

The Small Business Jobs Tax Relief Act of 2010 Includes Tax Incentives and SBA Loan Guarantee Limit Increases

by Robert F. Kelly, Esquire and Joseph M. Hayes, Esquire

The Small Business Jobs Tax Relief Act of 2010 was signed into law on September 27, 2010. Highlights of this new law include tax provisions that encourage investments in small businesses and increases in Small Business Administration (SBA) loan guarantee limits.

Tax Provisions

Qualified Small Business Stock Capital Gains. The Act increases to 100% the exclusion from gross income of the gain from a sale or exchange, after March 15, 2010, and before January 1, 2012, of qualified small business stock acquired at original issuance and held for more than five years. No portion of the gain is

an alternative minimum tax (AMT) preference item. The amount of the gain eligible for the exclusion is limited to the greater of (a) \$10,000,000 or (b) ten times the taxpayer's basis in the stock. Qualified small business stock is capital stock issued by a C corporation with less than \$50 million (including the proceeds received from the issuance of the stock) of gross assets and that meets certain specific active business requirements. (Under The American Recovery and Reinvestment Act of 2009 (ARRA), individuals could exclude 75% of the gain from the sale of qualified small business stock acquired at original issue and held more than five years. Prior to ARRA, the percentage exclu-

sion was 50% (or 60% for certain empowerment zone businesses).

Reduction of S Corporation Built-In Gains Holding Period to Five Years. The conversion of a C corporation to an S corporation is not itself a taxable event; however, after the conversion, the S corporation must hold assets owned at the time of the conversion for a certain period of time to avoid the 35% "built-in gains" tax on the unrecognized gain attributable to such assets. The Act reduces this holding period to five years for taxable years beginning in 2011. (ARRA had reduced this holding period from ten to seven years for conversions occurring in 2009 and 2010).

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Planning for the Expiration of the Bush Tax Cuts

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Most of the "Bush tax cuts," which were enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003, are, as of this writing, scheduled to expire December 31, 2010. The scheduled expiration of the Bush tax cuts coupled with the failure of Congress at this late point in 2010 to address the impact of the resulting tax increases creates uncertainty for many taxpayers. This article discusses the primary tax increases resulting from the expiration of the Bush tax cuts and some basic tax planning that can be undertaken in 2010 in anticipation of these tax increases.

Federal Estate and Gift Taxes

If the Bush tax cuts expire, then, effective January 1, 2011, the federal estate tax will have a maximum graduated rate of 55% and apply to estates greater than \$1 million. State death taxes will be a credit against the federal estate

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Questions or Concerns?

If you have any questions or concerns about 2010 or 2011 income, estate, gift or other tax planning, please feel free to contact Eizen Fineburg & McCarthy. We are ready to review and discuss your concerns in light of changing laws or circumstances and discuss planning challenges and opportunities.



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Increase of Section 179 Expensing and Expansion to Certain Real Property. For taxable years beginning in 2010 or 2011, the Act increases the Section 179 deduction amount of capital expenditures that a taxpayer may expense, rather than capitalize, to \$500,000, subject to a phase-out by the amount

by which these expenditures exceed \$2,000,000. Within these thresholds, taxpayers may expense up to \$250,000 of the cost of qualified leasehold improvements, qualified restaurant property, and qualified retail improvements. At the end of 2011, the Section 179 deduction amount returns to its pre-2008 amount of \$25,000, subject to a phase-out by the amount by which these expenditures exceed \$200,000. (ARRA had extended through 2009 the increased Section 179 deduction limits and phase-out amounts that had been implemented in 2008).

Extension of Bonus Depreciation. The Act extends the existing, additional 50% first-year "bonus depreciation" deduction through 2010 (and through 2011 for certain transportation property and certain property with a recovery period of at least 10 years). (ARRA had extended the bonus depreciation deduction that was implemented in 2008 through 2009 (and through 2010 for certain transportation property and certain property with a recovery period of at least 10 years)). Bonus depreciation allows for the write-off of the cost of certain capital expenditures faster than under ordinary depreciation schedules. In order to allow contractors that do not complete contracts within the same year in which they are entered into to benefit from

The Act extends "bonus depreciation" through 2010.

bonus depreciation, the Act separates bonus depreciation from allocation of contract costs under the percentage of completion accounting method rules for assets with a depreciable life of seven years or less.

Deduction for Start-Up Expenditures. For taxable years beginning in 2010, the

Act increases the amount of trade or business start-up expenditures deductible under Section 195 from \$5,000 to \$10,000, subject to a phase out by the amount by which these expenditures exceed \$60,000. Section 195 start-up expenditures generally are expenses paid or incurred in connection with creating, or investigating the creation or acquisition of, an active trade or business, which would be deductible if paid or incurred in connection with the operation of an existing active trade or business.

Deductibility of Health Insurance for Self-Employment Tax. For taxable years beginning in 2010 only, self-employed individuals may deduct

health insurance expenses for themselves and their spouses, dependents, and children who have not yet reached age 27. Prior to this change, health insurance expenses were not deducted in determining net income for purposes of the self-employment tax.

Deductions for Cell Phones and Similar Devices. For taxable years beginning in 2010, the Act removes cell phones and similar devices from the list of items that require taxpayer business purpose substantiation so that the cost can be deducted or depreci-

ated without burdensome documentation and recordkeeping requirements.

Use of General Business Credits against AMT; Five-Year Carryback. For taxable years beginning in 2010, the Act allows small businesses to use general business credits under Section 38(c) against their AMT and extends the carryback period from one year to five years. Previously, under the AMT, taxpayers generally could only claim these credits to the extent their regular tax liability exceeded their AMT liability. An eligible small business generally would be defined as a corporation the stock of which is not publicly traded, a partnership or a sole proprietorship with average annual gross receipts of less than \$50 million for the three prior years.

IRS Form 1099 for Rental Property Expense Payments. The Act requires landlords (i.e., recipients of rental income from real estate) to issue IRS Forms 1099 to service providers to

Landlords must issue IRS Forms 1099 for payments made beginning in 2011.

report rental property expense payments of \$600 or more paid to them during any year beginning in 2011. The Act provides exceptions to this reporting

requirement for individuals renting their principal residences on a temporary basis, taxpayers who receive only minimal amounts of rental income, and those for whom the reporting requirement would create a hardship. (Earlier this year, The Patient Protection and Affordable Care Act expanded IRS Form 1099 reporting requirements for payments of \$600 or more made in any taxable year beginning in 2012 to apply to (1) payments to corporations (other than a tax-exempt corporation) and (2) payments for property and other gross proceeds).

Increase in Penalties for Failure to File Information Returns. The Act increases penalties for failure to timely file information returns to the IRS. The first-tier (i.e., not filed correctly within 30 days of due date) penalty is increased from \$15 to \$30, and the calendar year maximum is increased from \$75,000 to \$250,000. The second-tier (i.e., not filed correctly by August 1) penalty is increased from \$30 to \$60, and the calendar year maximum is increased from \$150,000

The Act limits the penalty for failure to disclose reportable transactions to the IRS to 75% of the tax benefit received.

to \$500,000. The third-tier (i.e., not filed correctly after August 1) penalty is increased from \$50 to \$100, and the calendar year maximum is increased from \$250,000 to \$1.5 million. For small filers (\$5 million or less in gross receipts), the calendar year maximum is increased from \$25,000 to \$75,000 for the first-tier penalty, from \$50,000 to \$200,000 for the second-tier penalty, and from \$100,000 to \$500,000 for the third-tier penalty. The minimum penalty for each failure due to intentional disregard is increased from \$100 to \$250. The penalty amounts are adjusted every five years for inflation. Penalties for failure to file information returns to payees are similarly increased.

Limitation of Non-Disclosure Penalty. The Act limits the penalty for failure to disclose reportable transactions to the IRS to 75% of the tax benefit received. Reportable transactions are abusive tax shelters as identified by the IRS. The minimum penalty is \$10,000 for corporations and \$5,000 for individuals and the maximum penalty is \$200,000 for corporations and \$100,000 for individuals.

Transfer of Eligible Rollover Distributions to Designated Roth Accounts. The Act permits plan participants in Section 401(k) or 403(b) qualified retirement plans that permit designated Roth contributions to transfer an eligible rollover distribution into the participant's designated Roth account. Governmental Section 457(b) plans may add designated Roth accounts beginning in 2011. A designated Roth contribution is a plan contribution that the employee irrevocably designated as an after-tax contribution for deposit into the designated Roth account.

The transfer must be made from a non-designated Roth account in the same plan because of an event that triggers the eligible rollover distribution. An eligible rollover distribution is generally a qualified plan distribution other than a required minimum distribution, a distribution that is part of a series of substantially equal periodic payments, dividends on employer securities, a hardship distribution, a loan or a loan treated as a distribution, a return of an employee's nondeductible contributions and similar items.

For taxable rollover distributions, the participant can elect to include in gross income either 100% of the taxable amount in 2010 or 50% of the taxable amount to each of 2011 and 2012. A return of after-tax contributions is not taxable. The distribution is not subject to the early-distribution 10% additional tax.

Simplified Process for Partial Annuitization of Certain Contracts. The Act simplifies the process,

beginning in 2011, by which nonqualified deferred annuity owners may annuitize a portion of an annuity, endowment or life insurance contract that is not part of a qualified retirement plan while allowing the remaining amount to grow tax-deferred. The annuitized portion of the contract must be annuitized over a period of at least 10 years or the life of at least one individual.

Continuous Levy Extended to Employment Tax Liability of Certain Federal Contractors. Under the IRS's Federal Payment Levy Program (FPLP), the IRS can continuously levy up to 15% of government payments to federal contractors that are delinquent on their tax obligations. The levy generally continues in effect until the liability is paid or the IRS releases the levy. Before levying, the IRS provides the delinquent taxpayer with notice and opportunity for a collection due process (CDP) hearing. Effective for levies issued after September 27, 2010, the Act will now allow the IRS to impose the levy before a CDP hearing occurs.

Adjustment to 2015 Estimated Tax Payment by Corporations with \$1 Billion in Assets. In the case of a corporation with assets of at least \$1 billion (determined as of the end of the preceding taxable year), the estimated tax payments due in July, August or September, 2015, currently are increased to 123.25% of the payment otherwise due (with the next required payment reduced accordingly). The Act has now increased the required payment percentage for 2015 payments by 36 percentage points to 159.25% of the payment otherwise due (with the next required payment reduced accordingly).

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SBA Loan Guarantee Limit Increases

SBA 7(a) Loan Program. The Act increases the SBA loan guarantee \$2 million to \$5 million, and the government-guaranteed portion of the loan from 75% to 90%, under the SBA 7(a) Loan Program. This program is the SBA's primary loan program under which it offers financing guarantees. This program is designed for start-up and existing small businesses and is delivered through commercial lending institutions.

SBA 504 Loan Program. The Act increases the SBA 504 Loan Program loan guarantee limit from \$4 million to \$5.5 million. This program provides long-term, fixed-rate financing to acquire fixed assets (such as real estate or equipment) for expansion or modernization and is delivered by private, non-profit Certified Development Companies that contribute to community economic development.

Extension of Elimination of Fees. Fees normally charged under the SBA 7(a) Loan Program or SBA 504 Loan Program are eliminated through December 31, 2010. This provision of the Act is an extension of the temporary elimination of these fees that was enacted as part of ARRA.

SBA Microloan Program. Additionally, under the Act, the SBA Microloan loan guarantee limit is temporarily increased from \$35,000 to \$50,000. Microloans may be used for working capital or the purchase of inventory, supplies, furniture, fixtures, machinery and/or equipment but not to pay existing debts or to purchase real estate. SBA makes Microloan loan funds available to designated intermediary lenders that are nonprofit community-based organizations.

SBA Borrower Assistance Program. Under the Act, the SBA is directed to implement a program that provides payments to lenders of principal and interest on qualifying guaranteed SBA loans of up to \$300,000. A borrower receiving a qualifying small business loan is automatically enrolled in this program unless the borrower opts out. The amount committed to each borrower is 6% of the principal disbursed amount of the borrower's qualifying loan. ■

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tax rather than a deduction from the value of the estate. The federal gift tax will have a maximum graduated rate of 55% on taxable gifts with a \$1 million lifetime gift tax exemption. The generation skipping transfer tax will once again be applicable to gifts to grandchildren and other "skip" persons at a rate of 55% with only a \$1 million dollar lifetime generation skipping transfer tax exemption.

In anticipation of these increased gift tax rates, the return of the generation skipping transfer tax and the return of the federal estate tax, taxpayers should consider making taxable gifts in 2010. For some taxpayers, making taxable gifts in 2010 may present an excellent estate planning opportunity. A taxpayer can finalize gifts in late December, after it becomes clear whether Congress has taken any action to change the federal estate and gift tax regime, but this does not mean that the taxpayer should wait until late December to begin to consider and plan for making these gifts. Each taxpayer has different circumstances that need to be considered and analyzed as part of an overall gift program. Also, for gifts to grandchildren, there may be additional planning steps to address, such as the use of family limited partnerships or family limited liability companies as vehicles for making these gifts.

For the same reasons, taxpayers should also consider making a gift by establishing a grantor-retained annuity trusts (GRAT). A GRAT is a trust to which a grantor gifts certain assets and from which the grantor receives an annuity for a specified term. At the end of that term, the GRAT's remaining assets, if any, pass to the trust beneficiaries. The amount of gift tax payable by the grantor upon establishing the GRAT depends in part on the value of the annuity amount and specified term for payment he or she reserved.

A GRAT can be structured to provide for an annuity amount and term that reduces the taxable amount of the gift to zero (often referred to as "zeroed-out GRAT"). For example, a zeroed-out GRAT established in November 2010 must pay a minimum annuity based on an annual rate of 2% (the IRS November 2010 interest rate applicable to GRATs). If the grantor survives the annuity period and the zeroed-out GRAT's assets appreciate at a rate higher than the annuity rate, then, at the end of the annuity term, the GRAT's remaining assets pass to the trust beneficiaries gift-tax free.

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Another reason to consider creating a GRAT at this time is that, in the near future, Congress is expected to pass legislation to significantly limit the use of GRATs. Congress recently considered legislation for GRATs that would require that the right to receive fixed amounts from an annuity last for a term of not less than 10 years, that such fixed amounts not decrease during the first 10 years of the annuity term, and that the remainder interest have a value greater than zero when transferred.

Finally, taxpayers should consider making annual exclusion gifts, of up to \$13,000 per person, to reduce their taxable estates. A taxpayer may find it advantageous to make these gifts to Section 529 college savings plans. Prior to distribution from the Section 529 plan account, income and gains on the invested funds are not subject to federal income taxes. Distributions made from the Section 529 plan account to pay college costs of the plan beneficiary are not subject to federal income taxes.

Federal Income Taxes

If the Bush tax cuts expire, Federal income tax brackets on individuals will be 15%, 28%, 31%, 36% and 39.6%, instead of 10%, 25%, 28%, 33% and 35%, respectively. (The 10% income tax bracket becomes an expanded 15% income tax bracket.) Estates and trusts will also be subject to increases in income tax rates. Married taxpayers filing jointly will see the return of the "marriage penalty" of more narrow tax brackets. Their standard deduction will be reduced from \$11,600 to \$9,700 (and thus no longer be twice the single level). Each of the child tax credit, dependent care credit and adoption tax credit will be reduced.

Below are several planning consider-

ations in expectation of higher ordinary income tax rates in 2011.

Non-corporate taxpayers should identify items of ordinary income that may be accelerated into income in 2010 as well as all actions necessary to do so. For example, if a taxpayer anticipates being in a higher tax bracket in 2011, then in 2010 the taxpayer may desire to request payment of a bonus before 2011, take a taxable distribution from a retirement plan

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before 2011 or exercise non-qualified stock options that are "in the money." Non-corporate businesses may desire to accelerate collection of accounts receivable through more aggressive billing and collection efforts or by making arrangements for advance payments with clients and customers.

Non-corporate taxpayers should also identify deductions, such as charitable contributions and the payment of state and local taxes, to defer until 2011 if near the end of 2010 it appears that the taxpayer will be in a higher tax bracket in 2011.

Individual taxpayers with IRAs should also consider converting a traditional IRA to a Roth IRA. (Prior to 2010, taxpayers with an adjusted gross income of \$100,000 or more could not effectuate a Roth IRA conver-

sion). The amount converted is subject to income tax; however, the converted funds will appreciate tax free and if distributed after a 5-taxable-year period of participation and in connection with any of the taxpayer attaining the age of 59 1/2, his or her death, or his or her disability, the money will be able to be distributed tax free. By converting in 2010, a taxpayer will have two other options. First, a taxpayer will have until October 15, 2011 to undo the conversion which they might want to do if the investments in the Roth IRA have not performed as expected. Second, a taxpayer will have until October 15, 2011 to decide whether to pay taxes on the conversion in 2010 or split the income between 2011 and 2012.

In addition, if the Bush tax cuts expire, the long-term capital gain tax rate will rise from 15% to 20% (except for the 10% rate for taxpayers in the 15% income tax bracket). Non-corporate taxpayers may therefore wish to review their portfolios for highly-appreciated marketable securities or other assets subject to these tax rates for potential sale before the year end. Also, if the Bush tax cuts expire, dividends will be taxed at ordinary income tax rates rather than at the long-term capital gains rates. Corporations may therefore wish to pay dividends in 2010 rather than in 2011.

Any final decisions regarding acceleration of income or deferral of deductions should be made as late as practical in 2010 because the Bush tax cuts are currently subject to debate in Congress and thus there is still a possibility of Congressional action to keep some or even all of them intact. ■

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