



(Excerpt from October 2010 ValueLine e-Newsletter, by Vic Hausmaninger, CEO)



Greetings from HBLA and welcome to Fall...

As you might recall, last month after President Obama signed the Small Business Jobs Act of 2010 on September 27, we sent out a brief summary of the tax provisions on September 28 promising to follow up with more detail. Set forth below is a detailed description of the major provisions of the Act together with some comments and recommendations for your consideration.

President Signs Small Business Jobs Act with \$12 Billion in Tax Incentives

On September 27, 2010, President Obama signed into law a package of enhanced business tax incentives as part of a larger Small Business Jobs Act of 2010, H.R. 5297. Passage was marked by months of negotiations, culminating in House approval on September 23, 2010 by a vote of 237 to 187, after clearing the Senate on September 16, 2010 by a 61 to 38 margin.

The new law extends bonus depreciation, extends and doubles Code Sec. 179 expensing, provides for 100 percent gain exclusion for qualified small business stock, relaxes the S-Corp built-in gain conversion rules, extends the carry-back period for eligible small business credits to five years, removes cell phones from listed property, enhances the deduction for start-up expenses, provides retroactive penalty relief, and allows a self-employment FICA tax deduction for 2010 health insurance costs.

Revenue raising provisions to help pay for these tax breaks include a first-time opportunity for certain active participants in 401k and other plans to roll over existing balances to a designated Roth account under their plans (In a prior newsletter, we had discussed the benefits of converting traditional IRA accounts to Roth accounts). Among the revenue provisions that will not be as well received by certain taxpayers are increased failure-to-file penalties on information returns, new information reporting for rental property expense payments, tightened U.S. sourcing on guarantee fees, streamlined tax levies on federal contractors, accelerated estimated tax payments by certain large corporations, and more.

PLANNING NOTE. *The tax title's "small business" label does not reflect its true scope; its provisions impact businesses of many sizes. Bonus depreciation is one provision that is very valuable to larger businesses. The new law also includes some retirement savings incentives for individuals and other provisions impacting taxpayers beyond small businesses. Like many recent tax bills, the small business bill provides incentives but does not make most of them permanent. Some have a very short lifespan. For example, enhanced Code Sec. 179 expensing is available for 2010 and 2011; bonus depreciation is generally available only through the end of 2010; and rollovers within 401k and other elective deferral plans to designated Roth accounts are entitled to a special two-year tax deferral only if done in 2010.*

GENERAL BUSINESS INCENTIVES

The new law includes a familiar package of tax incentives designed to stimulate business investment and spending.

Bonus Depreciation

The new law extends, through December 31, 2010, 50-percent first-year bonus depreciation, which had expired at the end of 2009. The extension is retroactive to January 1, 2010. The new law also extends, through 2011, the additional year of bonus depreciation allowed for property with a recovery period of 10 years or longer, and for transportation property (tangible personal property used to transport people or property).

PLANNING NOTE. Bonus depreciation is not limited by the size of the business, unlike practical access to Code Sec. 179 “small business” expensing. Bonus depreciation under the new law carries a very short window of opportunity --- qualifying equipment must be purchased and placed into service on or before December 31, 2010.

Long-term contracts. The new law also decouples 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.

PLANNING NOTE. This change permits contractors to benefit from bonus depreciation even if they do not complete their contracts within the same year. This obviously provides significant potential tax benefits to contractors, many of whom are suffering because of the economy.

Automobile Depreciation- Code Sec. 280F-. The limitation on the amount of depreciation deductions allowed with respect to certain passenger automobiles is increased in the first year by \$8,000 for automobiles that qualify and for which the taxpayer does not elect out of the additional first-year deduction. For 2010, therefore, maximum first-year depreciation for passenger automobiles is \$11,060 (\$11,160 for light trucks).

Expensing of Equipment Additions- Code Sec. 179. Eligible taxpayers may elect to claim a Code Sec. 179 expense deduction on the purchase price of qualified Code Sec. 179 property. Under current law, the maximum deduction for tax years beginning in 2010 is \$250,000. The dollar limit is reduced by the amount by which the cost of qualifying property placed in service during the tax year exceeds \$800,000. For 2011, the expensing limit had been scheduled to revert to prior levels of \$25,000 and \$200,000, respectively, both not indexed for inflation. The new law increases the maximum deduction to \$500,000 and the investment limit to \$2 million for tax years beginning in 2010 and 2011. “The tax title’s ‘small business’ label does not reflect its true scope as its provisions impact businesses of many sizes.”

PLANNING NOTE. The new law increases in the qualifying property cap from \$800,000 to \$2 million effectively increases the availability of Code Sec. 179 expensing to many more businesses. Under the new law, the Code Sec. 179 expensing deduction does not phase out completely until the cost of eligible property exceeds \$2.5 million. Perhaps even more important, however, the nontax provisions in H.R. 5297 will serve to open up the credit markets needed by small businesses to find the capital to buy equipment that qualifies for either enhanced Code Sec. 179 expensing or bonus depreciation under the bill. Keep in mind that this provision of the Act is ONLY for 2010 and 2011.

Qualified real property. The new law also temporarily expands the definition of qualified Code Sec. 179 property to include qualified real property, which is defined as qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property. However, taxpayers are limited to expensing up to \$250,000 of the total cost of these properties. The new law provides that the dollar cap would apply to the aggregate cost of qualified real property. Further, the bill provides for limitations on the carryover of qualified real property deductions.

PLANNING NOTE. A taxpayer may elect to exclude real property from the definition of Code Sec. 179 property. That election might prove useful to certain taxpayers if the regular \$2 million eligible property cap is otherwise close to being reached. The bill continues to treat computer software as qualified Code Sec. 179 property that is subject to full Code Sec. 179 expensing otherwise reserved for tangible personal property.

S-Corp Built-In Gain Period

A C-corporation that converts to an S-corporation generally must hold any appreciated assets for 10 years following the conversion or, if disposed of earlier, pay tax on the appreciation at the highest corporate level rate (currently 35 percent). The American Recovery and Reinvestment Act of 2009 (2009 Recovery Act) temporarily shortened the usual 10-year holding period to seven years for dispositions in tax years beginning in 2009 and 2010. The new law further shortens the holding period to five years in the case of dispositions in any tax year beginning in 2011, if the fifth year in the recognition period precedes the tax year beginning in 2011.

PLANNING NOTE. The built-in gains tax prevents C-corporations from avoiding corporate level tax on the disposition of appreciated assets it acquired while a C-corporation by first converting to S-corporation status. The new law offers S-corporations more flexibility in shedding historic C-corporation assets that either no longer suit business needs or can provide additional capital through their sale to better assure the S-corporation’s survival during the economic downturn. The five-year period in the new law refers to five calendar years from the first day of the first tax year for which the corporation was an S-corporation.

Cell Phones

The new law removes cell phones and similar personal communication devices from their current classification as listed property thereby lifting the strict substantiation requirements of use and the additional limits placed on depreciation deductions. In addition, the provision enables the fair market value of personal use of a cell phone or other similar device provided to an employee predominantly for business purposes to be excluded from gross income.

TAX PLANNING NOTE. *This “listed property” designation was imposed on cell phones when they were novel, expensive, and not widely owned. Today, not only are cell phones widely available and used, but also necessary for doing business. IRS Commissioner Douglas Shulman announced in January 2010 that the IRS would call a temporary halt to enforcing strict substantiation on cell phone use until Congress made good on its leadership’s promise to pass remedial legislation. The new law’s relief applies to tax years beginning after December 31, 2009.*

SMALL BUSINESS PROVISIONS

The new law targets a variety of tax incentives exclusively to small businesses, including extended carry-back for the general business credit, enhanced AMT off set, and relief from Code Sec. 6707A penalties.

Extended Carry-back Of General Business Credit

The new law extends the carry-back period for eligible small business credits to five years. Eligible small business credits are the sum of the general business credits determined for the tax year with respect to an eligible small business. The extended carry-back provision is effective for credits determined in the taxpayer’s first tax year beginning after December 31, 2009.

PLANNING NOTE. *An eligible small business for purposes of the enhanced general business credit is a corporation whose stock is not publicly traded, a partnership or a sole proprietorship. Additionally, the average annual gross receipts of the corporation, partnership, or sole proprietorship for the prior three tax year periods cannot exceed \$50 million. One major change made in this Act is that 2010 credits (including the popular R&D credit) can now be used to offset AMT (alternative minimum tax) for 2010 or the years that any excess credits can be carried back to. In the past, these credits could not be used to reduce the AMT tax and many taxpayers, including shareholders in S-Corporations and other pass-through entities received no benefits from such tax credits. We suggest that you review this new benefit immediately and consider what could be done to maximize such credits for 2010 to reduce taxes (including AMT) for 2010 and carry-back any excess credits to prior years and receive tax refunds for prior year taxes paid.*

Qualified Small Business Stock

The 2009 Recovery Act temporarily increased the percentage exclusion for qualified small business stock sold by an individual from 50 percent to 75 percent for stock acquired after February 17, 2009 and before January 1, 2011, and held for more than five years. The new law raises the exclusion to 100 percent for gain on stock acquired after the date of enactment of the new law and before January 1, 2011. Under the new law, the excluded gain will not count as an AMT preference item but the five-year holding period continues to apply.

PLANNING NOTE. *With both the income tax and capital gains rates anticipated to rise in the future, the benefits of an investment in Section 1202 stock (original issue stock) become even more substantial as acquired shares are sold in 2015 or later under the five-year holding period rule. Since stock is the key to this benefit, the corporate form of doing business may have a leg up on unincorporated entities in this regard. To be eligible for the exclusion both prior to and under the bill, the individual must generally acquire the small business stock at its original issue (directly or through an underwriter) for money, for property other than stock, or as compensation for services. When the stock is issued, the aggregate gross assets of the issuing corporation may not exceed \$50 million. In addition, the corporation also must use at least 80 percent of the value of its assets in the active conduct of one or more qualified trades or businesses. The stock or eligible replacement must be held for at least five years. It is important to note that such stock must be acquired between September 27, 2010 and December 31, 2010. Also, under Code Sec. 1202 limitations already in place, the amount of gain eligible for the 100 percent exclusion by an individual with respect to any corporation is capped at the greater of (1) 10 times the taxpayer’s basis in the stock or (2) \$10 million.*

Start-Up Expense Deduction

Taxpayers have generally been able to deduct up to \$5,000 in qualified trade or business start-up expenses. The \$5,000 deduction is reduced (but not below zero) by the amount of the taxpayer’s total start-up costs that exceed \$50,000. The

new law raises the deduction limit to \$10,000 and increases the phase out threshold to \$60,000 for one year, 2010.

PLANNING NOTE. *Start-up expenses are costs related to creating an active trade or business, or investigating the creation or acquisition of an active trade or business. They are costs not directly related to capital or equipment and have been generally relegated to amortization above the current \$5,000 deductible amount. The increase in the deduction amount is intended to allow entrepreneurs to recover more small business start-up expenses up front, increasing cash flow and the ability to hire more workers.*

Self-Employment Income

A self-employed individual can take a deduction for health insurance costs paid for the individual and his or her immediate family for income tax purposes. However, in determining the self-employment income subject to self-employment taxes, the self-employed individual cannot deduct any health insurance costs. Under the new law, the deduction for income tax purposes for the cost of health insurance is allowed in calculating net earnings from self-employment for purposes of self-employment taxes. The provision only applies to the self-employed taxpayer's first tax year beginning after December 31, 2009.

PLANNING NOTE. *The health insurance business deduction for self-employed individuals was implemented in 1987 and subsequently made permanent. This equalized the treatment of health insurance costs that an employer pays for employees and for self-employed individuals. However, health insurance costs did not reduce wages subject to self-employment taxes. Under the provisions of this Act taxpayers will continue to deduct self-employed health insurance costs for purpose of computing adjusted gross income BUT ALSO will be able to reduce self-employment income by that amount reducing self-employment taxes payable. Note that at this point this benefit is only available for 2010.*

PROMOTING RETIREMENT SAVINGS

Rollovers To Roth Accounts

The new law authorizes governmental plans 401(k), 403(b), and 457 (b) to allow participants to roll over qualified distributions, including in-service distributions, into a designated Roth account within their plans. The rollover will be taxable, except for any after-tax contributions. The provision is effective for distributions after September 27, 2010. If an amount is rolled over in 2010, the amount is included ratably in income in equal amounts over 2011 and 2012, unless the taxpayer elects otherwise.

PLANNING NOTE. *The ability to report income from the 2010 rollover in 2011 and 2012 echoes existing rules for converting a traditional IRA to a Roth IRA in 2010. Plans and taxpayer may need to move quickly. First, the plan must be amended to permit these rollovers. Then, participants must act before year-end on any qualifying distribution if they want to take advantage of either the two-year deferral into 2011 or 2012 or lower tax rates in 2010 if Congress does not extend the 2001 individual marginal income tax rate reductions. With balances in retirement accounts still reeling from stock market declines, distribution rollovers to Roth accounts now --- while the income to be recognized on those balances upon distribution is still low --- will make immediate rollovers highly popular. One drawback, for many taxpayers, however, will be finding the cash to pay the income tax. If taken from the otherwise qualifying distribution, that amount would be taxed immediately and permanently lose the benefit of deferral. Keep in mind that analyzing your unique situation should be done now, if you want to avail yourself to the benefit to spread any income recognition over the two years ending December 31, 2011 and 2012; the rollover will have to be completed before December 31, 2010.*

REVENUE RAISERS

In addition to an estimated \$6.6 billion of taxes expected to be raised by the retirement-friendly roll-over provisions (discussed above), the Small Business Jobs Act offsets the price tag for its \$12 billion in tax relief with some not-so-friendly changes in the name of reducing the tax gap and closing unintended "loopholes."

Information Reporting On Rental Property Expense Payments

The new law requires qualified individuals receiving rental income from real property to file information returns with the IRS and to service providers reporting payments of \$600 or more during the year for rental property expenses. The new information reporting requirement applies to payments made after December 31, 2010.

PLANNING NOTE. *Expanded information reporting is a popular revenue raiser in Congress and predictions are that reporting obligations, and their related compliance costs, will more than quadruple for taxpayers if Congress continues on its present course. Reliance by Congress on increased information reporting to provide*

“quick and easy” revenue offsets worries many tax practitioners and the National Taxpayer Advocate. However, the IRS has promised to remove duplicative reporting where possible. The new law includes exceptions to the rental property expense reporting requirement, such as exceptions for individuals who can show that the reporting requirement creates a hardship and any individual who receives rental income of not more than a minimal amount (both as will be determined by the IRS). The new law also provides for an exception for members of the military or employees of the intelligence community who rent their principal residence on a temporary basis. Since this provision becomes effective for 2011, those owning rental properties should begin planning for this reporting requirements as soon as possible, including obtaining Social Security and Federal I.D. numbers from those payments are being made to (including attorneys, accountants, maintenance services, etc.—regardless of whether such entities are incorporated or not).

Higher Failure-To-File Penalties On Information Returns

The new law substantially increases the penalties for failing to timely file information returns with the IRS:

- First-tier penalties (filing an information return after the filing deadline but not more than 30 days after the due date) will increase from \$15 to \$30. The calendar year maximum will increase from \$75,000 to \$250,000.
- Second-tier penalties (filing an information return more than 30 days after it is due but before August 1) will increase from \$30 to \$60, and the calendar year maximum will increase from \$150,000 to \$500,000.
- Third-tier penalties (for failing to file before August 1) will increase from \$50 to \$100, and the calendar year maximum will increase from \$250,000 to \$1.5 million.

PLANNING NOTE. *The enhanced penalties apply to information returns required to be filed on or after January 1, 2011. The minimum penalty for each intentional failure-to-file will increase from \$100 to \$250. For qualified small filers with average gross receipts of not more than \$5 million, the calendar year maximum will increase 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 dollar amounts in the bill will be adjusted for inflation for each fifth calendar year beginning after 2012.*

PENDING TAX LEGISLATION

Individual Tax Rate Reductions

After December 31, 2010, reduced individual income tax rates are scheduled to revert to their pre-2001 levels, with the top rate rising to 39.6 percent. President Obama wants to permanently extend all of the individual rate cuts except for the top two rates. A growing number of lawmakers are calling for a temporary extension, for one or two years, of all the sunset tax cuts.

PLANNING NOTE. *Keep in mind that, in addition to the possible increase of the top tax rate back to 39.6 percent, the previously enacted Patient Protection and Affordable Care Act also provides that for 2013 there will be an additional .09 percent Medicare tax on wages and self-employment income and another 3.8 percent Medicare tax on “unearned income”, including capital gains, dividends, interest, etc. Both of these taxes will be imposed on income over defined thresholds (generally income in excess of \$250K for joint and \$200K for individual tax payers).*

Tax Extenders

A package of tax extenders (H.R. 4213), which passed the House earlier this year, has languished in the Senate. Sen. Max Baucus, D-Montana, recently introduced a new tax extenders bill. Baucus’ bill would extend a host of popular but temporary tax incentives, such as the state and local sales tax deduction, the teachers’ classroom expense deduction, and the higher education tuition deduction, through the end of 2010. Baucus’ bill excludes a controversial revenue raiser: the imposition of self-employment taxes on certain shareholders in S-corps. The individual tax rate reductions and tax extenders are not the only tax items on Congress’ fall agenda. The list includes: The federal estate tax; reduced capital gains/dividends tax rates; an AMT “patch;” worker classification reform; more international tax reforms; energy tax incentives; and national disaster relief.

FINAL COMMENTS

As you can see from the above summary and our PLANNING NOTES, tax planning for 2010 is quite a challenge given the many uncertainties with respect to tax rates that will be effective for 2010. We may have a better indication of the direction Congress and the White House will take with respect to rates once we see the outcome of the November election. We will comment on that in our next newsletter.

As discussed above, the Jobs Act signed September 27, 2010 provides significant tax savings opportunities for many businesses which should be carefully evaluated immediately to see what steps should be taken NOW to maximize such benefits.

Please call our office if we can answer any questions regarding the above matters or if we can assist you with your year-end tax planning needs.

Vic

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