

Congress Passes Small Business Tax Bill

Congress has passed, and President Obama has signed into law, a small business jobs bill (H.R. 5297) with valuable individual and business tax incentives. Many of the \$12 billion in tax incentives are temporary, with a short window to act. Others are permanent but require careful planning to maximize your tax benefits. We are including a summary of the bill's provisions with this correspondence. The [summary](#) has been prepared by a news service (CCH). This e-alert highlights certain tax incentives and revenue raisers in the new law and provides special commentary regarding the most important provisions of the bill to our clients.

Although the new law is labeled a "small business bill" and clearly helps small businesses in many ways, it actually is much more. The new law includes a number of provisions targeted to small businesses and investors in small businesses, such as 100% exclusion of gain on qualified small business stock, an increase in the amount allowed as a deduction for start-up expenditures, and more. Other provisions may benefit businesses of all sizes, such as extended bonus depreciation and extended and doubled Code section 179 expensing. Many individuals will benefit from a new rule allowing retirement rollovers from elective deferral plans to Roth designated accounts, along with other retirement savings incentives.

Below is an overview of just some of the several provisions in the new law that may be relevant to you or your business:

S Corporation Built-in Gains Tax

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 a special tax on some (or all) of the appreciation at the highest corporate level rate (currently 35%). The American Recovery and Reinvestment Act of 2009 (ARRA) temporarily shortened the usual ten 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 any tax year beginning 2011, if the fifth year in the recognition period precedes the tax year beginning 2011. Thus, owners of S corporations (with C corporation histories) may find 2011 an especially advantageous year to engage in a sale transaction.

POSTED:

Oct 7, 2010

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Rate Changes

Congress has not yet acted to extend Bush-era tax rates. Without action, the top federal rate for ordinary income is scheduled to increase from 35% to 39.6% and the federal capital gain rate would increase from 15% to 20% after December 31, 2010. Qualified dividends are currently taxed at capital gain rates, but without Congressional action, they will revert to being taxed at ordinary income rates. Companies that currently operate as C corporations for tax purposes may wish to consider distributing dividends prior to January 1, 2011 in order to qualify for the current beneficial tax rates (15% versus up to 39.6%). For C corporations planning 2011 (or later) dividends, the advantage to accelerating the dividends into 2010 are obvious and substantial.

Companies should be sure to review any applicable loan agreements to ensure that distributions will not violate loan covenants. Also, S corporations with prior C corporation earnings and profits may also wish to consider dividend distributions prior to December 31, 2010.

Illustration: Assume C Corporation declares and distributes a \$1,000,000 cash dividend on December 31, 2010 to its sole U.S. shareholder. The dividend will be subject to tax at a 15% federal rate, creating a tax liability of \$150,000. If the dividend were instead declared and distributed on January 1, 2011, the federal tax would be \$396,000.

Tax Extenders Bill

The Senate has not yet passed, but is considering a new tax extenders bill. The bill would extend a series of tax incentives, including the state and local tax deduction. As currently drafted, the extender bill would not include a provision that has been discussed whereby S corporation shareholders would be subject to self-employment taxes on their share of S corporation income.

Qualified Small Business Stock

To encourage investment in small businesses, ARRA temporarily increased the percentage exclusion for qualified small business stock acquired after February 17, 2009 and before January 1, 2011 to 75%. The new law raises the exclusion to 100% for "qualified stock" issued after September 27, 2010 and before January 1, 2011. The stock must be acquired at original issue from a qualified small business and held for at least five years. The ability to exclude 100% of the gain on

"qualified stock" is an important advantage in favor of C corporation status in selecting a form of entity.

Extended Carryback of General Business Credit

The new law extends the carryback period for eligible small business credits from one to five years. An eligible small business 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. The extended carryback provision is effective for credits determined in the taxpayer's first tax year beginning after December 31, 2009.

Self-Employment Income

Individuals who are self-employed may claim a deduction for qualified health insurance costs for income tax purposes. For self-employment taxes, the self-employed individual cannot deduct any health insurance costs. The new law allows the income tax deduction for the cost of health insurance in calculating net earnings from self-employment for purposes of self-employment (FICA) taxes. The provision only applies to the self-employed taxpayer's first tax year beginning after December 31, 2009.

Designated Roth Accounts

Under the new law, eligible retirement plan distributions made after September 27, 2010 may be rolled over to a designated Roth account within the plan. Any amount required to be included in gross income for the 2010 tax year is included in income in equal amounts for the 2011 and 2012 tax years unless the taxpayer elects otherwise.

Bonus Depreciation

An additional first-year bonus depreciation deduction equal to 50% of the adjusted basis was available for qualified property placed in service in 2008 and 2009 (2009 and 2010 for certain longer-lived property and transportation property). The new law extends bonus depreciation for qualified property acquired and placed in service during 2010 (or placed in service during 2011 for certain longer-lived property and transportation property). The new law also



includes a special long-term accounting rule for bonus depreciation.

Code Section 179 Expensing

The new law increases the maximum amount a taxpayer may expense under Code section 179 to \$500,000 and raises the phase-out threshold to \$2 million. Enhanced Code section 179 expensing is available for tax years beginning in 2010 and 2011. The new law also allows taxpayers to expense qualified leasehold investment property, qualified restaurant property and qualified retail improvement property. However, the maximum amount with respect to real property that may be expensed is limited to \$250,000.

Start-Up Expense Deductions

A certain amount of qualified business start-up expenses may be deductible in the tax year in which the active trade or business begins. The new law increases the amount of start-up expenditures that a taxpayer may elect to deduct from \$5,000 to \$10,000 for tax years beginning in 2010. The new law also increases the deduction phase-out threshold so that the \$10,000 is reduced, but not below zero, by the amount by which the cumulative cost of qualified start-up expenses exceeds \$60,000.

Rental Property Expense Payments

The new law imposes information reporting requirements on certain recipients of rental income from real estate. Rental income recipients making payments of \$600 or more to a service provider in a tax year will file an information return with the IRS and the service provider. The new law permits the IRS to exclude individuals for whom reporting would be a hardship and individuals who receive only minimal amounts of rental income from the requirement. Certain members of the military and intelligence services are also excluded. The reporting provision applies to payments made after December 31, 2010.

If you have any questions, feel free to contact your Reinhart attorney or any member of the Reinhart Tax Team.

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