Tax Provisions of the Small Business Jobs Act of 2010: Stimulating Investment and Entrepreneurship with US$12 Billion in Tax Incentives Paid for by Corresponding Revenue Raisers

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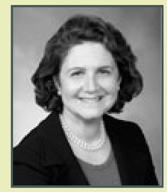

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On September 27, 2010, President Obama signed into law the Small Business Jobs Act of 2010 (HR 5297) (Act). The tax provisions of the Act are expected to generate US$12 billion in tax incentives over the next 10 years and are intended to create jobs by stimulating investment in small businesses and providing support for their development and growth.

The Act includes provisions which extend the bonus depreciation available to all businesses regardless of their size for one year, increase the expensing limitations under Code Section 179 for 2010 and 2011, limit penalties assessed for failure to disclose information regarding reportable transactions retroactive to 2007, provide for exclusion of gain on disposition of qualified business stock after date of enactment and before 2011, and increase start-up deductions for 2010.

These tax incentives are expected to be paid for by a number of revenue generating provisions, which focus on reducing the so-called "tax gap" (essentially, the difference between the total tax the Internal Revenue Service (IRS) estimates should be reported and paid by taxpayers and the amounts actually reported and paid through voluntarily reporting or enforcement actions) and closing unintended loopholes. The Act also contains some taxpayer-friendly measures for retirement preparation.

This Advisory highlights the key tax provisions in the Act.

Incentives Package

The Act introduces a number of incentives, which address various aspects of the business enterprise.

The key features of those incentives are summarized below. In addition, the Act authorizes a one-time US$5.2 billion appropriation to the US Trade Representative to develop market access opportunities for small- and medium-sized US businesses and to enforce trade agreements to which the United States is a party. In its efforts, the US Trade Representative is to focus on those initiatives that will have the greatest positive impact on the US job market and economy.

Taxpayers should be aware that most of the incentive measures are temporary, with some applicable only during 2010.

Encouraging Investment

First-year bonus depreciation under Code Section 168 extended for property placed in service in 2010 (and 2011 for certain property). The American Recovery and Reinvestment Act of 2009 (Pub. L. No. 111-5) (2009 Act) made it possible for businesses to deduct 50 percent of their basis in "qualified property" placed in service in 2008 and 2009 (2010 for certain property) and the Act extends this bonus depreciation for property placed in service in 2010 (and 2011 for certain property). "Qualified property" generally includes (i) property with a MACRS recovery period of 20 years or fewer; (ii) water utility property; (iii) specified computer software; and (iv) qualified leasehold improvement property. With US$5.4 billion in tax relief over the 10-year period from 2011 to 2020, according to a Joint Committee on Taxation (JCT) report issued on September 16, 2010, this measure is expected to provide the most tax relief to taxpayers.

Special rule for long-term contract accounting introduced for assets placed in service in 2010 and later. The Act decouples bonus depreciation under Code Section 168 from allocation of contract costs under the percentage of completion accounting method, but only with respect to assets with a depreciable life of seven or fewer years. This provision allows contractors who take in excess of one year to complete their contracts to take advantage of bonus depreciation without accelerating income. JCT expects this provision to be revenue neutral over the next 10 years.

Expensing under Code Section 179 expanded for tax years beginning during 2010 and 2011. To facilitate the recovery of costs associated with capital expenditures—principally machinery, equipment, certain tangible personal property and business vehicles, computers, certain software, and office fixtures—the Act increases (i) the maximum amount that a business can expense from US$250,000 to US$500,000; and (ii) the ceiling at which this write-off begins to phase out from US$800,000 to US$2 million. Separately, the Act expands the definition of property the cost of which can be expensed to include certain real property, but limits the maximum write-off on such property to US$250,000 (in the aggregate) and restricts the ability to carry over any excess write-off from one tax year to the next. JCT estimates that these provisions will generate US$2.2 billion in tax relief over the next 10 years.

Providing Access to Capital

Exclusion of gain on dispositions of "qualified small business stock" (QSBS) acquired after date of enactment and before January 1, 2011 increased to 100 percent. Code Section 1202 allows certain noncorporate investors to exclude from their taxable income up to 50 percent of the gain they realize on the sale of QSBS. Very generally, QSBS is stock of a C corporation with no more than US$50 million of gross assets where at least 80 percent of the value of those assets is used in the active conduct of one or more qualified trades or businesses. The 2009 Act temporarily increased this exclusion—from 50 to 75 percent—for QSBS acquired after February 17, 2009 and before January 1, 2011, and held for more than five years. The Act further increases the exclusion to 100 percent. JCT estimates that this provision will generate US$518 million in tax relief over the next 10 years.

Five-year carryback of general business credits of eligible small businesses and use of those credits to offset alternative minimum tax permitted in the first tax year beginning after 2009. The Act allows eligible small businesses (non-publicly traded corporations, partnerships, and sole proprietorships with average annual gross receipts for the prior three tax years of US$50 million or less) to carry eligible small business credits (ESBCs) back five years. JCT estimates that this provision will generate US$107 million in tax relief over the next 10 years.

In a related measure, the Act now allows ESBCs to be used to offset alternative minimum tax liability (in addition to regular tax liability). JCT estimates that this measure will generate US$977 million in tax relief over the next 10 years.

Reduction of S corporation holding period for built-in gains extended one year. A C corporation that converts to an S corporation must hold appreciated assets for 10 years following conversion before disposing of those assets; otherwise, it will pay tax (currently, at 35 percent rate) on the associated built-in gains. The 2009 Act reduced the relevant holding period to seven years for dispositions taking place in tax years beginning in 2009 and 2010. To further facilitate the ability of converted S corporations to streamline their operations, raise capital and increase growth prospects, the Act further shortens the holding period to five years if the fifth year in the holding period precedes a tax year beginning in 2011. JCT estimates that this provision will generate US$70 million in tax relief over the next 10 years.

Promoting Entrepreneurship

Amount allowed as a deduction for start-up expenditures increased for 2010. The Act increases the amount of qualified trade or business expenses that may be deducted from US$5,000 to US$10,000. It also increases the deduction phaseout threshold from US$50,000 to US$60,000. JCT projects estimates that this provision will generate US$230 million in tax relief over the next 10 years.

Promoting Small Business Competitiveness (Fairness)

Deduction of health insurance costs in computing self-employment taxes allowed for tax years beginning in 2010. A self-employed individual is entitled to deduct health insurance costs paid for him/herself and his/her immediate family for income tax purposes. The Act allows those individuals to deduct these costs for self-employment tax purposes as well. JCT estimates that this provision will generate US$1.9 billion in tax relief over the next 10 years.

Cellular telephones and similar telecommunications equipment are not "listed property" for tax years beginning after December 31, 2009. Prior to the Act, cellular telephones and similar telecommunication equipment was "listed property," the cost of which could only be deducted by businesses if they complies with stringent record-keeping requirements. By removing these devices from the "listed property" classification, the Act facilitates businesses' ability to claim depreciation deductions. JCT estimates that this provision will generate US$410 million in tax relief over the next 10 years.

Penalties for failure to disclose reportable transactions based on resulting tax benefits limited for penalties assessed in 2007 and later. Under current law, taxpayers that do not disclose their participation in certain tax shelter transactions are subject to onerous penalties, often out of line with the tax benefits of such transactions. In response, the Act sets the penalties at 75 percent of the decrease in tax generated by the tax shelter transaction. The penalties are subject to floors (US$5,000 for individual taxpayers and US$10,000 for all others regardless of the type of transaction) and caps (dependent on the type of taxpayer and transaction, with a ceiling of US$200,000 for non-individual taxpayers failing to disclose listed transactions). JCT estimates that this provision will generate US$176 million in tax relief over the next 10 years.

Revenue Raisers

In order to offset the tax relief generated by the new incentives, the Act introduces a number of revenue raisers, ranging from taxpayer-friendly retirement provisions to measures intended to close loopholes and reduce the tax gap.

Promoting Retirement Preparation

Rollovers from elective deferral plans to designated Roth accounts allowed after date of enactment. In certain circumstances, the Act permits individuals to convert their pre-tax balances in employer-sponsored retirement plans (such as Code Section 401(k), 403(b) and 457(b) plans) into designated Roth accounts. Contributions to Roth accounts are made on an after-tax basis, but earnings grow tax-free and can be distributed tax-free if certain requirements are satisfied. Although the conversion is taxable, individuals taking advantage of this provision may elect to include the income triggered by the conversion in equal installments over the two succeeding tax years. JCT estimates that this provision will generate US$5.1 billion in tax relief over the next 10 years.

Partial annuitization of certain annuity contracts permitted for amounts received in tax years beginning after December 31, 2010. The Act allows holders of annuity contracts other than tax-qualified retirement plans or individual retirement accounts to bifurcate those contracts into a stream of annuity payments subject to current taxation and a remainder that continues to grow on a tax-deferred basis. JCT estimates that this provision will generate US$956 million in tax revenue over the next 10 years.

Treatment of elective deferrals as Roth contributions by participants in governmental Code Section 457(b) plans allowed for tax years beginning after December 31, 2010. The Act allows participants in state and local government-sponsored Code Section 457(b) plans to treat elective deferrals as contributions to Roth retirement accounts, thus bringing Code Section 457(b) plans in line with Code Section 401(k) and 403(b) plans. This change does not apply to plans sponsored by nonprofit organizations. JCT estimates that this provision will generate US$506 million in tax revenue over the next 10 years.

Closing Unintended Loopholes

Source rules for guarantee fees clarified for guarantees issued after date of enactment. The Act treats as US source income fees received for guaranteeing indebtedness if they are paid by (i) a US person; or (ii) a foreign person if the fees are effectively connected with the foreign person's US trade or business. In determining source according to the characteristics of the payor, the Act treats guarantee fees as interest income and thus legislatively overrules *Container Corp.* v. *Commissioner*, 134 T.C. 5 (2010), in which the US Tax Court held that guarantee fees should be sourced like service income—according to the guarantor's place of performance under the guarantee. JCT estimates that this provision will generate US$2 billion in tax revenue over the next 10 years.

Crude tall oil sold or used in 2010 and later not eligible for cellulosic biofuel producer credit. Generally, qualified producers of cellulosic biofuel are eligible to receive a nonrefundable income tax credit. The Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act excluded "black liquor" from the group of cellulosic biofuels eligible for the credit. The Act goes further and also excludes crude tall oil and other corrosive fuels from the group of cellulosic biofuels eligible for the credit. JCT estimates that this provision will generate US$1.9 billion in tax revenue over the next 10 years.

Reducing the Tax Gap by Increasing Compliance

Information reporting required for rental property expense payments made in 2011 and later. The Act requires persons earning more than a stated amount of real estate rental income to file information reports if they pay US$600 or more in rental property expenses in a given tax year. Active-duty military personnel and members of the intelligence community who temporarily rent out their homes are exempted, as are persons for whom the reporting would pose a hardship (as determined in Treasury regulations). JCT estimates that this provision will generate US$2.5 billion in tax revenue over the next 10 years.

Continuous levies for US federal tax liabilities of certain US federal contractors permitted for levies issued after date of enactment. This provision allows the IRS to issue levies on certain US federal contractors who owe US federal taxes prior to a collection due process hearing. The JCT estimates that this measure will generate US$1.1 billion in tax revenue over the next 10 years.

Penalties related to information returns and payee statements required to be filed on or after January 1, 2011 increased. The Act increases penalties for failing to file correct information returns with the IRS and payees. It doubles the penalties for each occurrence and increases the maximum aggregate annual penalties significantly (for instance, one such maximum penalty is raised from

US$250,000 to US$1.5 million). The Act also puts in place special provisions dealing with intentional failures to file and small filers. JCT estimates that this provision will generate US$421 million in tax revenue over the next 10 years.

We hope that you have found this advisory useful. If you have any questions, please contact your Arnold & Porter attorney or:

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