2010, an eligible small business can carry its general business credits back for five years. An eligible small business is (a) one of (i) a nonpublicly traded corporation; (ii) a partnership; or (iii) a sole proprietorship that (b) has average annual gross receipts for the three-tax-year period preceding the tax year of no more than $50 million.

7. **Temporary Deduction for Health Insurance Costs for Purposes of Calculating Self-Employment Tax.** Pursuant to the Act, for a taxpayer's first tax year beginning after December 31, 2009, the income tax deduction allowed to self-employed taxpayers for the cost of health insurance for (i) themselves; (ii) their spouses; (iii) dependents; and (iv) effective March 30, 2010, children who have not attained the age of 27 is now also allowed in determining net earnings from self-employment for purposes of calculating the self-employment tax.

Revenue Raisers:

1. **Information Reporting Required for Rental Property Expense Payments.** Effective for payments made after December 31, 2010 the Act requires a taxpayer who receives rental income from real property to file information returns (i.e., typically Form 1099-MISC) with the IRS necessary to report all payments of $600 or more made to service providers (i.e., painters, plumbers, accountants, etc.) for rental property expenses. Exceptions are provided for taxpayers who rent their principal residence and for those taxpayers whose rental income does not exceed an IRS determined minimal amount (such amount to be specified in Treasury regulations).

2. **Increased Information Return Penalties.** The Act increases the applicable penalties associated with the failure to file information returns (such as a Form 1099), and also increases the applicable calendar year limitations.

3. **Rollovers of Deferral Plans to Roth Accounts.** Effective September 27, 2010 the Act allows participants in 401(k), 403(b) and governmental 457(b) plans to roll their pre-tax account balances into a designated Roth account. The amount of

the rollover will be includible in taxable income (except with respect to after-tax contributions). For rollovers made in 2010, the participant can elect to pay the tax in 2011 and 2012.

4. **New Rules for Sourcing Certain Guarantee Fees.** Prior to the Act, courts have treated guarantee fees paid to a foreign entity as analogous to payments for services when the entity had no primary obligation to make payments on the underlying guaranteed debt. In such instances, the guarantee payments would often be foreign sourced and avoid US withholding tax. Pursuant to the Act, designed to legislatively overrule the prior court decisions, amounts received for guarantees of indebtedness of a US payor issued after September 27, 2010 are sourced in the United States. As a result, such amounts paid by a US taxpayer to a foreign person will generally be subject to US withholding tax (subject to any applicable provision of an Income Tax Treaty to the extent it affects the US withholding tax on some basis other than the sourcing of the fee).

What the Future Holds

In addition to the Act, Congress has had other tax legislation under active consideration this year. This legislation includes the possible extension of some or all of the 2001 and 2003 income tax reductions and certain other taxpayer-friendly provisions, which will otherwise expire at the end of this year, and revisions to the federal estate and gift tax provisions, which, if no action is taken, will revert to a $1 million federal estate tax exemption, equal to the current gift tax exemption, and a maximum gift and estate tax rate of 55 percent. It is anticipated that much of this pending legislation will be considered in the "lame duck" session of Congress that will follow the November elections, although it is, of course, impossible to predict at present what will be included in any legislation that eventually may be enacted. We continue to monitor further developments and will issue further Alerts as appropriate. In the interim, in light of the possible significant increases in the federal income and transfer tax rates next year, end-of-year transactions, which take advantage of these lower current rates, may be appropriate for certain taxpayers.

If you would like more information concerning these planning opportunities, please call either your principal contact at Squire Sanders or any of the lawyers listed on this Alert.

The contents of this update are not intended to serve as legal advice related to individual situations or as legal opinions concerning such situations. Counsel should be consulted for legal planning and advice.

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