# Client Alert.

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# Small Business Jobs Act of 2010 - Key Tax Incentive Provisions

**By Stephen L. Feldman, Robert A.N. Cudd, Joy S. MacIntyre and Arthur Man**

On September 27, 2010, President Obama signed into law the Small Business Jobs Act of 2010 (H.R. 5297, the "Act"). The Act includes $12 billion in tax cuts aimed at small businesses, provides incentives to help small businesses grow, and expands lending to small businesses. However, because many of the Act's provisions are (i) temporary changes to the federal tax rules and (ii) aimed at certain taxpayers, many people may find this Act to be of limited use. The revenue raisers in the Act will be the subject of a separate client alert.

Key tax-incentive provisions in the Act include the following:

**Provisions Expanding Small Business Access to Capital**

- *Temporary 100% exclusion of gain on certain small business stock*. In general, non-corporate taxpayers may exclude 50% of the gain from the sale of qualified small business stock ("QSBS") acquired at original issue and held for at least five years.[1] The amount of gain eligible for exclusion with respect to a small business is the greater of (a) 10 times the taxpayer's basis in the QSBS or (b) $10 million. In general, QSBS is stock in a C corporation that conducts an active trade or business and has gross assets not exceeding $50 million at the time the stock is issued. A percentage of the excluded gain is subject to the alternative minimum tax.

  Under the Act, 100% of the gain from a non-corporate taxpayer's sale of QSBS acquired after the date of the Act's enactment and before January 1, 2011 that is held for five years is excluded from taxable income, and none of such gain is subject to the alternative minimum tax. The very limited window for application of this exclusion will likely limit its value as a meaningful incentive.

- *Temporary reduction in recognition period for S corporation built-in gains tax*. In general, a C corporation that converts to an S corporation must pay tax, currently at a 35% rate, on gain that arose prior to the conversion to an S corporation and that is recognized by the S corporation during the first 10 tax years in which its S corporation election is in effect (the "recognition period").[2] For taxable years beginning in 2009 and 2010, the recognition period is shortened to seven years from 10 years. Accordingly, with respect to gain that arose prior to the conversion of a C corporation to an S corporation, for taxable years beginning in 2009 and 2010, no tax is imposed under Code Section 1374 after the seventh taxable year the S corporation election is in effect. This built-in gains tax also applies to gains with respect to net recognized built-in gain attributable to property an S corporation receives from a C corporation in a carryover basis transaction.[3] The recognition period in such cases is the date the asset was acquired by the S corporation, rather than the first taxable year that the S corporation election is in effect.

  Under the Act, for taxable years beginning in 2011, the recognition period is decreased from 10 years (or seven years) to five years, beginning with the first day of the first taxable year for which the S corporation election is in effect.

[1] Section 1202 of the Internal Revenue Code of 1986, as amended (the "Code"). The 50% exclusion is increased to 60% for certain empowerment zone businesses. For QSBS acquired after February 17, 2009 and before January 1, 2011, the percentage exclusion is increased from 50% to 75%.
[2] Code Section 1374.
[3] Code Section 1374(d).

 

Thus, solely in the case of any tax year beginning in 2011, if the fifth year of the recognition period preceded that tax year, the new provision will apply to prevent the application of the built-in gains tax to a sale of property during that tax year. This provision of the Act is effective for taxable years beginning after December 31, 2010. Given its very limited window of application, this provision does not provide planning opportunities for corporations considering converting, or that have recently converted, to S corporation status. Instead, the provision could prove a significant benefit for corporations contemplating a sale during 2011 of assets that will already have been held for more than five years after their S election became effective.

- *Five-year carryback of eligible small business' general business credit*. A taxpayer's general business tax credit (the sum of various business credits) for a taxable year is generally limited to the excess of the taxpayer's net income tax over the greater of (a) the taxpayer's tentative minimum tax or (b) 25% of the excess of the taxpayer's net regular tax liability over $25,000.[4] General business tax credits in excess of this limitation may be carried back one year and forward up to 20 years.[5]

  Under the Act, the general business tax credits of an eligible small business may be carried back five years, instead of just one year. For this purpose, an eligible small business is a non-publicly traded corporation or partnership that has average annual gross receipts for the three taxable years prior to the current taxable year of $50 million or less. This provision is effective for credits determined in the taxpayer's first taxable year beginning after December 31, 2009.

- *General business credit of eligible small business not subject to alternative minimum tax*. As mentioned, a taxpayer's general business tax credit (the sum of various business credits) for a taxable year is generally limited to the excess of the taxpayer's net income tax over the greater of (a) the taxpayer's tentative minimum tax or (b) 25% of the excess of the taxpayer's net regular tax liability over $25,000.[6] A taxpayer's tentative minimum tax is an amount equal to specified tax rates imposed on the excess of the taxpayer's alternative minimum taxable income over an exemption amount.[7] In applying the tax liability limitation for purposes of the general business credit limitation, tentative minimum tax is treated as being zero for certain specified credits.[8]

  The Act provides that the tentative minimum tax is treated as being zero for eligible small business credits. For this purpose, an eligible small business is a non-publicly traded corporation or partnership that has average annual gross receipts for the three taxable years prior to the current taxable year of $50 million or less. Accordingly, an eligible small business credit may offset both a taxpayer's regular tax and alternative minimum tax liabilities. This provision of the Act is effective for credits determined in a taxpayer's first year beginning after December 31, 2009.

**Provisions Encouraging Small Business Investment & Growth**

- *Increased and expanded expensing of certain depreciable business assets*. Under Code Section 179, a taxpayer may elect to deduct (or "expense") the cost of "qualifying property" rather than recover such costs through depreciation deductions. In general, "qualifying property" is defined as depreciable tangible personal property that is purchased or used in the active conduct of a trade or business. For taxable years beginning after 2007 and before 2011, the maximum amount a taxpayer may elect to deduct under Code Section 179 is $250,000 of the cost of qualifying property placed in service for the taxable year. The maximum amount for all other taxable years is $25,000. For taxable years beginning after 2007 and before 2011, this $250,000 maximum amount is reduced by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $800,000 ($200,000 for all other taxable years). In addition, the amount that may be expensed under Code Section 179 for a taxable year may not exceed the taxable income for such taxable year that is derived from the active conduct of a trade or business, with the excess being carried forward to succeeding taxable years.

[4] Code Section 38(c).
[5] Code Section 39.
[6] Code Section 38(c).
[7] Code Section 55(b).
[8] *See* Code Section 38(c).

Under the Act, the maximum amount a taxpayer may expense under Code Section 179, for taxable years beginning after 2009 and before 2012, is increased to $500,000 of the cost of qualifying property placed in service for the taxable year. The $500,000 amount is reduced by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $2,000,000. The Act also temporarily expands the definition of qualified property for Code Section 179 purposes to include certain real property (i.e., qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property). The maximum amount with respect to real property that may be expensed is $250,000. This provision of the Act is effective for taxable years beginning after December 31, 2009. However, as mentioned above, this increased amount for Code Section 179 expenses applies only for taxable years beginning after 2009 and before 2012.

- *Extension of additional first-year depreciation allowance*. For "qualified property" placed in service during 2008 and 2009 (2009 and 2010 for certain longer-lived and transportation property), taxpayers are allowed an additional first-year depreciation deduction equal to 50% of the adjusted basis of such qualified property.[9] Depreciation deductions for subsequent taxable years (and the basis of the qualified property) are adjusted to reflect this additional first-year depreciation deduction. To be "qualified property" for these purposes, the property must be (i) property to which MACRS applies with an applicable recovery period of 20 years or less, (ii) water utility property (as defined in Code Section 168(e)(5)), (iii) computer software other than computer software covered by Code Section 197, or (iv) qualified leasehold improvement property (as defined in Code Section 168(k)(3)). In addition, the "original use" of the property must commence with the taxpayer after December 31, 2007,[10] the taxpayer must purchase the property within a statutorily defined time period (generally, between December 31, 2007 and January 1, 2010) and the property must be placed in service after December 31, 2007 and before January 1, 2010.[11]

  The Act extends the additional first-year depreciation deduction for one year so that it also applies to qualified property acquired and placed in service during 2010 (or placed in service during 2011 for certain longer-lived and transportation property). This part of the Act applies to property placed in service in taxable years ending after December 31, 2009.

- *Bonus depreciation disregarded in computing percentage completion*. In general, the percentage-of-completion method is used to determine taxable income from a long-term contract.[12] Under the percentage-of-completion method, percentage completion is determined by comparing costs allocated to the contract and incurred before the end of the taxable year with the estimated total contract costs.

  Under the Act, solely for purposes of determining the percentage of completion under the percentage-of-completion method, the cost of qualified property is taken into account as a cost allocated to the contract as if the additional first-year depreciation deduction did not exist. This part of the Act is effective for property placed in service after December 31, 2009.

**Provisions Promoting Entrepreneurship**

- *Start-up expenditures deduction amount increased*. In general, a taxpayer may elect to deduct up to $5,000 of start-up expenditures in the taxable year in which the taxpayer's active trade or business begins.[13] This $5,000 amount is reduced by the amount by which the cumulative cost of start-up expenditures exceeds $50,000. Start-up expenditures generally include amounts that otherwise would have been deductible as trade or business expenses had they not been paid or incurred prior to business commencing. Start-up expenditures include costs paid or incurred in connection with (a) investigating the creation or acquisition of an active trade or business, (b) creating an

[9] Code Section 168(k).
[10] "Original use" means the first use to which the property is put, regardless of whether or not such use corresponds to the use of such property by the taxpayer.
[11] The placed-in-service date is extended by one year to January 1, 2011 for certain property with a recovery period of 10 years or longer and certain transportation property.
[12] Code Section 460(a).
[13] Code Section 195.

active trade or business, or (c) certain activity engaged in for profit and for the production of income before the day on which the active trade or business begins.

The Act increases the amount of start-up expenditures a taxpayer may elect to deduct from $5,000 to $10,000 and increases the deduction phase-out threshold so that this $10,000 is reduced by the amount by which the cumulative cost of start-up expenditures exceeds $60,000. This part of the Act is effective for taxable years beginning after December 31, 2009.

- *Authorization of appropriations to the Office of the U.S. Trade Representative*. Authorization for funding for the Office of the U.S. Trade Representative ("USTR") expired in 2004.

  The Act authorizes appropriations in the amount of $5,230,000 for USTR to (a) analyze and develop opportunities for U.S. businesses to access foreign markets, and (b) enforce trade agreements to which the United States is a party. This part of the Act is effective on the date of the Act's enactment.

**Provisions Promoting Small Business Fairness**

- *Temporary deduction for health insurance costs in computing self-employment income*. Self-employed individuals are taxed on their net earnings from self-employment ("self-employment income") under the Self-Employment Contributions Act ("SECA"). For purposes of the SECA tax, self-employment income is computed without regard to the deduction allowable for the cost of health insurance for the self-employed individual, the individual's spouse, dependents, and certain children.

  Under the Act, the deduction allowable for the cost of health insurance for the self-employed individual, the individual's spouse, dependents, and certain children is now taken into account in determining self-employment income for purposes of calculating the SECA tax. This part of the Act applies for the taxpayer's first taxable year beginning after December 31, 2009.

- *Penalty for failure to disclose certain information limited*. Taxpayers are subject to special reporting requirements to the extent they participate in "reportable transactions" (which, in general, are transactions that the government has determined to have a potential for tax avoidance or tax evasion).[14] Penalties are imposed for failure to comply with these reporting requirements.[15] For listed transactions (a type of "reportable transaction" that is the same as, or substantially similar to, a transaction specifically identified by the Treasury Department as a tax avoidance transaction), the penalty is $100,000 for individuals and $200,000 for all other persons. For reportable transactions other than listed transactions, the penalty is $10,000 for individuals and $50,000 for all other persons.

  The Act changes the penalty for failure to properly report reportable transactions. Under the Act, a taxpayer who participates in a reportable transaction and who fails to properly report it is subject to a penalty equal to 75% of the reduction in tax reported on the taxpayer's income tax return as a result of the participation in the reportable transaction, or that would result if the transaction were respected for federal tax purposes. Such penalty is subject to minimum amount and maximum amount limitations. For listed transactions, the maximum penalty is $100,000 for individuals and $200,000 for all other persons. For reportable transactions other than listed transactions, the maximum penalty is $10,000 for individuals and $50,000 for all other persons. The minimum penalty for failure to properly report any reportable transaction (including listed transactions) is $5,000 for individuals and $10,000 for all other persons. This part of the Act applies to all penalties assessed under Code Section 6707A after December 31, 2006.

- *Cellular phones and similar telecommunications equipment removed from definition of listed property*. In general, in respect of property used in a trade or business, taxpayers may claim depreciation deductions under the applicable

[14] Treasury regulations 1.6011-4.
[15] *See* Code Section 6707A.

 

cost recovery rules only for that portion of the cost of the property that is attributable to use in a trade or business.[16] However, for “listed property” no deduction is allowed unless the taxpayer adequately substantiates the expense and business usage of the property.[17] Listed property is defined as (a) any passenger automobile and any other property used as a means of transportation, (b) any property of a type generally used for purposes of entertainment, recreation, or amusement, (c) any computer or peripheral equipment, (d) any cellular telephone (or other similar telecommunications equipment), and (e) any other type of property as specified in Treasury regulations. In addition, special depreciation rules apply to listed property.

Under the Act, cellular phones and other similar telecommunications equipment are removed from the definition of listed property. Accordingly, the heightened substantiation requirements and special depreciation rules applicable to listed property do not apply to cellular phones and other similar telecommunications equipment. This part of the Act is effective for taxable years ending after December 31, 2009.

For questions or comments, you may contact Stephen L. Feldman, Robert A.N. Cudd, Joy S. MacIntyre or Arthur Man of the Federal Tax Department.

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[16] Code Section 162.
[17] Code Section 274(d).

 