

Legislative Alert

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Small Business Jobs Act

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On Monday, September 27, 2010, President Obama signed into law a package of enhanced business tax incentives, as part of the larger Small Business Jobs Act of 2010, H.R. 52. The act provides a handful of tax saving opportunities through the end of 2010. Do not be fooled, however, the “Small Business” label is misleading; both large and small businesses are sure to be affected. Careful planning also should take tax rates into consideration, as the current low rates are set to expire by year end, unless Congress agrees on an extension when the Senate and House reconvene after November elections.

The Small Business Jobs Act

General Business Benefits – With certain investment and other limitations, these provisions are available across the board.

- Retroactive from January 1, 2010, bonus depreciation is extended until the end of 2011.
- Doubles the Code Sec. 179 expensing limit from \$250,000 to \$500,000 for the same period, while increasing the cap from \$800,000 to \$2,000,000.
- Reduces the period that a converted S corporation must hold any appreciated assets from seven to five years.

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- Removes cell phones from listed property, and allows it to be excluded from the gross income of the employee.

Small Business Benefits – In keeping with the name of the act, there are some provisions that only apply to small businesses.

- 100% gain exclusion for the sale of qualified small business stock acquired from September 27, 2010, until January 1, 2011, that is held for five years.
- Extends the carryback period for eligible small business credits to five years.
- Start-up expense deduction increased to \$10,000; reduced by the amount that costs exceed \$60,000.
- Self employed individuals can deduct the cost of health insurance for themselves from net earnings in addition to the previously allowed deduction for income tax.

Retirement Savings – Taxpayers have increased options for allocating their retirement funds under the Small Business Jobs Act.

- Taxpayers may elect to roll over pre-tax 401(k), 403(b) and 457(b) account balances into a designated Roth account within their plans.

SBA Loan Enhancements – Short term SBA loan enhancements that ran out of funds in May are reinstated and replaced. Its provisions will save businesses material fees, provide access to capital and improve difficult collateral positions by increasing the percentage guarantee. Coupled with historic low rates, this portion of the Small Business Jobs Act is expected to provide meaningful assistance to small businesses in recovery. The Act provides:

- Loan fee waivers on 7(a) and 504 loans through December 31, 2010
- Increased borrowing limits
 - 7(a) loans increase from \$2,000,000 to \$5,000,000
 - 504 loans increase from \$1,500,000 to \$5,500,000
 - 7(a) express loans increase from \$350,000 to \$1,000,000
- Government guarantees increase from 75% to 90% on 7(a) loans

Return of the 2001 Rates

If Congress cannot resolve its partisan log jam, top marginal rates on ordinary income and capital gains will jump 5%, and dividends will return to the ordinary income rate in effect in 2001. Currently, the President and his party want existing rates to be made permanent only for lower income taxpayers; whereas Republicans and some Independents advocate extending the low rates across the board. There also has been no meaningful headway on revising federal estate tax law, which on New Year's Day, without intervention, will rise like a Phoenix from the ashes of an expired tax holiday to slash inheritances with higher rates and lower lifetime credits than we have seen in a decade. Whether the November elections can bring legislators to a consensus by the time we sing "Auld Lange Syne" remains to be seen.

While the return of the 2001 tax levels standing alone merit planning consideration, the incentives created by the Small Business Jobs Act magnify this because most of the incentives have very short life spans. For example, enhanced Code Sec. 179 expensing is only available for 2010 and 2011; bonus depreciation generally is

available on through the end of 2010; and rollovers within 401(k) and other elective deferral plans to designated Roth accounts are entitled to a special two-year tax deferral only if done in 2010.

The expiration of the 2001 and 2003 tax acts, as well as the short time frame from which to take advantage of the Small Business Jobs Act savings, merit short term and perhaps some long term planning over the balance of this year.

Planning Opportunities

Planning opportunities under the Small Business Jobs Act primarily involve short term incentives made available to businesses investing capital, perhaps through enhanced SBA loan programs, and shortened cost recovery by front end loaded depreciation. Additional planning opportunities arise if you expect Congress will not extend the long term capital gain rate on dividends and the current rates on higher income taxpayers by year end. Three areas merit your consideration: 1) business transition planning; 2) tax deferred reorganizations; and 3) accounting.

Business Transition Planning – For some businesses, especially family businesses, proceeds from the transitioning of ownership from one generation to the next are taxed as dividends. Starting January 1, 2011, that rate can jump from 15% to almost 43%, because of a combination of three expiring tax laws. Redemptions usually are preferred for these transactions as the company is a meaningful and sometimes the only available source of funds, and the next generation may find it difficult to cash flow payments with after tax savings/earnings. The redemption of all or a part of the parents' majority stock in a closely held corporation is taxed as a dividend if enough shares owned by their children are "attributed" to them after the sale because of family relationship. While attribution can in many instances be waived, it comes with a requirement that the parents cut all ties to the corporation as an employee, officer or director. Severing these relationships also will disqualify them from coverage under the company's group health and hospitalization insurance. If the transition is completed by the end of this year, the 15% tax rate applies regardless of dividend treatment, and the parents can continue to provide the leadership appropriate to complete a transition of ownership to the next generation. Wait past year end, and the parents can have a difficult choice: either sever this valuable tie with their company, or pay an additional 28% in income tax. So, businesses contemplating this transition, especially family businesses, would do well to bring the planning to a conclusion, and if appropriate, complete the transition soon.

Business Reorganizations - Yet another strategy meriting consideration is a reorganization of a business's structure. Certain corporate reorganizations qualify for tax deferral under complicated laws that leave the parties exposed to a risk that IRS will challenge the transaction as taxable, and if so, then taxable as a dividend. The risk may be a reasonable business risk but a risk just the same. If the reorganization is completed by year end, the risk is at a 15% tax rate. After year end, the risk can be as high as 43%.

So, if the owners of a business are looking to split off a division or different locations, to separate different businesses into their own free-standing entities for any purpose, such as: asset protection, as part of a business continuity or management arrangement, or potentially to provide for a more effective compensation structure, there may be more viable alternatives, and less risk if it is completed before year end. Because the related law and issues are complicated, to give it fair consideration you will need sufficient time. Better to start as early as feasible, than to lose an opportunity.

Accounting Considerations – Whenever tax rates change, some closely held businesses on the cash method of accounting consider the limited opportunities available to affect the timing of income and deductions in

year end planning. When rates are due to increase, the change has to be significant because “planning” involves paying tax a year early, and any savings would be offset by the time value of money and other benefits inherent with deferral. Other than for dividends which are addressed above, the expected marginal rate difference is about 5%. So, if a business or its owners expect to earn a net 5% or better on their funds, the full benefit of any of this planning would be lost. On the other hand, a 5% net return in the current economy might be considered a reasonable return, and if it is assured, could be provide a reasonable hedge against possible lower earnings.

The Small Business Jobs Act further increases the possibility for substantial tax savings through variations in accounting. The Act 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. This change permits contractors to benefit from bonus depreciation even if they do not complete their contracts within the same year.

Conclusion

Some of these ideas are dependent upon a healthy skepticism which may not prove to be an accurate prognosticator. Waiting until year end ultimately will provide an answer, but may not afford sufficient time to reflect and make good decisions. You should be the judge and, if you would like to discuss any of these ideas further, or potentially other ideas, we would be pleased to assist you.

The attorneys at Eastman & Smith Ltd. have given considerable effort to mastering the techniques and strategies offered herein. Please consider calling us to determine what impact these changes could have on your business.

Mr. Harden is the member of Eastman & Smith responsible for the Firm's tax practice. He is active in transactional business practice and frequently represents clients in tax controversies with IRS, state and local authorities. He is peer reviewed and recognized in Best Lawyers in America (since 1995) and Ohio Super Lawyers every year since its inception. He has a masters of tax law (LL.M) from New York University, a juris doctor from the University of Toledo College of Law and a bachelors of business administration, majoring in accounting, from The University of Notre Dame. 2021 Update: Mr. Harden is now employed by Harden Law, a firm with whom Eastman & Smith has a strategic alliance.

Mr. Peterson and Mr. Didion are associates of the Firm. Prior to joining Eastman, Mr. Peterson worked as a deputy auditor in the Real Estate Division of the Franklin County Auditor's Office. Mr. Didion concentrates his practice in the areas of estate planning, estate and trust administration and estate and gift taxation. Mr. Didion also has experience working with general business and real estate matters. 2021 Update: Mr. Peterson and Mr. Didion are no longer employed at Eastman & Smith.

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