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Banking Bill With Tax Provisions Signed Into Law

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Overview

For the past couple of weeks, we have been posting articles on legislation that is winding its way through the Congress that contains important tax provisions. Our first article, noted that the Senate had voted to cut-off debate on a bill that contained numerous tax provisions. Later, on September 16, the Senate passed the Bill (H.R. 5297 as amended) by a 68-31 vote (two Republicans supported the Bill). There were slight variations in the Bill as it worked its way through the Senate from an earlier version that the House had passed. But, after Senate passage of its version of the Bill, House leadership announced that the House would simply approve the Senate version, pass the Bill, and send it to the President for signature. Indeed, on September 23, the House approved the legislation by a 237-187 vote (with only one Republican supporting the Bill). On September 27, the Bill was signed into law.[1]

The primary focus of the legislation, termed the Small Business Jobs Act of 2010 ("Act"), is another TARP-like bailout of the banking system. The theory behind the Act's sponsor (the Act was originally sponsored by Rep. Barney Frank (D-Mass.) and supporters is that banks either lack the funds to lend or need additional incentives to lend to small businesses. Accordingly, the Act establishes a "Small Business Lending Fund" authorizing the U.S. Treasury to make up to $30 billion in credit available to small community banks at various interest rates.[2] Under the Act, the Treasury Secretary is instructed to require "capital investment recipients" to provide "linguistically and culturally appropriate outreach and advertising in the applicant pool using media outlets which target organizations, trade associations, and individuals that represent or work within or are members of minority communities, women and veterans." [3] In addition, to get funds, a bank must submit to the Treasury Department a small business lending plan describing how its business strategy and operating goals address the needs of small businesses in the areas it serves and a plan to provide "linguistically and culturally appropriate outreach."[4] Lower rates on capital borrowed from the fund are available to banks that successfully meet these requirements, just as they are to banks that are owned by minorities, women or veterans that serve low and moderate income communities and other underserved or rural communities.[5]

Along with the banking bailout provisions, the Act does contain several important tax provisions purportedly designed to stimulate business activity. But, tax increases, additional filing requirements and penalties are also included in the Act.

Here are the details of the tax provisions contained in the Act that has now been sent to the President.

Provisions Intended as Tax Relief

Bonus Depreciation - The Act renews bonus depreciation for 2010 (2011 for certain long-lived assets) retroactive to January 1, 2010 at the 50 percent level. Contractors that aren't able to complete contracts within the same year in which they are entered into can now benefit from bonus depreciation because the provision decouples bonus depreciation from allocation of contract costs under the percentage of completion method rules for assets with a depreciable life of seven years or less. *Act, Secs. 2022 and 2023, effective for qualified property placed in service after December 31, 2009, and before January 1, 2011.*

> **Note:** As noted above, to be eligible for the provision, qualified property must be purchased *and* placed in service before January 1, 2011. However, aircraft and certain other long-lived assets are eligible for the provision if they are purchased and placed in serviced before January 1, 2012.[6]

Expense Method Depreciation - Legislation enacted earlier this year restored expense method depreciation retroactive to January 1, 2010, at the $250,000 level with the dollar-for-dollar phase-out kicking in at $800,000 of qualified asset purchases for the year. The Act raises the expense method limit to $500,000 for tax years beginning in 2010 and 2011 and would change the phase-out from $800,000 to $2,000,000. Without subsequent legislation, the Act specifies that the $500,000 amount will drop to $25,000 for tax years beginning after 2011. Also, the Act specifies that for tax years beginning in 2010 or 2011, certain qualified real property (is also eligible for expense method depreciation, but only up to $250,000, with the dollar cap applying to the aggregate cost of qualified real property. To qualify, the real property must be of a character subject to an allowance for depreciation, and be acquired by purchase for use in the active conduct of a trade or business. The phrase "qualified real property" is defined to include qualified leasehold improvement property,[7] qualified restaurant property[8]and qualified retail improvement property.[9] In addition, no amount that is attributable to qualified real property may be carried over to a tax year beginning after 2011. For these disallowed amounts, such property is treated as if no expense method depreciation election has been made with respect to the property. *Act, Sec. 2021(a)-(b), amending I.R.C. §179(b) and adding I.R.C. §179(f).*

The Act also specifies that computer software is to be treated as property eligible for expense method depreciation for tax years 2010 and 2011. *Act, Sec. 2021(c), amending I.R.C. §179(d)(1)(A).*

In addition, the Act specifies that taxpayers can revoke an expense method depreciation election for any tax year that begins before 2012.[10] *Act, Sec. 2012(c), amending I.R.C. §179(c)(2).*

> **Note:** Because the IRS has previously stated that the statutory provision concerning revocations of expense method depreciation elections (I.R.C. §179(c)(2)) also applies to *making* such elections, a taxpayer may make an expense method depreciation election on an amended return for tax years beginning before 2012.[11]

Practitioner Warning: Many states do not couple with the federal government on the depreciation provisions. The restoration of bonus depreciation and the enhancement of expense method depreciation will further complicate return filing in those states.

Capital Gain Exclusion - The Act removes the AMT preference on the exclusion (which is changed from 50% to 100% under the Act) applicable to gain on C corporate stock acquired after the date the Act becomes law and January 1, 2011, if the stock is held for more than five years. *Act, Sec. 2011, I.R.C. §1202(a), effective for stock acquired after date of enactment.*

> **Note:** Because the provision is applicable only to eligible stock acquired after the date of enactment and before January 1, 2011, taxpayers will, in effect, have only three

months to acquire such qualified small business C corporate stock which then can be sold tax-free once it has been held for five years. Consequently, the provision will be of negligible stimulative effect.

S Corporation Built-In Gain - The Act changes the 10-year built-in gain recognition period (presently 7 years for gain recognized in 2009 and 2010) to five years *for gains recognized in tax years beginning in 2011.* The built-in-gain recognition period will again become 10 years beginning in 2012. *Act, Sec. 2014, amending I.R.C. §1374(d)(7), effective for tax years beginning after December 31, 2010.*

AMT Waiver for Credits - The Act allows general business credits to be carried back five years (rather than the current one year) with an offset for AMT for "eligible small businesses" in 2010 only (for credits generated in 2010). A 20-year carry-forward of remaining credits still applies. *Act, Secs. 2012 and 2013, amending I.R.C. §§39(a) and 38(c), effective for credits determined in tax years beginning after 2009 with the AMT exemption applicable only to credits determined in tax years beginning in 2010.*

Health Insurance Deduction - The Act specifies that for tax years beginning in 2010, taxpayers with self-employment tax can reduce self-employment income by their deductible self-employed health insurance. (i.e., the amounts such a taxpayer pays for themself, their spouse, dependents and children under age 27 as of the end of 2010). Thus, such taxpayers can take the deduction into account when calculating net earnings from self-employment for SECA tax purposes. *Act, Sec. §2042, amending I.R.C. §162(l)(4), effective for tax years beginning in 2010.*

Cellular Phones Not Listed Property - Effective for tax years beginning after 2009, the Act specifies that cell phones (and similar property) are no longer within the definition of listed property contained in I.R.C. §280F(d)(4). *Act, Sec. 2043, amending I.R.C. §280F(d)(4), effective for tax years beginning after December 31, 2009.*

Start-Up Expenditures - The Act takes the existing $5,000 limit for deductible start-up expenses to $10,000 for tax year 2010 only. Also, the beginning point for the limitation on the deduction is changed from $50,000 to $60,000. This all means that, for 2010 only, the deduction is the lesser of the amount of the startup expenses, or $10,000 reduced (but not below zero) by the amount by which the startup expenses exceed $60,000. *Act, Sec. 2031, amending I.R.C. §195(b), effective for tax years beginning in 2010.*

Revenue-Raising Provisions

1099 Reporting - The Act subjects taxpayers that receive rental income from real estate to file information returns just like taxpayers that are engaged in a trade or business. This means that persons that receive rental income from real estate will have to file information returns to IRS and to service providers reporting payments of $600 or more during the year for rental property expenses. The Act contains exceptions for taxpayers (including military personnel) that rent their homes on a temporary basis, taxpayers that have only a minimal amount of rental income (with the minimum amount to be determined by IRS) and taxpayers that would be unduly burdened by the reporting requirement. *Act, Sec. 2101, amending I.R.C. §6041, effective for payments made after December 31, 2010.*

> **Note:** The impact of the provision is that taxpayers with rental income who pay amounts of $600 or more to such persons as plumbers, carpet layers, painters, accountants, lawyers, etc., will be required to file information returns. Also, taxpayers with land in the Conservation Reserve Program will have to file information returns for payments made to farmers who, for example, provide mid-contract maintenance services on the land worth $600 or more.[12]

Enhanced Penalties Associated With Information Returns - The Act increases the

I.R.C. § 6721 penalties for failure to timely file information returns. The $15 penalty is doubled and the calendar year maximum is changed from $75,000 to $250,000. For small filers, the calendar year maximum penalty for the first-tier penalty is tripled (from $25,000 to $75,000), the second tier penalty is quadrupled and the third tier penalty is quintupled. The minimum penalty for each failure to file due to intentional disregard goes up to $250 from $100. The I.R.C. § 6722 penalties (for failure to file information returns to payees) are also increased in the same fashion. The provision applies to information returns required to be filed after 2010. *Act, Sec. 2102, amending I.R.C. §6721, effective for information returns required to be filed on or after January 1, 2011.*

Tax Increase on Oil - The Act contains a provision that would exclude crude tall oil from the biofuel producer tax credit. Earlier this year, as part of the health care bill, black liquor was similarly excluded from the biofuel tax credit. Both tall oil and black liquor are by products of the paper milling process. Also, beginning this year domestic production of oil and gas has already been hit with a tax increase by virtue of not getting the increase in the I.R.C. § 199 deduction to 9% (it remains at 6%). *Act, Sec. 2121, amending I.R.C. §40(b)(6)(E), applicable for fuels sold or used on or after January 1, 2010.*

Income From Guarantees - The Act negates a recent opinion of the U.S. Tax Court (*Container Corp. v. Comr., 134 T.C. No. 5 (2010)*) where the court held that guarantee fees that a U.S. company paid to its Mexican parent were non-U.S. source income not subject to U.S. withholding taxes. Under the provision (new I.R.C. § 861(a)(9)), income from U.S. sources includes amounts received either directly or indirectly, from a non-corporate resident or a domestic corporation for the provision of guaranteed debt of such person. *Act, Sec. 2122, amending I.R.C. §861(a), applicable to guarantees issued on or after the date of enactment.*

Corporate Estimated Tax - The Act increases by 36 percentage points the required corporate estimated tax payments for corporation having assets of at least $1 billion for payments due in the third quarter of 2015. *Act, Sec. 2131.*

Reported and Listed Transactions - Under the Act, the I.RC. § 6707A penalty for the failure to disclose a "reportable" transaction is limited to 75% of the decrease in tax that the transaction caused. The penalty maximum is capped at $10,000 for natural persons and $50,000 for all other taxpayers. For listed transactions, the penalty is higher - $100,000 for natural persons and $200,000 for all other taxpayers. The minimum penalty is $5,000 for natural persons and $10,000 for all other taxpayers. The Act also requires the IRS to report to the Congress by the end of this year (and then every year thereafter) on the penalties assessed for tax shelters and reportable transactions. The Act does not provide for any discretion on the part of the IRS to abate the penalty when the taxpayer has acted in good faith. *Act, Sec. 2041, amending I.R.C. §6707A(b), effective for penalties assessed after December 31, 2006.*

Retirement Related Provisions

Elective Deferrals as Roth Contributions - The Act allows I.R.C. §457 plans to treat elective deferrals as Roth contributions, beginning in 2011. *Act, Sec. 2111, amending I.R.C. 402A(e), effective for tax years beginning after 2010.*

Rollovers To Designated Roth Accounts - The Act allows rollovers from elective deferral plans to Roth-designated accounts, for distributions made after the date of enactment. *Act, Sec. 2112, amending I.R.C. 402A(c), effective for distributions made after date of enactment.*
Annuities Received From a Portion of a Contract. The Act specifies that, effective for tax years after 2010, a portion of an annuity, endowment or life insurance contract can be annuitized while the balance is not annuitized so long as the period of annuitization is at least 10 years, or is for the life of at least one person. *Act, Sec. 2113, amending I.R.C. §72(a), effective for amounts received in tax years beginning after 2010.*

Estate and Gift Tax Increase?

In July of 2010, the U.S. House passed H.R. 5486 by a 247-170 vote (with only 5 Republicans supporting the bill). The Bill contained a provision that would have required that grantor-retained annuity trusts (GRATs) be structured such that the annuity payments to the grantor continue for at least ten years, the annuity payment could not decrease relative to any prior year during the first 10 years of the term, and the remainder interest must have a value greater than zero.

The initial version of S. Amendment 4594 contained the provision, but the version as finally voted on by the Senate on September 16 did not include it.

> **Note:** A GRAT is a trust that a grantor uses to transfer property but yet retain the right to receive a series of payments for a period of years. Typically, the payments are structured such that, after accounting for a rate of return mandated by federal law, the present value of the payments equals the value of the property transferred to the GRAT. This allows the GRAT to be "zeroed-out" because the remainder interest is valued at zero for gift tax purposes - so, no gift tax is due and none of the grantor's $1 million gift tax exemption is used upon funding. Because the Bill requires the remainder interest to have a value greater than zero, the grantor will have to pay gift tax or use some of the grantor's gift tax exemption at the time the GRAT is established. Because the GRAT may or may not realize an investment return in excess of the federally-required rate so as to actually pass property to the GRAT remainder beneficiaries, the result may be at least a partial waste of the grantor's gift tax exemption or the payment of gift tax without any purpose. In addition, because the Bill requires the annuity payments to continue for at least 10 years, it will increase the tax risk of using GRATs by older persons, and will enhance the mortality risk of GRAT planning (especially for those anticipating short-term appreciation in the GRAT property). The provision is particularly harmful at the present time - asset values have fallen and the mandated interest rate (under I.R.C. Sec. 7520) is near an all-time low. That would indicate GRATs are a useful tool presently and this provision would provide a disincentive to use them.

Additional Tax Legislation?

After the Senate and then the House passed the Act, leadership in the Senate stated further consideration of what taxpayers (and businesses) would face an income tax increase beginning with the 2011 tax year will be put off until after the fall election. House leadership initially indicated similarly, but then stated that it was possible that the House could consider such legislation before the election. Also left on the table at the present time is the annual AMT "patch." Without a patch for 2010, the AMT exemption is only $45,000, which is down from $70,950 in 2009. Without the "patch," the result will be a significant tax increase for millions of taxpayers.[13] Thus, it appears likely at the present time that the lame-duck Congress will have the opportunity to deal with some significant income tax issues before the end of the year (not to mention, estate tax, corporate tax, dividend and capital gain rates).

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[1] Pub. L. No.

[2] Act, Sec. 4103.

[3] Act, Sec. 4103(d)(1)(E).

[4] *Id.*

[5] Act. Sec. 4105(2).

[6] Because of its retroactive nature, the provision applies to qualified assets that have been purchased and placed in service in 2010 before the Act became law. Thus, for taxpayers that have already made qualified asset purchases in 2010, the provision has no stimulative effect and is merely a windfall.

[7] As described in I.R.C. §168(e)(6).
[8] As described in I.R.C. §168(e)(7) and without regard to the dates specified therein.
[9] As described in I.R.C. §168(e)(8) and without regard to subparagraph (E) thereof.
[10] This amounts to a one-year extension of the provision.
[11] Rev. Proc. 2008-54, 2008-38, I.R.B. 722. IRS later issued Info. 2009-0059 (Feb. 17, 2009) to reiterate that taxpayers make or revoke an expense method depreciation election on an amended return before the last tax year provided in I.R.C. §179(c)(2) (which is now specified as 2012).
[12] An amendment by Sen. Johanns (R-NE) would have repealed the 1099 reporting requirement for taxpayers that purchase $600 or more in goods or services from a vendor beginning in 2012 (as included in the health care bill), but the amendment failed 46-52. The Administration has vowed to veto any attempt to eliminate the 1099 reporting requirement in the health care bill.
[13] The $25,950 decrease in the AMT exemption for 2010 (compared to 2009), when multiplied by the AMT rate of 26 percent results in an additional tax of $6,747 on the same income in 2010 over 2009. While the full impact of the AMT is felt at higher income levels, the lack of an AMT "patch" for 2010 will impact incomes for some taxpayers as low as $75,000. In addition, the additional standard deduction for elderly persons will be eliminated without the "patch" as will the $1,000 property tax deduction that was recently added to the standard deduction.