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Spurring investment
Tax provisions in the Small Business Jobs Act

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Congress has approved and President Obama has signed into law a $12 billion tax incentives package that provides an additional year of bonus depreciation for businesses of all sizes, as well as enhanced section 179 expensing rules and other relief targeted to small businesses. The Small Business Jobs Act of 2010 (the Act) became law on September 27, 2010.

The tax incentives in the Act – most of which are temporary – are paid for with permanent provisions that require guarantee fees to be sourced like interest, impose additional information reporting and administrative requirements to close the "tax gap," and make crude tall oil ineligible for the cellulosic biofuel producer credit. Additional revenue comes from taxpayer-friendly changes to the qualified retirement plan rules.

This publication analyzes the tax planning opportunities – and potential tax traps – in the legislation.

Incentives

Bonus depreciation

The Act extends for one additional year the temporary 50 percent depreciation bonus first enacted in the Economic Stimulus Act of 2008 and subsequently renewed in the American Recovery and Reinvestment Act of 2009. (The provision expired at the end of last year.) Under the bonus depreciation provision, 50 percent of the basis of qualified property may be deducted in the year the property is placed in service and the remaining 50 percent recovered under normal depreciation rules. Generally, qualified property includes:

- Property with a MACRS recovery period of 20 years or less;
- Water utility property;
- Certain computer software; and
- Qualified leasehold improvement property.

As a result of this extension, bonus depreciation is generally available for qualified property the original use of which commences with the taxpayer and is placed in service during 2008, 2009, or 2010 (2011 in the case of certain property with longer production periods). The Joint Committee on Taxation (JCT) staff estimates the provision will cost $5.45 billion over 10 years.

No accelerated credits in lieu of bonus depreciation – The related provisions under code section 168(k)(4) to accelerate the alternative minimum tax and research credits in lieu of bonus depreciation were not extended as part of the Act.

Observation
Bonus depreciation may allow some taxpayers to preserve or increase cash flow by reducing current tax liability, and it may also enable some companies to increase a loss that can be carried back. However, taxpayers must consider several factors when claiming bonus depreciation, including its interaction with other code provisions – such as the section 199 production activities deduction, the section 263A UNICAP rules, and the section 861 source rules. Bonus depreciation automatically applies to assets placed in service that qualify, but taxpayers can elect out of it on a class-by-class basis.

Special rule for long-term contract accounting – This provision 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 in order to allow contractors that do not complete contracts within the same year in which they are entered into to benefit from bonus depreciation. It is estimated to have no cost over 10 years.

Treatment of employer-provided cell phones

The Act removes employer-provided cell phones and similar telecommunications equipment from "listed property" effective for taxable years beginning after December 31, 2009.

Business deductions for listed property are subject to strict substantiation-of-use requirements. If the listed property is not used predominantly for business purposes or if business use is not properly substantiated, annual depreciation deductions (and any small-business expensing deductions) may be limited or disallowed.

By de-listing employer-provided cell phones, the Act effectively removes the strict substantiation-of-use requirement and the limitation on depreciation deductions, and eases administrative burdens on employers, employees, and the IRS.

Small-business incentives

The Act increases the section 179 expensing limitations for 2010 and 2011 to $500,000 with a phase-out threshold of $2 million and allows taxpayers to expense up to $250,000 of the cost of qualified leasehold improvement, restaurant, and retail property. The JCT estimates this provision will cost $2.18 billion over 10 years.

Another provision increases the section 1202 small-business stock exclusion by allowing taxpayers to exclude 100 percent of small-business capital gains for stock acquired after the date of enactment and before January 1, 2011. The minimum tax preference also will not apply. No regular or alternative minimum tax will therefore be imposed on the sale of qualified stock held at least five years. This provision is estimated to cost $518 million over 10 years.

The Act also includes a number of other small-business incentives that:

- Extend the carryback period for eligible small-business credits to five years for 2010;
- Provide that general small-business credits are not subject to the alternative minimum tax for 2010;
- Reduce the recognition period for purposes of the tax on net recognized built-in gains of S corporations to seven years for taxable years beginning in 2009 or 2010 and to five years for taxable years beginning in 2011;
- Limit the penalty for failure to disclose reportable transactions based on the resulting tax benefits; and
- Provide a deduction for health insurance costs in computing self-employment taxes in 2010.

Increase in amount allowed as deduction for start-up expenses – The Act temporarily raises the amount a taxpayer can deduct as start-up expenditures in the year an active trade or business begins to $10,000 (from $5,000) and increases the phase-out threshold for the deduction to $60,000 in cumulative expenditures (from $50,000). The provision is effective for taxable years beginning in 2010, and the JCT estimates it will cost $230 million over 10 years.

Revenue offsets

Source rules on guarantees

On the revenue side, the Act includes a provision that modifies the tax treatment of guarantee fees received by a foreign corporation from a U.S. subsidiary. In the recent case of *Container Corp. v. Commissioner*, the IRS argued that these guarantee fees should be sourced like interest. However, the Tax Court held that the fees should be sourced like compensation for services – that is, based on where the services are performed. The government filed its appeals brief in the Fifth Circuit on September 15 and continues to rely on its analysis of older court holdings in the *Bank of America* and *Centel Communications* decisions, which treated acceptance and confirmation letters of credit (*Bank of America*) and financial guarantees (*Centel*) as income that is more closely analogous to interest.

Under the Act, fees for guarantees issued after the date of enactment will be sourced like interest (that is, by reference to the residence of the obligor). This will result in fees paid by U.S. taxpayers to foreign persons being treated as U.S.-source payments that are subject to U.S. withholding tax unless otherwise exempted under an income tax treaty. According to a technical explanation of this provision prepared by the JCT staff, no inference is intended on the treatment of guarantees issued before the date of enactment.

The JCT staff estimates this provision will raise $2 billion over 10 years.

Tax gap & tax administration provisions

The Act also raises revenue through several information reporting and penalty provisions that are intended to shrink the tax gap.

Information reporting for rental property expenses – The Act generally imposes the same information reporting requirement on persons engaged in passive real estate investment as those engaged in a real estate trade or business. Specifically, it requires recipients of real estate rental income that make payments of $600 or more to a service provider (such as a plumber or accountant) in the course of earning rental income to send an information return (generally, Form 1099-MISC) to the IRS and to the service provider. Exceptions apply for active-duty military personnel and employees of the intelligence community, individuals whose rental income falls below a threshold to be determined in Treasury regulations, and individuals who meet certain hardship standards (again to be determined in Treasury regulations). The provision is effective for payments made after December 31, 2010. The JCT staff estimates this provision will raise approximately $2.5 billion over 10 years.

Levies on payments to federal contractors – The Act raises an additional $1.1 billion over 10 years through a provision that allows the IRS to issue levies before a collection due process hearing on federal contractors who owe federal taxes. The levies are still limited to 15 percent of certain specified payments and taxpayers would have an opportunity for a collection due process hearing within a reasonable time after the levy. This provision is effective for levies issued after the date of enactment.

Penalty provisions – The Act also increases the penalties for failure to file correct information returns, and requires adjustments to account for inflation every five years. This provision is effective for returns required to be filed on or after January 1, 2011.

IRS reports to Congress – The Act requires the IRS to submit annual reports to the House Ways and Means and Senate Finance Committees regarding the administration of certain tax penalty provisions relating to reportable transactions. The first report is due no later than December 31, 2010.

Cellulosic biofuel producer credit

The Act provides that certain processed fuels with an acid number exceeding 25 are ineligible for the cellulosic biofuel producer credit under section 40(b)(6). Effectively, this revenue offset targets the highly corrosive fuel known as "crude tall oil," another byproduct of the paper manufacturing process from which "black liquor" is derived. (Black liquor sold or used after 2009 became ineligible for the cellulosic biofuel producer credit in March when the Patient Protection and Affordable Care Act was signed into law.)

This provision is effective for fuels sold or used on or after January 1, 2010, and is estimated to raise roughly $1.85 billion over 10 years.

Taxpayer-friendly changes to retirement plan & annuity rules

Roth accounts in employer plans – The Act expands opportunities for individuals to convert pre-tax balances in employer-sponsored retirement plans into designated Roth accounts.

In cases in which an employer sponsors a tax-deferred retirement plan (such as a section 401(k), 403(b), or 457(b) account) that also includes a qualified designated Roth contribution program, the Act permits participants (or surviving spouses) to convert amounts held in the non-Roth accounts under the plan into the Roth account in the plan. However, a retirement plan that does not already have a designated Roth program cannot establish one solely to facilitate these types of rollover contributions.

In order for a participant to make this conversion, the funds must be otherwise eligible for distribution to the participant at the time of conversion. If the plan does not currently permit an account to be distributed, the employer can amend the plan to expand distribution options beyond those currently offered by a plan (for example, adding in-service distributions or distributions before normal retirement age). However, the employer cannot make distributions available for accounts for which distributions are not permissible. For example, a distribution of a pre-tax 401(k) account to a participant prior to attainment of age 59 ½ or termination of employment would not be permitted.

An individual who elects to roll over a distribution to a Roth account must include the distribution in gross income (subject to basis recovery) but can nevertheless receive preferential tax treatment. The taxpayer has the option of including income triggered by the distribution into his or her income in equal amounts over the next two succeeding tax years. Taxpayers cannot take distributions from the Roth account during a five-year period following the rollover without being subject to an early distribution penalty. However, the opportunity to take advantage of the income spread will soften the impact of the conversion and allow for tax-free distributions at retirement.

The Act does not require employers who sponsor plans with a Roth program to make the rollover contribution option available. Employers can amend their plans to grant the opportunity, however. Further, an employer who expands distribution options in its plan to make conversions available is permitted to limit this expansion to amounts the participant would convert to Roth accounts. In its technical explanation of the provision, the JCT staff states that "it is intended that the IRS will provide employers with a remedial amendment period that allows the employers to offer this option to employees (and surviving spouses) for distributions during 2010 and then have a sufficient time to amend the plan to reflect this feature."

The provision is expected to raise $5.1 billion over 10 years as taxpayers make the conversions and pay related taxes, and is effective for distributions made after the date of enactment.

Roth accounts in 'eligible' section 457 plans of governmental entities – The Act also permits participants in government-sponsored section 457 plans to treat elective deferrals as Roth retirement account contributions, effective for taxable years beginning after December 31, 2010. Prior to this change, Roth deferrals were permitted only in 401(k) plans and 403(b) arrangements.

The provision is expected to raise $506 million over 10 years as government employers add Roth features to their existing plans, plan participants designate deferrals as Roth contributions, and participants convert existing balances to Roth accounts.

Partial annuitization of nonqualified annuity contracts – The Act allows holders of annuity contracts outside of a tax-qualified retirement plan or IRA (for example, an annuity, endowment, or life insurance contract) to elect to receive a portion of the contract in the form of a stream of annuity payments and leave the remainder of the contract to accumulate income on a tax-deferred basis. The annuitization period must be for at least 10 years for the life of one or more individuals.

The portion of the annuity providing the stream of annuity payments during the qualified period will be treated as a separate contract for purposes of section 72. The investment in contract will be allocated on a pro rata basis between the portion producing the annuity stream and the remainder. The changes under the Act are not intended to change current rules for annuities in the case of plans qualified under section 401(a), 403(a) plans, section 403(b) tax-deferred annuities, or individual retirement plans.

The provision is effective for amounts received in taxable years beginning after December 31, 2010. It is expected to raise $956 million over 10 years.

Corporate estimated tax payments

The Act increases the payment factor for estimated taxes of corporations with assets of at least $1 billion by 36 percentage points for payments due in July, August, or September of 2015, with an offsetting reduction in 2016. The provision raises $21.3 billion in 2015 but is revenue neutral over 10 years.

Outlook: Further action on taxes unlikely until lame duck session

The enactment of the Small Business Jobs Act marks what is likely to be the last significant action on tax legislation before the midterm elections in November. Members of the House and Senate plan to spend the bulk of October on the campaign trail, and during the short time remaining in their current work session they may be reluctant to hold many votes on hot-button issues that could have adverse consequences at the polls. As a result, the fate of the Bush tax cuts – which expire at the end of this year – and legislation to extend a host of business and individual tax incentives that expired last year is expected to remain uncertain until the post-election lame duck session.

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