

October 15, 2010

To our Clients and Friends:

On 9/27/10, President Obama signed into law the new Small Business Jobs Act of 2010. The legislation includes a number of taxpayer-friendly changes (most of which are temporary), as well as some unfavorable ones (most of which are permanent). This letter summarizes the most important changes. We will start with the good news.

### **Section 179 First-year Depreciation Deductions Doubled for 2010 and 2011**

The Section 179 deduction allows many small and medium-sized businesses to immediately write off most or all of the cost of qualifying new and used assets in the first year instead of having to depreciate the cost off over a number of years. The new law doubles the maximum annual Section 179 deduction to \$500,000 for eligible assets placed in service in tax years beginning in 2010 and 2011 (up from the \$250,000 maximum that applied for tax years beginning in 2009). Most types of depreciable personal property (including computers, other equipment, and furniture) and most purchased software qualify. For the first time, some types of real estate improvement costs also qualify (more on that later).

However, larger businesses can lose all or part of the Section 179 deduction allowance due to an unfavorable phase-out rule. Under that rule, the allowance is reduced dollar for dollar by the cost of qualifying assets placed in service during the year (those that would otherwise be eligible for the Section 179 deduction) in excess of the applicable threshold. For tax years beginning in 2010 and 2011, the new law greatly increases the phase-out threshold to \$2 million (up from the \$800,000 threshold for tax years beginning in 2009). Thanks to this change, far fewer businesses will be limited by the phase-out rule in 2010 and 2011.

**Note:** Watch out if your business already has a tax loss for the year (or close) before considering any Section 179 deduction. You cannot claim a Section 179 write-off that would create or increase an overall business tax loss for the year.

### **Some Real Property Improvement Costs Qualify for Section 179 Depreciation Deductions**

Until now, real property improvement costs were ineligible for the Section 179 deduction. That is no longer true. For tax years beginning in 2010 and 2011, up to \$250,000 of qualified improvement costs for the following types of real property can be immediately deducted under the Section 179 deduction provision:

- Interiors of leased nonresidential buildings.
- Restaurant buildings.

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- Interiors of retail buildings.

The \$250,000 Section 179 allowance for real estate improvements is part of the overall \$500,000 allowance. Again, watch out if your business already has a tax loss for the year (or close) before considering any Section 179 deduction. You cannot claim a Section 179 write-off that would create or increase an overall business tax loss for the year.

### **50% First-year Bonus Depreciation Retroactively Reinstated for 2010**

The new law retroactively reinstates 50% first-year bonus depreciation for one year, to cover qualifying new (not used) personal property assets and purchased software placed in service by 12/31/10. Before this retroactive change, the bonus depreciation provision had expired as of 12/31/09. It is now back for eligible assets placed in service by the end of this year.

Unlike Section 179 deductions, bonus depreciation is available to even the largest businesses. However, small and medium-sized outfits that can take advantage of both the Section 179 deduction and bonus depreciation are the biggest winners.

### **Bigger First-year Depreciation Deductions for New Autos and Light Trucks for 2010**

Imagine a scenario where your business buys a new (not used) passenger auto or light truck during 2010 that is subject to the dreaded luxury auto depreciation limitations (most passenger vehicles are except for big SUVs, pickups, and vans). The reinstated 50% bonus depreciation write-off increases the maximum first-year depreciation deduction by \$8,000 for vehicles placed in service by 12/31/10.

- For new cars, bonus depreciation raises to the maximum first-year depreciation write-off for 2010 to \$11,060 (assuming 100% business use).
- For new light trucks, the maximum first-year depreciation deduction for 2010 is raised to \$11,160 (assuming 100% business use).

### **Start-up Cost Deduction Rule Liberalized for 2010**

For tax years beginning in 2010, the new law increases the maximum deduction that can be claimed for start-up costs in the year when a new business commences operations to \$10,000 (up from \$5,000). However, the \$10,000 deduction allowance is phased out once cumulative start-up costs exceed \$60,000. Start-up costs that cannot be deducted in the year when business commences under the \$10,000 allowance can be amortized over 180 months, starting with the month when business commences.

### **QSBC Stock Sale Rules Liberalized for Shares Issued in Narrow Three-month Window**

Before the new law, non-C corporation sellers of Qualified Small Business Corporation (QSBC) shares generally paid a 28% capital gains tax on only 50% to 25% of the gain on the sale of these shares (depending on when the QSBC shares were purchased). However, a percentage of the excluded gain was potentially subject to the Alternative Minimum Tax (AMT). To encourage new investments in QSBC stock, the new law exempts 100% of the gain realized on qualifying sales of QSBC shares that are issued between 9/28/10 and 12/31/10. This 100% exclusion applies for both the 28% capital gains tax and the AMT.

**Note:** The QSBC shares must be held for over five years to qualify for any of these gain exclusion breaks. Therefore, for the 100% exclusion to apply, a sale must occur in 2015 and beyond. Also, there is only a three-month window of opportunity to acquire QSBC shares that qualify for the 100% exclusion. If you are interested in taking advantage of this, you will need to close the deal by 12/31/10. Finally, there are numerous rules that must be met for the stock to qualify as QSBC shares. If you think these rules might apply to you, please contact us for additional information.

### **Break for S Corporation Built-in Gains Recognized in 2011**

When a C corporation converts to S corporation status, the corporate-level built-in gains tax generally applies when built-in gain assets (including receivables and inventories) are turned into cash or sold within the recognition period. The recognition period is normally the 10-year period that begins on the conversion date. For tax years beginning in 2011, the new law exempts gains from the built-in gains tax if the fifth year of the recognition period has passed before the start of the 2011 tax year. Therefore, deferring asset sales that would generate built-in gains until 2011 is something to consider. Please contact us if you have questions about this issue.

### **Eligible Small Businesses Get Special Treatment for 2010 General Business Credits**

Before the new law, most general business credits could be used to offset regular income taxes but not AMT. General business credits generated in the current year that could not be used in that year (unused credits) could be carried back one year or forward 20 years. The new law creates an exception that allows general business credits that arise in tax years beginning in 2010 to offset AMT for 2010. Also, unused general business credits from 2010 can be carried back five years. However, these exceptions are only available to Eligible Small Businesses (ESBs) with average annual gross receipts for the preceding three tax years of \$50 million or less.

### **Cell Phones Used for Business Are No Longer Listed Property**

Effective for tax years beginning after 2009, cell phones and similar telecommunications devices used for business are no longer subject to the ultra-strict recordkeeping requirements that formerly applied. This retroactive change has some taxpayer-friendly consequences. For instance, a self-employed individual is no longer required to keep detailed usage records to prove that a cell phone is used for business. However, if the individual has only one cell phone that is used for both personal and business purposes, some sort of recordkeeping will still be necessary to determine allowable business deductions. An employee who uses a personal cell phone for his or her employer's business can claim the related costs as a miscellaneous itemized deduction without having to prove the phone usage was for the employer's convenience.

**Note:** There is some speculation that the IRS might soon issue rules that would allow employers to provide cell phones to employees as a tax-free fringe benefit. We shall see.

### **Health Insurance Premiums Can Be Deducted in Calculating 2010 Self-employment Taxes**

Until now, a self-employed individual's federal income tax deduction for health insurance premiums could *not* be deducted as an expense when calculating his or her self-employment tax liability on Schedule SE.

**Good news:** For 2010, the health insurance premium deduction *is* allowed as an expense on Schedule SE. This can be a fairly big deal, especially if your health insurance deduction is significant.

### **Rental Property Owners Must Issue 1099s to Service Providers**

Starting next year, owning a rental property will generally be considered a business for purposes of the dreaded Form 1099 information return reporting requirements. Therefore, rental property owners will generally be required to file a 2011 Form 1099 for any service provider that is paid \$600 or more during 2011 (for things like yard care, painting, and accounting). Also, a copy of the Form 1099 (a so-called payee statement) must be provided to each payee.

**Note:** Starting in 2012, another tax-law change included in the healthcare reform legislation will impose onerous new Form 1099 reporting requirements for payments by businesses. Since owning rental property is now considered a business for purposes of the 1099 rules, property owners will be affected by the new requirements.

### **Harsher Penalties for Failure to Comply with Form 1099 Reporting Rules**

Starting next year, the IRS can assess much harsher penalties for failing to file Form 1099 information returns with the IRS and failing to send copies to payees (so-called payee statements). In many cases, the penalties will be doubled. The new rules (which are quite complicated) will apply to Forms 1099 and payee statements due in 2011 and beyond.

### **Conclusion**

This letter only covers what we think are the most significant tax changes in the new Small Business Act. In the next 30 days we will be publishing our year-end planning letter which will cover many more issues. In the meantime, please contact us if you have questions about issues discussed in this letter or about anything you have heard regarding the Small Business Act.

Very truly yours,

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