



# SBLC WEEKLY

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## **AMERICAN RECOVERY AND REINVESTMENT ACT**

Congress has passed H.R. 1, the American Recovery and Reinvestment Act (ARRA). The Senate approved it by a 60-38 margin. The House approved it by a 246-183 margin. The following is a summary of some of the major provisions of interest to small business. It is a massive bill and there were last minute changes in many of these provisions. I would like to say I got them all correctly, but I am sure I will be revising this summary as more details become available. You may see references to the American Recovery and Reinvestment Tax Act (ARRTA). The tax "division" of the bill had its own name and I imagine tax professionals may use that as a shorthand reference. Finally, in the text, I refer to the "new law." Until the President signs it, it is still not "law," but for convenience sake, I have written it up that way.

### **DIRECT EXPENSING**

Internal Revenue Code Section 179 allows business to write off small amount of annual investment in capital assets such as machinery in the year of purchase in lieu of

depreciating the investment over a number of years.

While it commonly referred to as a small business provision, there is no size limitation on business eligibility. The allowance is reduced and eliminated completely the more capital assets a business buys during the year, as will be explained later. As a result, the provision is generally not used by large businesses that make significant investments in equipment and machinery each year.

Under present law, there was a temporary increase in the maximum amount a taxpayer could expense for taxable year 2008. The amount was \$250,000 of the cost of qualifying property placed in service for in that taxable year. The new legislation extends the \$250,000 maximum through 2009.

Qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. Off-the-shelf computer software placed in service in taxable years. In computing the maximum amount, the maximum increase amount for extension property is reduced by bonus depreciation

amounts for preceding taxable years only with respect to extension property.

In 2008, the \$250,000 amount was reduced (but not below zero) by dollar for dollar by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$800,000. This will now be the case for 2009. Therefore, if the business bought assets of more than \$1,050,000 in 2008, Section 179 was of no use, hence the "small business" connection.

It is important to note that this extension is a temporary increase. For taxable year beginning in 2010, the limitation goes back down \$125,000, and the cap is \$500,000. Both these amounts will be indexed for inflation. For taxable years beginning in 2011 and thereafter, the amounts are \$25,000 and \$200,000 respectively and are not indexed for inflation.

[See IRS Publication 946, How To Depreciate Property](#)

### **BONUS DEPRECIATION**

There was a temporary first-year depreciation "bonus" deduction equal to 50 percent of the adjusted

basis of qualified property placed in service during 2008 (and 2009 for certain longer lived and transportation property.

The additional first-year depreciation deduction was allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service. The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, there are no adjustments to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies. The taxpayer may elect out of additional first-year depreciation for any class of property for any taxable year.

There are host of rules that apply to the bonus depreciation. Under the temporary provision, the key one was the property must have been placed in service after December 31, 2007, and before January 1, 2009.

The new law amends extends the temporary bonus deduction through 2009 for property purchased and placed in service before January 1, 2010.

#### *Direct Expensing and Bonus Depreciation*

As was the case under the current temporary bonus depreciation, under the new law, a taxpayer is entitled to depreciate 50 percent of the adjusted basis after subtracting any section 179 deduction taken on that property of qualified property during the year the property is

placed in service. For example, if the taxpayer purchased and placed in service in 2009 a single piece of property at a cost of \$450,000 that qualified for section 179 expensing and the 50 percent special depreciation allowance, \$250,000 of the cost could be immediately expensed (under section 179) and the remaining \$200,000 of adjusted basis would be available for the 50 percent special depreciation allowance. The taxpayer would also be permitted to take regular depreciation on the remaining \$100,000 of adjusted basis during that year.

See IRS Publication 946, How To Depreciate Property

#### **NET OPERATING LOSSES**

Under present law, a net operating loss ("NOL") generally means the amount by which a taxpayer's business deductions exceed its gross income. In general, an NOL may be carried back two years and carried over 20 years to offset taxable income in such years. NOLs offset taxable income in the order of the taxable years to which the NOL may be carried back. The alternative minimum tax rules provide that a taxpayer's NOL deduction cannot reduce the taxpayer's alternative minimum taxable income ("AMTI") by more than 90 percent of the AMTI. There are a host of other rules for special situations.

The new law will permit an eligible small business to elect to increase the present-law carry back period for an *applicable 2008* NOL from two years to any whole number of years elected by the taxpayer that is more than two and less than six. An eligible small business is a taxpayer meeting a \$15,000,000 gross

receipts test. Corporations, partnerships, and sole proprietorships are all included. The general rule for the gross receipts test is a business meets the \$15,000,000 gross receipts test for any prior taxable year if the average annual gross receipts of such entity for the 3-taxable-year period ending with such prior taxable year does not exceed \$15,000,000.

An *applicable NOL* is the taxpayer's NOL for any taxable year ending in 2008, or if elected by the taxpayer, the NOL for any taxable year beginning in 2008. However, any election under this provision may be made only with respect to one taxable year.

See IRS Publication 536 Net Operating Losses (NOLs) for Individuals, Estates, and Trusts

#### **ALTERNATIVE MINIMUM TAX**

The Alternative Minimum Tax (AMT) is the amount by which a tentative minimum tax exceeds the regular income tax. An individual's tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed \$175,000 (\$87,500 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The taxable excess is so much of the alternative minimum taxable income ("AMTI") as exceeds the exemption amount. The maximum tax rates on net capital gain and dividends used in computing the regular tax are used in computing the tentative minimum tax. AMT is the individual's taxable income adjusted to take account of specified preferences and adjustments.

The exemption amounts for 2008 were \$69,950 for married individuals filing a joint return and surviving spouses and \$46,200 for other unmarried individuals. Since the exemption increases were temporary, the exemptions for 2009 were to drop to \$45,000 and \$33,750, respectively.

The exemption amount is phased out by an amount equal to 25 percent of the amount by which the individual's AMT income exceeds \$150,000 in the case of married individuals filing a joint return and surviving spouses, and \$112,500 in the case of other unmarried individuals.

The new law extends the temporary "patch" for 2009. The individual AMT exemption amount for taxable years beginning in 2009 is \$70,950, in the case of married individuals filing a joint return and surviving spouses and \$46,700 in the case of other unmarried individuals.

### **SMALL BUSINESS ESTIMATED TAXES**

Under current law, the required annual payment is the lesser of 90 percent of the tax shown on the return or 100 percent of the tax shown on the return for the prior taxable year (110 percent if the adjusted gross income for the preceding year exceeded \$150,000).

The new law provides that the annual estimated tax payments of a qualified individual for taxable years beginning in 2009 will not be greater than 90 percent of the tax liability shown on the tax return for the preceding taxable year. A qualified individual means any individual if the adjusted gross income shown on the tax return for the preceding taxable year is less

than \$500,000 (\$250,000 if married filing separately) and the individual certifies that at least 50 percent of the gross income shown on the return for the preceding taxable year was income from a small trade or business. For purposes of this provision, a small trade or business means any trade or business that employed no more than 500 persons, on average, during the calendar year ending in or with the preceding taxable year.

### **MAKING WORK PAY CREDIT**

The new law provides eligible individuals a refundable income tax credit for two years (taxable years beginning in 2009 and 2010, the credit is the lesser of (1) 6.2 percent of an individual's earned income or (2) \$400 (\$800 in the case of a joint return). For these purposes, the earned income definition is the same as for the earned income tax credit with two modifications. *First, earned income for these purposes does not include net earnings from self-employment which are not taken into account in computing taxable income.* Second, earned income for these purposes includes combat pay excluded from gross income. The credit is *phased out at a rate of two percent* of the eligible individual's modified adjusted gross income above \$75,000 (\$150,000 in the case of a joint return).

Withholding tables will be adjusted as soon as possible by the Department of Treasury to reflect the change.

### **VEHICLES**

The law provides all taxpayers with a deduction for state and local sales and excise taxes paid on the purchase of new cars, light truck, recreational vehicles, and

motorcycles through 2009. This deduction is subject to a phase-out for taxpayers with adjusted gross income in excess of \$125,000 (\$250,000 in the case of a joint return).

### **HOMEBUYER'S CREDIT**

Currently, a taxpayer who is a first-time homebuyer is allowed a refundable tax credit equal to the lesser of \$7,500 (\$3,750 for a married individual filing separately) or 10 percent of the purchase price of a principal residence. The credit is allowed for the tax year in which the taxpayer purchases the home unless the taxpayer makes an election. The credit is allowed for qualifying home purchases on or after April 9, 2008 and before July 1, 2009 (without regard to whether there was a binding contract to purchase prior to April 9, 2008). The credit phases out for individual taxpayers with modified adjusted gross income between \$75,000 and \$95,000 (\$150,000 and \$170,000 for joint filers) for the year of purchase. The credit is recaptured ratably over fifteen years with no interest charge beginning in the second taxable year after the taxable year in which the home is purchased.

The new law extends the existing homebuyer credit for qualifying home purchases before December 1, 2009. In addition, it increases the maximum credit amount to \$8,000 (\$4,000 for a married individual filing separately) and waives the recapture of the credit for qualifying home purchases after December 31, 2008 and before December 1, 2009.

The Senate had approved a much broader credit for all homebuyers but that was not included.

## ***SMALL BUSINESS STOCK***

You will hear about a change regarding small business stock. This is a change to a very narrow specialized provision that has been the tax code for years; most small businesses do not utilize this provision. Under present law, individuals may exclude 50 percent (60 percent for certain empowerment zone businesses) of the gain from the sale of certain small business stock acquired at original issue and held for at least five years. The portion of the gain includible in taxable income is taxed at a maximum rate of 28 percent under the regular tax. A percentage of the excluded gain is an alternative minimum tax preference; the portion of the gain includible in alternative minimum taxable income is taxed at a maximum rate of 28 percent under the alternative minimum tax.

Under the new law, the percentage exclusion for qualified small business stock sold by an individual is increased from 50 percent (60 percent for certain empowerment zone businesses) to 75 percent.

This is what limits the scope of this. Qualified small business stock. This is stock that meets all the following tests.

1. It must be stock in a C corporation.
2. It must have been originally issued after August 10, 1993.
3. The corporation must have total gross assets of \$50 million or less at all times after August 9, 1993, and before it issued the stock. Its total gross assets immediately after it issued the stock must also be \$50 million or less. When figuring the corporation's total gross assets, you must also count the assets of any

predecessor of the corporation. In addition, you must treat all corporations that are members of the same parent-subsiary controlled group as one corporation. 4. You must have acquired the stock at its original issue, directly or through an underwriter, in exchange for money or other property (not including stock), or as pay for services provided to the corporation (other than services performed as an underwriter of the stock). In certain cases, your stock may also meet this test if you acquired it from another person who met this test, or through a conversion or trade of qualified small business stock that you held.

5. The corporation must have met the active business test, defined next, and must have been a C corporation during substantially all the time you held the stock.

6. Within the period beginning 2 years before and ending 2 years after the stock was issued, the corporation cannot have bought more than a de minimis amount of its stock from you or a related party.

7. Within the period beginning 1 year before and ending 1 year after the stock was issued, the corporation cannot have bought more than a de minimis amount of its stock from anyone, unless the total value of the stock it bought is 5% or less of the total value of all its stock.

## ***BUILT IN GAINS FOR CERTAIN S CORPORATIONS***

This is an interesting provision that has affects a very clear subset of small businesses. Basically, this is a "you know who you are" provision.

If you have converted from a C Corporation to an S Corporation, you know a corporate level tax, at

the highest marginal rate applicable to corporations (currently 35 percent) is imposed on an S corporation's gain that arose prior to the conversion of the C corporation to an S corporation and is recognized by the S corporation during the recognition period, i.e., the first 10 taxable years that the S election is in effect. It means that if you have appreciated assets, you have to hold on to them for at least 10 years after you convert to S Corporation status, otherwise you pay an additional tax on the "profits" from the sale of those assets.

The new provides for any taxable year beginning in 2009 and 2010, no tax is imposed on an S corporation if the seventh taxable year in the corporation's recognition period preceded such taxable year. Thus, with respect to gain that arose prior to the conversion of a C corporation to an S corporation, no tax will be imposed after the seventh taxable year the S corporation election is in effect.

## ***GOVERNMENT CONTRACTOR WITHHOLDING***

One of the "tax gap" closing proposals that Congress had previously passed and had been signed into law by President Bush was a withholding requirement at a three-percent rate on certain payments made by the government of the United States, every State, every political subdivision thereof, and every instrumentality of the foregoing (including multi-State agencies) to persons providing property or services to those governments. It was to go in to effect for payments made after December 31, 2010.

The new law delays the implementation of the three percent withholding requirement by one year to apply to payments after December 31, 2011.

### ***COBRA***

The details of a temporary premium subsidy are very complex. COBRA, the Consolidated Omnibus Budget Reconciliation Act (COBRA) are the health benefit provisions Congress passed in 1986. COBRA provides certain former employees, retirees, spouses, former spouses, and dependent children the right to temporary continuation of health coverage at group rates by paying their employer the premium plus some administrative costs.

Group health plans for employers with 20 or more employees on more than 50 percent of its typical business days in the previous calendar year are subject to COBRA so it is not on most small businesses' radar, although some states have COBRA-like requirements too with different thresholds.

The new law includes an enhancement – a temporary 65 percent subsidy for COBRA premium payments for nine months. It has a quirky delivery method for the subsidy. The employee would pay the employer the lowered 35 percent of premium. Employers would take a credit against their payroll taxes for the amount of the subsidy. No additional federal money changes hands (unless the total subsidies exceed the employer's payroll taxes) between the former employee, employer, and the government. There are not a lot of details on how it would work, but it does mean the payroll tax deposit

and reporting system will have to be altered to accommodate it. There will definitely be some additional administrative responsibilities and new notice requirements for employers. There are also a couple other substantive COBRA changes. The subsidy would also be made available to the COBRA-like state programs that might have lower employee size coverage thresholds.

### ***ENERGY CREDITS***

A number of temporary energy efficiency and energy conservation credits/deductions are renewed.

### ***BUY AMERICAN***

None of the funds appropriated or otherwise made available by the new law may be used for a project for the construction, alteration, maintenance, or repair of a public building or public work unless all of the iron, steel, and manufactured goods used in the project are produced in the United States.

This condition shall not apply in any case or category of cases in "which the head of the federal department or agency involved finds that-

- (1) applying this condition would be inconsistent with the public interest;
- (2) iron, steel, and the relevant manufactured goods are not produced in the United States in sufficient and reasonably available quantities and of a satisfactory quality; or
- (3) inclusion of iron, steel, and manufactured goods produced in the United States will increase the cost of the overall project by more than 25 percent.

If the head of a federal department or agency determines that it is necessary to waive the application

of the condition because of the exceptions, the head of the department or agency shall publish in the Federal register a detailed written justification as to why the provision is being waived.

The Buy American requirement shall be applied in a manner consistent with United States obligations under international agreements. The conference report says Congress anticipates that the Administration will comply with U.S. obligations under the WTO Agreement on Government Procurement and under U.S. free trade agreements and so that the Buy American requirement will not apply to least developed countries. To the same extent that it does not apply to the parties to those international agreements.

### ***PREVAILING WAGE***

All laborers and mechanics employed by contractors and subcontractors on projects funded directly by or assisted in whole or in part by and through the Federal Government pursuant to the new law shall be paid wages at rates not less than those prevailing on projects of a character similar in the locality as determined by the Secretary of Labor.