Tax Law
ALERT
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Small Business Jobs Act of 2010 Contains Important Tax Provisions – Year End Estate and Gift Tax Planning

H.R. 5297, the Small Business Jobs Act of 2010 ("Act"), was signed into law by President Obama on September 27, 2010. The Act contains significant tax provisions in addition to other provisions intended to stimulate investment in small business and facilitate the access of small business owners to capital. This Client Alert will briefly summarize those tax provisions that we believe will be of most interest to our clients. For more information about these, or other provisions of the Act, please feel free to contact a member of our group.

100% Exclusion of Small Business Capital Gains

The Internal Revenue Code has contained a provision that allows individual taxpayers to exclude 50% of the gain they realize from the sale of qualifying small business stock. The 50% exclusion was increased to 75% for small business stock acquired between February 18, 2009 and December 31, 2010. The Act further increases the exclusion to 100% for qualifying small business stock acquired between September 28 and December 31, 2010. The Act also eliminates the full amount of the excluded gains as a tax preference item for the alternative minimum tax on stock acquired during this period.

To qualify, the stock must be held for more than five years. A qualifying small business is a C corporation with gross assets not in excess of $50,000,000 and engaged in the active conduct of a trade or business. You must acquire your stock at its original issuance by the corporation. The maximum amount of gain that can be excluded under the provision is the greater of 10 times your tax basis of the stock or $10 Million.

Expanded Carryback and AMT Relief Available to Small Businesses for General Business Credits

General business tax credits are normally permitted to reduce a taxpayer's liability for the regular income tax but not for the alternative minimum tax. If a taxpayer has credits available in excess of the amount that can be used, the excess can be carried back for one year and forward for 20 years. For small businesses, for tax years beginning in 2010 only, the Act expands the carry back period to five years and permits the general business credits to offset the alternative minimum tax as well as the regular income tax. General business credits include almost all of the tax credits that are related to business including investment credits, work opportunity credits, research credits, low income housing credits, and others.

A small business is a corporation that is not publicly traded, a partnership or a proprietorship having average annual gross receipts for the three prior years of not more than $50 Million.

S Corporation Built-In Gain Holding Period Temporarily Reduced

If a C corporation elects to be treated as an S Corporation, any gain built into its assets at the time of conversion is subject to corporate level income taxes if those assets are disposed of within 10 years. For 2009 and 2010, the 10 year period is reduced to seven years if the seventh post-conversion year preceded such year. For example, assume a C corporation converted to an S corporation on January 1, 2003. On December 31, 2009 there would be seven full post-conversion

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years, so if the S corporation sold its assets during 2010, there would be no corporate level tax on its built-in gains.

Under the Act, the built-in gain recognition period is further reduced to five years for taxable years beginning during 2011. If a C corporation converted to an S Corporation on January 1, 2006, its fifth post-conversion year would end on December 31, 2010 and the corporation could sell its assets during 2011 without recognizing corporate level gain. After 2011, the recognition period for built-in gains will go back up to 10 years unless additional legislation is enacted.

Temporary Increase to Amount of Depreciable Property That Can be Expensed

The Internal Revenue Code has long permitted business taxpayers to deduct the cost of depreciable property of up to $25,000 per year. This limit was increased to $250,000 per year for taxable years 2008 through 2010. The ability to claim this deduction is phased out if the taxpayer's investment in qualifying property exceeds $800,000.

Under the Act, for taxable years beginning in 2010 and 2011, the deduction limit is increased to $500,000 and not phased out until the taxpayer acquires more than $2,000,000 of qualifying property. Also, for the first time, the expensing provision applies to certain types of real property, including qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property. The limit with respect to any of these types of real property is $250,000 rather than $500,000.

Extension of Additional First Year Depreciation

Taxpayers who acquired certain types of new depreciable property in 2008 and 2009 were permitted additional depreciation deductions in the year the property was purchased in an amount equal to 50% of the cost of the property. Eligible property included property with a depreciation life of not more than 20 years, certain computer software and qualified leasehold improvement property. The Act extends these provisions for one additional year through December 31, 2010, so otherwise qualifying property purchased and placed in service during 2010 will qualify for the additional 50% of cost depreciation deduction. The other 50% of the property's cost is depreciated over the normal depreciation life.

Amount of Deductible Start-Up Expenses Increased for 2010

The expenses incurred in starting a new business may be deducted, but only up to the first $5,000 of such expenses. Expenses in excess of that amount must be capitalized and recovered through amortization deductions over 15 years. The deductible amount is phased out if the start-up expenses exceed $50,000. For expenses incurred during 2010 in starting a new business, the deduction limit is increased from $5,000 to $10,000. The threshold at which the deduction phase-out begins is increased from $50,000 to $60,000.

Deduction of Cost of Health Insurance in Computing Self-Employment Tax

Self-employed taxpayers are permitted a deduction in computing their adjusted gross income for the cost of obtaining health insurance for themselves, their spouses and children who have not attained the age of 27 by the end of the taxable year. Self-employed individuals, including partners in partnerships, also pay "self-employment tax" which is essentially equivalent to the FICA taxes withheld from the salary of employees. However, in the case of self-employment taxes, the individual effectively pays both the employer and employee share of the taxes. The ability to claim a deduction alleviates a part of this additional cost. For 2010, the rate is 12.4% of the first $106,800 of net earnings from self-employment for the old age, survivors and disability insurance and 2.9% of all net earnings from self-employment for the Medicare hospital insurance tax. The cost of health insurance is not permitted as a deduction for purposes of computing net earnings from self-employment.

For the tax year 2010 only, a self-employed individual may deduct the cost of health insurance for his family in computing his net earnings from self-employment for purposes of determining his self-employment tax as well as his income tax.

Information Reporting Required for Certain Expenses in Connection with Rental Property

In order to be revenue neutral, the Act needed to contain provisions designed to increase revenue, since the provisions described above (and a few others) will all reduce the tax revenue flowing to the government. One of the revenue raisers is a new reporting rule that is likely to apply to numerous individuals. Taxpayers who are engaged in a "trade or business" are required to report payments they make to

others for goods and services if payments to the provider are $600 or more during the tax year. These payments are reported using one of the 1099 forms. Until now, these reporting requirements have not been applicable to investors who owned rental real estate, because these investors were not considered to be engaged in a trade or business.

Under the Act, recipients of rental income from rental real estate will be required to provide forms 1099 to providers of goods and services even though the recipient of the rental income is not considered to be engaged in a trade or business. This would include payments to a variety of service people such as plumbers, painters, electricians and gardeners who you pay $600 or more during the year. There is to be an exception for individuals who receive only minimal amounts of rent as provided in regulations. There is also an exception for members of the military or foreign intelligence service who rent their principal residence on a temporary basis. These new reporting rules apply starting in 2011.

Allow Roth Rollovers from Certain Elective Deferral Plans

Another way the government can raise revenue is by expanding the circumstances under which a taxpayer can roll tax deferred retirement funds into a Roth retirement account. When a taxpayer makes such a rollover, he must pay tax currently on the amount transferred (less any after-tax amounts he contributed to the account) but then subsequent earnings on the account and future withdrawals from the account are not taxed. Roth conversions raise revenue for the government now but will reduce revenue in future years.

The Act added a provision to the Roth account rules which permits amounts in 401k plans to be rolled over to the plan's Roth account, provided the plan has a Roth feature. The rollover must be in accordance with the plan's distribution provisions, however a plan may be amended to permit in service or pre-retirement rollovers. The amendment may limit pre-retirement distributions to those that are rolled over to the plan's Roth account. For rollovers made during 2010, the amount rolled over is subject to tax in equal parts in 2011 and 2012.

No Provisions Affecting GRATS Contained in Act

The Act does not contain the anticipated provision that would require a 10 year minimum term for grantor retained annuity trusts ("GRATS"). This provision has come up several times, most recently in H.R. 5982, the Small Business Tax Relief Act of 2010, which failed in a vote in the House of Representatives on July 30, 2010. This provision is still a part of the President's 2011 Budget Proposal, so it is likely to resurface.

Year-End Estate and Gift Tax Planning

It is now unlikely that legislation will be enacted in 2010 that changes the current estate, gift, and generation-skipping transfer tax picture. For 2010, the gift tax rate is 35%, the lowest rate since 1934, the lifetime gift tax exemption is $1,000,000, and the estate tax and generation-skipping transfer tax are not in effect. In addition, the so-called "7520 rate" applicable to GRATs remains low (i.e., the October 7520 rate is 2.0%), and the Applicable Federal Rate ("AFR") schedule is also low (the October AFRs for short term, mid-term, and long-term loans with interest compounded annually are .41%, 1.73%, and 3.32%, respectively). As a result, there are important and time sensitive estate and tax planning strategies available during 2010 that will end when the currently scheduled tax law changes take effect on January 1, 2011. At that time, barring changes in the tax law, the estate tax, gift tax, and generation-skipping transfer tax will be reinstated at a rate of 55%, the estate and gift tax exemptions will be $1,000,000, and the generation-skipping transfer tax exemption will be approximately $1,300,000. Taxable gifts, especially direct skip gifts to grandchildren and more remote descendants, net gifts, GRATs, and low interest loans to children and more remote descendants are among the estate and tax planning strategies that can be especially effective during the balance of 2010.

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