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CLIENT ALERT

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Tax Provisions of the 2010 Small Business Jobs Act Impacting Corporations

On September 27, 2010, President Obama signed into law the 2010 Small Business Jobs Act (the "2010 SB Act"). The 2010 SB Act includes various tax breaks aimed at small business and a broad array of revenue-raising provisions. A brief summary of the provisions of the 2010 SB Act potentially impacting C corporations and S corporations follows.

1. Built-in Gains Tax Period for S Corporations Reduced to Five Years for 2011

A C corporation that converts to an S corporation must pay a corporate-level tax on built-in gains that existed as of the date of the S corporation election if those gains are recognized during the 10-year period immediately following the date of the S corporation election. For taxable years beginning in 2009 or 2010, no tax is imposed on the S corporation after the seventh taxable year the S corporation election is in effect.

The 2010 SB Act reduces the recognition period to five years for taxable years beginning in 2011. Former C corporations that elected S corporation status within the last five to nine years and are planning a sale within the next few years may want to consider accelerating that future sale to take advantage of this benefit.

2. Increased Carryback Period and AMT Relief on Eligible Small Business Tax Credits

General business tax credits under Section 38(a) of the Internal Revenue Code of 1986, as amended (the "Code"), otherwise allowed for any tax year are subject to a limitation based on the taxpayer's tax liability for that tax year. Section 38(c) of the Code states that the tax credits allowed under Section 38(a) for any taxable year may not exceed the excess (if any) of the taxpayer's net income tax over the greater of: (a) the taxpayer's tentative minimum tax for the taxable year or (b) 25 percent of the taxpayer's net regular tax liability in excess of $25,000. A taxpayer's net income tax is the sum of the taxpayer's regular tax liability and alternative minimum tax reduced by certain tax credits. A taxpayer's tentative minimum tax is an amount equal to specified rates of tax imposed on the taxpayer's alternative minimum taxable income in excess of an exemption amount. A taxpayer's alternative minimum tax is generally the excess of the taxpayer's tentative minimum tax over the taxpayer's regular tax reduced by the foreign tax credit and certain other amounts. A taxpayer generally can offset its alternative minimum tax liability only with certain general business credits (e.g., empowerment zone employment credits, New York Liberty Zone employment credits). General business tax credits that exceed the $25,000 limitation of Code Section 38(c) may be carried back one year and forward up to 20 years.

The 2010 SB Act provides new benefits for small businesses with tax credits that are "eligible small business credits." Eligible small business credits are the sum of the general business tax credits for that tax year for a business that is an "eligible small business." An eligible small business is defined as a business that (i) is either a corporation, the stock of which is not publicly traded, or a partnership and (ii) which has average annual gross receipts of not more than $50 million for the three taxable years preceding the tax year. For tax years starting in 2010, the 2010 SB Act helps eligible small businesses in two ways. First, the 2010 SB Act extends the carryback period for eligible small business credits from one to five years. Second, the 2010 SB Act provides that the tentative minimum tax is treated as zero with respect to eligible small business credits. Since eligible small business credits can include any general business tax credits that meet the definition of eligible small business credits, this change, effectively, will allow a taxpayer's eligible business credits to offset both that taxpayer's regular tax liability and alternative minimum tax liability. Both of these provisions are effective for taxable years beginning after December 31, 2009.

3. Temporary Exclusion of Gains on Certain Qualified Small Business Stock

Prior to the 2010 SB Act, individuals could exclude from their regular taxable income 50 percent of the gain on the sale or exchange of "qualified small business stock" ("QSBS") held for more than five years. The excluded percentage was increased to 60 percent for certain empowerment zone businesses. In addition, the amount of the gain eligible for exclusion by an individual with respect to any corporation was the greater of (i) ten times the individual's tax basis in the stock or (ii) $10 million. The portion of the gain that was not excluded was subject to a maximum federal income tax rate of 28 percent. To meet the definition of qualified small business stock, the business must be a qualified small business and the stock must be acquired by the taxpayer at its original issue in exchange for money, for other property (not including stock) or as compensation for services provided to the corporation. To qualify as a qualified small business, the entity must be a domestic C corporation with gross assets that do not exceed $50 million. The corporation also must meet certain active trade or business requirements. For alternative minimum tax purposes, a percentage of the excluded gain was treated as a preference item and the portion of the gain included in alternative minimum taxable income was taxed at the alternative minimum tax rate of 28 percent.

The 2010 SB Act increases the exclusion to 100 percent for both regular and alternative minimum tax purposes for QSBS acquired after the enactment date of the 2010 SB Act and before January 1, 2011. Therefore, any taxpayers wanting to take advantage of this measure will need to do so quickly because it will apply only with respect to QSBS issued during the three-month period from the enactment date for the 2010 SB Act until December 31, 2010.

4. Temporary Expansion of Section 179 Expensing

Section 179 of the Code permits a small business that satisfies limitations on annual investment to elect to deduct the cost of certain qualified property in the year of acquisition rather than capitalizing these costs and recovering them over time. For taxable years beginning after 2007 and before 2011, the maximum annual expensing limit was $250,000. This limit was reduced (but not below zero) by the amount by which the cost of all qualifying property placed in service in that taxable year exceeded $800,000. In general, property qualifying for expensing under Code Section 179 was defined as depreciable tangible personal property purchased for use in the active conduct of a trade or business. Off-the shelf computer software placed in service before 2011 was treated as qualifying property.

The 2010 SB Act increases the maximum annual expensing limit from $250,000 to $500,000 and the phase-out threshold from $800,000 to $2,000,000 for taxable years beginning in 2010 or 2011. The 2010 SB Act also temporarily expands the definition of property qualifying for Section 179 expensing to include the following qualified real property: (i) qualified leasehold improvement property, (ii) qualified restaurant property and (iii) qualified retail improvement property. With respect to qualified real property, the maximum amount that may be expensed is $250,000. Section 179 deductions attributable to qualified real property also are limited to the taxpayer's active trade or business. In addition, if a taxpayer's Code Section 179 deductions attributable to qualified real property for a taxable year beginning in 2010 exceed the $250,000 annual limit, the excess may be carried over to the taxpayer's taxable year beginning in 2011, with the carryover amount being treated as attributable to property first placed in service in 2011.

5. Extension of Bonus Depreciation

Additional first-year depreciation ("bonus depreciation") allows a taxpayer to deduct an amount equal to 50 percent of the adjusted tax basis of certain qualifying property for the year the property is placed in service. The basis of the property and the remaining depreciation allowances are appropriately adjusted to reflect the additional first-year deduction. Bonus depreciation is allowed as a deduction for both regular and alternative minimum tax purposes. The amount of bonus depreciation is not affected by a short taxable year. In addition, taxpayers may elect out of the bonus depreciation for any class of property for any taxable year. Qualifying property for bonus depreciation must meet all of the following requirements. First, the property must be: (i) property to which the Modified Accelerated Cost Recovery System ("MACRS") applies with an applicable recovery period of 20 years or less, (ii) computer software other than computer software covered by Code Section 197, (iii) water utility property or (iv) qualified leasehold improvement property (within the meaning of Code Section 168(k)(3)). Second, the original use of the property must commence with the taxpayer after December 31, 2007. Third, the taxpayer must purchase the property within the applicable time period. Lastly, the property must be placed in service after December 31, 2007 and before January 1, 2010. For certain transportation equipment, the placed-in-service date is extended to January 1, 2011. Transportation property is defined as tangible personal property used in the trade or business of transporting persons or property.

The 2010 SB Act extends the additional first-year bonus depreciation for one year to apply to qualified property acquired or placed in service during 2010 (or placed in service in 2011 for certain long-lived property and transportation property). This provision is effective for property placed in service in taxable years after December 31, 2009.

6. Extension of Depreciation for Passenger Automobiles that are Qualified Property

Code Section 280F limits the amount of depreciation deductions (including Code Section 179 deductions) with respect to "passenger vehicles." These limits are adjusted annually. In general, the adjusted first-year limit for passenger automobiles placed in service in 2010 would be $3,060. For passenger automobiles built on a truck chassis (e.g., light trucks), the adjusted first-year limit for such vehicles placed in service in 2010 would be $3,160. For any passenger car that is "qualified property" and which isn't subject to a taxpayer election to forgo the 50 percent bonus depreciation and alternative minimum tax depreciation relief otherwise available for "qualified property" under Code Section 168(k), the applicable first-year depreciation limit is increased by $8,000.

The 2010 SB Act extends the $8,000 increase in annual depreciation for passenger automobiles that meet the above requirements to passenger automobiles placed in service in 2010. Under these rules, the maximum first-year depreciation for a passenger car in 2010 would be $11,060 ($11,160 for light trucks). This provision is effective for property placed in service before January 1, 2011.

7. Increased Start-up Deduction Limits under Section 195

A taxpayer can elect to deduct up to $5,000 of start-up expenditures in the taxable year in which a trade or business begins. The $5,000 limit is reduced on a dollar-for-dollar basis to the extent the start-up expenditures exceed $50,000. Start-up expenditures that are not deducted in the first taxable year are capitalized and amortized on a straight-line basis over a 15-year period beginning with the month the trade or business begins. Start-up expenditures are amounts that would have been deductible as trade or business expenses had they not been paid or incurred before business began, including amounts paid or incurred in connection with (i) investigating the creation or acquisition of an active trade or business, (ii) creating an active trade or business or (iii) any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business.

For taxable years beginning in 2010, the 2010 SB Act increases the limit on the amount of start-up expenditures that a taxpayer can elect to deduct from $5,000 to $10,000. The 2010

SB Act also increases the deduction phase-out threshold limit from $50,000 to $60,000. This provision is effective for taxable years beginning after December 31, 2009. Interestingly, the 2010 SB Act did not similarly adjust the limits under Section 709 of the Code for organization costs of partnerships.

8. Cell Phones

In general, a taxpayer may deduct ordinary and necessary business expenses of the taxpayer's trade or business (including the cost of and the monthly telecommunication charges with respect to cell phones). In the case of certain listed property (including any cellular telephone or other similar telecommunications equipment), no deduction is allowed unless the taxpayer meets certain additional substantiation requirements.

The 2010 SB Act removes cell phones from the definition of listed property. Thus, for taxable years ending after December 31, 2009, the heightened substantiation requirements that apply to listed property will no longer apply to cell phones.

9. Increased Information Reporting

Code Section 6041(a) requires information reporting to the Internal Revenue Service by all persons engaged in a trade or business who make certain payments of $600 in the course of that trade or business to another person. Payments subject to information reporting under Code Section 6041(a) are rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments and other fixed or determinable income. A taxpayer whose trade or business is a rental real estate activity would be subject to these information-reporting rules, but a taxpayer whose rental real estate activity is not a trade or business would not be subject to these rules.

The 2010 SB Act imposes information reporting on recipients of rental income from real estate, making these payments subject to these same information-reporting rules as taxpayers engaged in a trade or business. This provision is effective for payments made after December 31, 2010.

10. Increase in Information Return Penalties

The Code provides for penalties for failing to file information returns. The penalty is tiered and capped. The maximum amount of the penalty varies depending on when the information return is filed and if the taxpayer is a qualified small business.

The 2010 SB Act increases the penalty amounts and imposes new maximum penalty amounts. The 2010 SB Act also revises the penalty for failing to furnish a payee statement to provide tiers and caps similar to the tiers and caps for failing to file the information return. This provision is effective for information returns required to be filed on or after January 1, 2011.

11. Estimated Payments for Large Corporations

The 2010 SB Act increases the required payment of estimated tax by large corporations (i.e., corporations with assets of at least $1 billion) by 36 percent for July, August and September 2015. This provision was effective as of the enactment date of the 2010 SB Act.