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The Small Business Jobs Act of 2010 - Tax Changes and Incentives to Small Businesses ***by Brad Hamilton***

This is Part 2 of 2 articles on the Small Business Jobs Act of 2010. This article summarizes the tax changes and incentives, and Part 1 summarizes the loan incentives and benefits of the Jobs Act.

On September 27, 2010 President Obama signed into law the Small Business Jobs Act of 2010, P.L. 111-240 (the "Jobs Act"). The Act, attempting to ease credit lending, has $12 billion in tax cuts, including

- extension and expansion of the SBA Recovery Loan program,
- increase in asset expensing, and
- a continuation of bonus depreciation.

Some of the most important tax breaks and incentives for small businesses are summarized below:

Health Insurance Deduction for Self-Employed

The Jobs Act provides that self-employed taxpayers can deduct the cost of health insurance for themselves and their family members in calculating their self-employment taxes. The Act creates a special rule for taxable years beginning in 2010 that allows the deduction under Code §162(l) for health insurance costs of self-employed individuals to be taken into account in determining net earnings from self-employment, for purposes of the tax on self-employment income. This provision is estimated to provide over $1.9 billion in tax cuts for the self-employed.

Temporary End of Capital Gain Tax on Certain Small Business Stock

The Jobs Act allows individuals to exclude 50% (60% for certain empowerment zone businesses) of the gain from the sale of certain small business stock, if it was acquired at original issue and held for at least five years. The percentage exclusion for qualified small business stock acquired after February 17, 2009, and before January 1, 2011, **is increased to 75%**. But for qualified small business stock acquired the rest of this year (after September 27, 2010 and before January 1, 2011), **the percentage exclusion is increased to 100%**. To qualify as a small business, when the stock is issued, the gross assets of the corporation may not exceed $50 million – more than one million businesses in the United States meet this criteria. The business also must meet certain active trade or business requirements.

This means that if you start a new business, or invest in an existing small business, between now and January 1, 2011, and hold the stock for more than 5 years, when you sell your stock you will not have to pay any capital gains on the sale – your profit will not be taxed either as ordinary income or taken into AMT (up to $10 million or 10 times your investment).

- It must be stock of a corporation, not a limited liability company or a partnership,

- You must purchase the stock from the corporation, for cash or property, or for services,
- The corporation has to be an active business; it can't be a holding company,
- Certain businesses are excluded – banking, farming, hotels, mining and resources.

In addition to starting a new corporation, or investing in an existing small business, any of the following type of transactions might benefit from this 100% exclusion if they are done by the end of this year (2010):

- Exercising a stock option, warrant, convertible note or other convertible security
- Granting stock or warrants for compensation
- Converting a partnership or LLC into a corporation
- Converting debt to stock

Before implementing any of these transactions, work with your lawyer and tax accountant – these are complex tax code provisions.

Expensing Capital Investments

For 2010 and 2011 small businesses can immediately write off $500,000 in capital investments (reduced by the amount of the cost above $2 million). For taxable years beginning after 2011, the amount is $25,000, with a phase out reduced by the amount of the cost above $200,000.

The Jobs Act provides an election, available for tax years beginning in 2010 or 2011, to treat (1) qualified restaurant property, (2) qualified retail improvement property, and (3) qualified leasehold improvement property, as IRS Code §179 property that may be expensed in the year it is purchased, instead of depreciated over a period of years.

The cost of qualified real property that may be expensed is limited to $250,000 per year, and excess amounts would not be carried over to tax years beginning after 2011. According to the Senate Finance Committee, § 179 expensing makes it cheaper for small businesses to invest in new equipment because expensing in the current year decreases the net cost to the business compared to long-term depreciations.

Extension of 50% Bonus Depreciation to Encourage Capital Investment

The Jobs Act extends the Recovery Act's 50% "bonus depreciation" benefit through 2010, allowing small businesses to continue accelerating the rate at which they deduct capital expenditures. Specifically, the Act extends for one year the IRS Code §168(k) special allowance of first-year depreciation equal to 50% of the adjusted basis of qualified property to include qualified property acquired before January 1, 2011, or acquired pursuant to a written binding contract which was entered into after December 31, 2007, and before January 1, 2011. Qualified property would have to be placed in service before January 1, 2011 (before January 1, 2012 for certain property).

Cell Phone Deductions Made Easier

The Jobs Act changes rules for cell phones and similar telecommunications equipment so that they can be deducted without burdensome extra documentation – by removing this communications equipment from the definition of listed property, the heightened substantiation requirements and special depreciation rules that apply to listed property no longer apply to cell phones.

Increase in the Deduction for Start-Up Expenses

For 2010, entrepreneurs can deduct $10,000 of start-up expenses (but the deduction is reduced by the amount by which the cumulative cost of start-up expenditures exceeds $60,000). This means that the deduction, which was $5,000, is increased to $10,000 for small 2010 start-ups. Unless it is extended, this increased deduction only applies to the 2010 tax year.

Carryback of General Business Credits Extended from One year to 5 Years

Eligible small businesses will be able to carryback eligible small business credits five years, instead of only one year. Only corporations whose stock is not publicly traded, or partnerships, whose average annual gross receipts do not exceed $50 million, are eligible. In the case of a sole proprietorship, the gross receipts test is applied as if it were a corporation. Credits determined with respect to a partnership or S corporation are not treated as eligible small business credits by a partner or shareholder unless the partner or shareholder meets the gross receipts test for the taxable year in which the credits are treated as current year business credits. This credit carryback allows the small business owner to use the credit to offset both regular and alternative minimum tax liability.

Makes it Easier for a Corporation to Convert from a C Corporation to an S Corporation by Providing "Built-in Gain" Relief

A "small business corporation" (as defined in IRS Code §1361(b)) may elect to be treated as an S corporation. Unlike C corporations, S corporations generally pay no corporate-level tax. Instead, income and loss of an S corporation is passed-through to its shareholders to report on their individual tax returns.

It is difficult to convert a C corporation to an S corporation because after the conversion, corporate level tax, at the highest marginal rate applicable to corporations (currently 35%) is imposed on an S corporation's gain that arose prior to the conversion, and is recognized by the S corporation for 10-years after the conversion. In other words, if the S corporation had property that appreciated in value, and thus has a "gain", for 10-years after converting the corporation will pay taxes on that gain (if it sells the property) as though it was a C corporation.

The built-in gains tax also applies to net recognized built-in gain attributable to property received by an S corporation from a C corporation in a carryover basis transaction. For these built-in gains, the capture period begins when the asset was acquired by the S corporation instead of the first tax year of conversion to an S corporation.

Gains recognized in the recognition period are not built-in gains if they are shown to have arisen while the S election was in effect or are offset by recognized built-in losses. The amount of the built-in gains tax is treated as a loss taken into account by the shareholders in computing their individual income tax.

However, under the Jobs Act for the 2009 and 2010 tax years, the built-in gain capture period is reduced to 7 years. Therefore, for 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 §1374 after the seventh taxable year the S corporation election is in effect.

For taxable years beginning in 2011, the Jobs Act provides that for purposes of computing the built-in gains tax, the "recognition period" is 5 years beginning with the tax year of the conversion to an S corporation.

The Small Business Jobs Act also

- Limits the penalty on small businesses for errors in tax reporting, changing the penalty from a fixed dollar amount to a percentage of the tax reduction achieved by the error, with a minimum ($5,000 individual, $10,000 business) and maximum penalty ($100,000./ $200,000),

- Changes the information reporting requirements for rental property expense payments,

- Increases the information reporting penalties, and

- For large corporations (with assets of at least $1 billion) increases the required estimated tax payments by 36 percentage points.

For help in understanding how the tax benefits provided by the Small Business Jobs Act of 2010 apply to your business or investments, contact your lawyer or tax accountant.

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