Maximizing small-biz incentives in the Recovery Act

The $787 billion American Recovery and Reinvestment Act of 2009 (P.L. 111-5, Feb. 17, 2009) provides almost $300 billion in tax relief. As a stimulus package, the bill makes available over $280 billion in tax relief in the short term in 2009 and 2010. For business, over $75 million in tax benefits are provided for 2009 and 2010. Although most of that is accelerated depreciation, which over a 10-year period when tax bills are "scored," almost evens out, the immediate benefits to business taxpayers are substantial. What's more, to avoid discouraging taxpayers from making investments and purchases before the act was passed, most of the tax incentives are retroactive to Jan. 1, 2009.

While some of the business benefits can help businesses of any size, the act targets significant benefits at small businesses in particular. This is consistent with the Obama administration's view that small business is the principal engine for jobs growth. Notably, the act seeks to encourage spending for major purchases of capital equipment by extending enhanced small-business expensing and 50 percent first-year bonus depreciation. Small businesses that are incurring losses now but made profits within the last five years can take advantage of enhanced net operating loss carrybacks. S corporations and owners of qualified small-business stock also received benefits that can reduce their taxes.

One caution is necessary: The Internal Revenue Code does not have a uniform definition of small business. Different tax benefits use different definitions, based on assets, gross receipts, number of employees, or number of shareholders, for example. To analyze what benefits are available to small businesses, it is necessary to decipher how each Tax Code provision defines a small business.

- **Small-business expensing.** Both large and small businesses can generate large deductions from capital purchase through first-year expensing (Code Sec. 179) and bonus depreciation

(Code Sec. 168(k)). Code Sec. 179 is known as small-business expensing, because the benefit is phased out as a company increases its purchases.

First-year expensing once was limited to $25,000 a year, and then was increased to $100,000. In 2008, the limit was increased to $250,000, and the recent act extended this limit through 2009. If a company spends more than $800,000 on eligible purchases, the $250,000 limit is phased out dollar for dollar, until purchases reach $1.05 million and the limit is reduced to zero.

Businesses that qualify should take advantage of small-business expensing in 2009, because under current law, the limit reverts to a lower amount (approximately $125,000 with a $500,000 phase-out) in 2010. Expensing is available generally for tangible personal property described in Code Sec. 1245. Generally this is property subject to the Modified Accelerated Cost Recovery System with a recovery period of 20 years or less. Eligible property also includes water utility property, off-the-shelf computer software, and qualified leasehold improvement property.

The property must be purchased and placed in service during the tax year, which can be any tax year beginning in 2009. The enhanced limits apply to certain assets with long production periods (10 year or more), transportation property costing over $1 million with an estimated production period over one year, and certain aircraft contracted for prior to Jan. 1, 2010. Only capitalized costs incurred prior to 2010 can be written off. The property can be new or used, a useful distinction from bonus depreciation, which is available only for new property. The $250,000 amounts is limited by taxable income, which prevents the use of expensing to create or increase an NOL.

Certain businesses may qualify for an increased limit of $350,000: those in empowerment zones, renewal communities, the Gulf Opportunity Zone, the Kansas disaster area, or any other federally declared disaster area since 2007.

- **50 percent bonus depreciation.** The act extended 50 percent bonus depreciation for one year, so that it now applies in 2009 to property acquired and placed in service before Jan. 1, 2010. Qualified property is the same as for small-business expensing. An extended placed-in-service date to Dec. 31, 2010, also applies for certain long-lived and transportation property.

  Unlike expensing, only new property qualifies for bonus depreciation. Fifty% bonus depreciation is taken on top of regular depreciation for the year the property is placed in service. Taking bonus depreciation results in a smaller future depreciation deduction, so it only makes sense if the company has gross receipts to offset.

Because there are special caps on depreciation for luxury vehicles, bonus depreciation is provided by adding $8,000 to the normal caps for new vehicles placed in service in 2009. For 2008, the normal limit on depreciation was $2,960 for cars. With the $8,000 increase, it was $10,960.

NOL CARRYBACKS

Initially the act would have provided an extended NOL carryback for all businesses. To reduce the cost of the measure, this was scaled back to small businesses. (The possibility that the administration's FY 2010 budget outline leaves open the possibility of expanding it to all businesses is encouraging, although the reason it might pass that the economy will still be in trouble at the end of 2009 is not.) The benefit under the '09 Recovery Act applies to a corporation, partnership or sole proprietorship with average annual gross receipts of $15 million or less for each of the immediate three-year periods.

The use of NOL carrybacks can provide a significant and immediate cash infusion for cash-starved businesses that are running a current loss. Under prior law, a taxpayer had the option of carrying back an NOL two years and generating a tax refund if it reported income the prior year. The act allows a small business to carry back an NOL for an optional period of three, four or five years. As a result, the business can generate a refund for profits earned three to five years preceding the NOL year. Taxpayers can elect this extended carryback period of ran NOL resulting from a tax year beginning or ending in 2008. The amount of the NOL is computed with specified modifications to taxable income.

The normal two-year carryback period returns for losses incurred in 2009. Earlier versions of the bill included 2009. Congress could revisit this provision if economic recovery remains slow.

The extended carryback period is elected on the return filed for 2008. Taxpayers can then file a claim for a quick refund, using Form 1045 for individuals and Form 1139 for corporations, providing a potential cash infusion to the business. The taxpayer can instead file amended Forms 1040X of 1120X to claim the refund. There is a risk that the IRS will challenge positions taken in the carryback year. The act also allows taxpayers to revoke an election previously made to waive the two-year carryback period, by making an election before April 18, 2009, to claim the increased carrybacks period.

Some businesses may decide to forego the carryback if they expect to be in a higher tax bracket in future years, when then unused NOL may be more beneficial to claim. However, if the NOL at least equals the taxpayer’s combined income for the third, fourth and fifth years before the NOL, it makes sense to carry back the NOL to the fifth year. If the NOL is less than the total income, it makes sense to carry it back to the year in which income was taxed at the highest rate. This will provide the highest refund. It may be better not to elect the extended carryback and instead carry back the NOL the normal two years.

Previously, a taxpayer owning qualified small-business stock could exclude 50% of gain realized on a sale of the stock, if the stock was acquired when issued and was held for five years. The act increased the exclusion to 75% of the gain, for stock issued after Feb 17, 2009, through the end of 2010. The higher exclusion created an effective tax rate of 7% (25% of the 28% rate) on the gain, a significant reduction from the 15% capital gains rate that would normally apply to stock gains.

To be qualified small business, the corporation must have gross assets that do not exceed $50 million when the stock was issued. The corporation must conduct an active trade or business. The investor cannot be a corporation. The amount of gain that is eligible for the exclusion is unchanged at 10 time the owner's basis in the stock of $10 million, whichever is greater.

S CORPS

The holding period rules impose a corporate-level tax on S corporations that converted from C corporation status and held appreciated assets at the time of conversion. The provision is designed to prevent C corporations from converting to S corporation status to avoid corporate taxes. Under the old rules, any appreciated assets sold within 10 years after the conversion were subject to a separate corporate-level tax on the appreciation. The gains were taxed at the highest corporate rate (35 percent) in effect at the time of the election.

Under the act, the additional tax applies only if the assets are sold in 2009 or 2010 and the sale occurs within seven years after the conversion. If the seventh year since conversion occurs before 2009 or 2010 (that is, a conversion in 2001 of 2002), the S corporation will benefit from the change. This change benefits S corporations that are facing downsizing and the need to unload assets. The built-in gain rules may discourage S conversions in situations in which the business may not survive under C corporation rules. The new law gives shareholders more flexibility during the current economic crisis. The 10-year holding period will apply again in 2011 unless Congress further changes the law.

This benefit provides a safe harbor for estimated taxes of 90% of the prior year's tax, rather than 100% of the prior year's tax, or 90% of the current year's tax. Of course, if profits decline in 2009, then the safe harbor may not be useful. The reduced limit applies to individuals with adjusted gross income on the prior year's return of less than $500,000, where more than 50% of income is derived from a business with an average of less than 500 employees in 2008. This benefit only applies for 2009, but should lower estimated taxes starting with the April 15, 2009, payment.

- **Work Opportunity Tax Credit.** Other business provisions apply to all businesses and can benefit small business. The WOTC provides an incentive for workers from targeted groups that have a particularly high unemployment rate. The act adds two new groups: unemployed veterans and disconnected youth. If a person from these groups is hired and begins work during 2009 or 2010, the WOTC provides a $2,400 first-year credit from the wages paid. The credit can be particularly helpful to small businesses, which often train their own workers.

A veteran is a soldier discharged or released within five years of the hiring date, who received unemployment compensation for at least four weeks in the past year. A youth is a person age 16-24 who has not attended school in the past six months, was not regularly employed, and is not readily employable because they lack basis skills for employment.

- **Deferral of COI income.** Cancellation-of-indebtedness income realized in 2009 or 2010 can be deferred until 2014, instead of being recognized in the current year. Beginning in 2014, it then must be recognized ratably over five years. This reduces current income and lessens the need for cash to pay taxes. The benefit applies to repurchases for cash, debt-for-debt exchanges, modifications of debt instruments treated as an exchange, exchanges of equity for debt, and contributions of debt to capital. It also applies to a complete forgiveness of the debt by the debt holder.

However, the income is accelerated and must be recognized immediately on a sale of substantially all business assets, the ceasing of business, or liquidation of the company. The benefit applies to any applicable debt instrument: a bond, debenture, note, certificate or other instrument issued by a C corporation of by any other person, in connection with the conduct of a trade or business.

- **Refundable credits.** This is an effective provision for putting cash into the pockets of businesses operating at a loss. A company with accumulated research credits or AMT credits from before 2006 that buys equipment eligible for bonus depreciation in 2009 can elect to monetize the accumulated credits. The act extends this provision one year, from 2008. A taxpayer can claim 20% of the excess bonus depreciation on the property. The benefit is capped at the lesser of $30 million or 6% of pre-2006 credits.

The act also allows the business to change its election from 2008 to 2009, or to make an election in 2009 when none was made in 2008, so that it can monetize the excess credits in one year but not the other. This is a sharp difference from IRS guidance that made the 2008 election (or non-election) binding for 2009.

The act provides significant benefits to business, despite grumblings that it could have done more. A number of the general business benefits are targeted particularly to small business, as defined in turn in the particular statute providing the benefit.

Some benefits, such as write-offs of capital purchases, will reduce current year income substantially. Others will help relieve pressures on cash flow, such as deferral of debt income and a reduced safe harbor for estimated taxes. And some benefits will allow a business to generate cash using accumulated deductions or losses, such as the NOL carryback and the election to convert bonus depreciation into an AMT credit or research credit. Businesses need to look at the act and explore their options for reducing taxes and generating cash.