

Small Business Jobs Tax Relief Act of 2010 (H.R. 5486)

June 16, 2010

Special Report

HIGHLIGHTS

- 100 Percent Exclusion For Qualified Small Business Stock
- Relief From Code Sec. 6707A Penalty
- Enhanced Expense Deduction For Start-Ups
- Ten-Year Minimum Term For GRATs

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House Passes Small Business Tax Relief Package

A package of small business tax incentives was passed by the House on June 15, 2010 by a vote of 247 to 170. The Small Business Jobs Tax Relief Act of 2010 (H.R. 5486) includes a 100 percent gain exclusion for qualified small business stock, retroactive Code Sec. 6707A penalty relief and an enhanced deduction for start-up expenses. The House bill is completely offset by new limitations on grantor retained annuity trusts (GRATs) and the cellulosic biofuel producer credit along with a shift in corporate estimated taxes for large corporations in 2015.

IMPACT. *The Small Business Jobs Tax Relief Act is the latest in the Democrats' series of "jobs" bills, which have enjoyed significant momentum in the House but have languished in the Senate. In fact, this bill represents a second time around for its provisions, with all relief provisions and the GRAT revenue offset already having appeared in a larger Small Business Jobs Tax Relief Act (H.R. 4849) that passed the House on March 24, 2010, but went nowhere in the Senate. This earlier bill also contained provisions that have found their way into the American Jobs and Closing Tax Loopholes Act (H.R. 4213) now also before the Senate.*

Timeline. It is unclear if the Senate will take up the House bill before its Independence Day recess. House Ways and Means Committee Chair Sander Levin, D-Mich., predicted that the Senate would likely seek to amend the bill but he did not specify how. Senate Democrats also are preoccupied with passing the American Jobs and Closing Tax Loopholes Act (H.R. 4213), which extends a host of temporary tax incentives,

and a war spending bill. Many of the provisions in the House bill have been endorsed by the Obama administration, such as the expanded exclusion for qualified small business stock, Code Sec. 6707A penalty relief and limits on GRATs.

QUALIFIED SMALL BUSINESS STOCK

The American Recovery and Reinvestment Act of 2009 (2009 Recovery Act) increased the Code Sec. 1202 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. The House bill would raise the exclusion to 100 percent starting March 16, 2010 and would extend it at the 100 percent level for stock issued before January 1, 2012.

IMPACT. *With both the income tax and capital gains rates anticipated to rise in the future, the benefits of an investment in Section 1202 stock become even more substantial should this House provision become law.*

To be eligible for the exclusion both under present law and under the House enhancement, the small business stock generally must be acquired by the individual 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 have at least 80 percent of the value of its assets used 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.

COMMENT. *As under current law, the amount of gain eligible for the 100 percent exclusion by an individual with respect to any corporation under the House bill is the greater of (1) 10 times the taxpayer's basis in the stock or (2) \$10 million.*

CODE SEC. 6707A PENALTY RELIEF

Under Code Sec. 6707A, the penalties for failing to disclose a reportable transaction on a tax return are \$10,000 for an individual and \$50,000 for all other taxpayers. A reportable transaction is one that the IRS has determined is required to be disclosed because it has a potential for tax evasion. If the taxpayer fails to report a listed transaction, the penalties jump to a mandatory \$100,000 for an individual and \$200,000 for all other taxpayers. A listed transaction is a reportable transaction that has been specifically identified by the IRS as an improper tax avoidance transaction.

Under the House bill, the penalty with respect to any reportable transaction would be 75 percent of the decrease in tax shown on the return as the result of the transaction or which would have resulted if the transaction was respected for federal tax purposes. The maximum penalty for a reportable transaction that is not a listed transaction would be \$10,000 for an individual and \$50,000 for all other taxpayers. The maximum penalty for failing to disclose a listed transaction would be \$100,000 for an individual and \$200,000 for all other taxpayers.

IMPACT. *The change is intended to ameliorate the impact of the penalty on small businesses. At Congressional hearings in 2009, small business owners told lawmakers of being assessed penalties that vastly exceeded the tax benefits of the transactions, many of which, the small business owners testified, they did*

not know were tax shelters. The Senate approved a similar version of Code Sec. 6707A relief in February 2010.

The House bill also provides for minimum penalties, albeit at levels much lower than currently required. The minimum penalty for an individual taxpayer failing to disclose a reportable transaction, including a listed transaction, would be \$5,000. The minimum penalty for all other taxpayers would be \$10,000. The House bill would apply to Code Sec. 6707A penalties assessed after December 31, 2006.

"The Small Business Jobs Tax Relief Act of 2010 (H.R. 5486) includes a 100 percent gain exclusion for qualified small business stock, retroactive Code Sec. 6707A penalty relief and an enhanced deduction for start-up expenses."

COMMENT. *The IRS temporarily stopped collecting Code Sec. 6707A penalties for undisclosed tax shelter transactions starting in June 2009, and extended its forbearance several times. Its latest collections moratorium officially ended on June 1, 2010.*

COMMENT. *The House bill directs the IRS to submit an annual report to Congress on Code Sec. 6707A and related penalties. The first report from the IRS would be due before January 1, 2011.*

START-UP EXPENSE DEDUCTION

Under current law, taxpayers generally may immediately 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 exceeding \$50,000. For tax years beginning in 2010 or 2011, the House bill increases the deduction for qualified start-up expenses from \$5,000 to \$20,000 and increases the threshold amount from \$50,000 to \$75,000.

IMPACT. *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 are generally relegated to being amortized above the current \$5,000 deductible amount. The quadrupling of the limit to \$20,000 is intended to allow entrepreneurs to recover small business start-up expenses upfront, increasing cash flow and the ability to hire more workers.*

PLANNING NOTE. *Taxpayers are deemed to elect to deduct their start-up expenses up to the allowable amount and amortize the remainder under Reg. Sec. 1.195-1T. However, taxpayers may elect to capitalize their start-up expenses by doing so on their income tax return (filed by the due date, including extensions) for the tax year in which the active trade or business begins. If a taxpayer timely filed its return for the year without making the election, the taxpayer can make the election by filing an amended return within six months of the due date of the return (excluding extensions).*

SBA LOANS

In certain cases, expenses financed with non-recourse debt are subject to at-risk rules to prevent taxpayers from sheltering unrelated income. The House bill provides an exception to the at-risk rules for non-recourse small business investment company (SBIC) loans from the Small Business Administration (SBA). Under the House bill, a taxpayer's amount at risk includes qualified SBIC financing, which means any financing that is borrowed by an SBIC and is either

borrowed from, or guaranteed by, the SBA under the authority of its SBIC program. The provision would be effective for qualified loans and guarantees made after the date of enactment of the bill.

SMALL BUSINESS BORROWER ASSISTANCE PROGRAM

A temporary federal program, the Small Business Borrower Assistance Program, assists qualified small businesses in repaying their creditors. Generally, amounts received under the program will be excluded from gross income. The House bill also denies any double benefit, such as a deduction for interest.

LIMITS ON GRATs

In a grantor retained annuity trust (GRAT), the grantor creates an irrevocable trust and retains the right to receive for a specified term an annuity based on a specified sum or fixed percentage of the value of the assets transferred to the trust. Generally, the value of a remainder interest in a GRAT for gift tax purposes is determined by deducting the present value of the annuity to be paid during the GRAT term from the fair market value of the property contributed to the GRAT. If the grantor of the GRAT dies during the term, the portion of the trust assets needed to produce the annuity is included in the grantor's gross estate. Consequently, some taxpayers have created short-term GRATs to minimize the chance of dying during the term of the GRAT.

H.R. 5486: ESTIMATED REVENUE EFFECTS

Revenue Raisers*	
Limitations on GRATs	\$5.3 billion
Reforms to Cellulosic Biofuel Producer Credit	\$1.84 billion
Expenditures*	
Qualified Small Business Stock Exclusion	\$1.96 billion
SBA Non-Recourse Loans	\$942 million
Start-Up Expenses Deduction	\$508 million
Code Sec. 6707A Penalty Relief	\$176 million

*Over 10 years

The House bill requires a GRAT to have a minimum 10-year term, carry a remainder interest with a value greater than zero, and prohibits any decreases in annuity payments during the first 10 years of the GRAT term.

IMPACT. *Although a minimum term would not prevent zeroing-out the gift tax value of the remainder interest, a minimum term would increase the risk of the grantor's death during the term of the GRAT and the resulting loss of any anticipated transfer tax benefit.*

IMPACT. *The limitations on GRATs in the House bill would be imposed only for transfers made after the date of enactment.*

CELLULOSIC BIOFUEL PRODUCER CREDIT

The cellulosic biofuel producer credit rewards qualified taxpayers with a \$1.01 per gallon nonrefundable income tax credit for the production of qualified cellulosic biofuel. The health care reform package (the

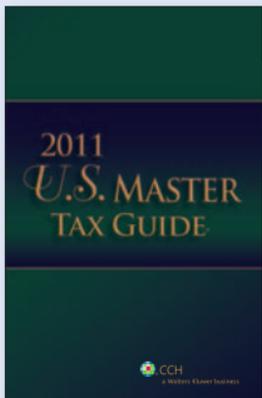
Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act) excluded so-called "black liquor" from the cellulosic biofuel producer credit. The House bill excludes crude tall oil and other corrosive fuels from the cellulosic biofuel producer credit.

COMMENT. *Crude tall oil, like black liquor, is a waste product of paper manufacturing.*

CORPORATE ESTIMATED TAX PAYMENTS

The Hiring Incentives to Restore Employment (HIRE) Act, enacted by Congress in March 2010, increases the estimated tax payments required to be made by corporations with assets of \$1 billion or more in July, August or September of 2015 to 121.5 percent of the payment otherwise due. The next required installment is proportionately reduced to reflect the increase. The House bill increases the percentage under the HIRE Act by 7.75 percentage points.

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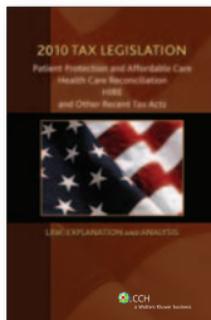
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