LATHAM & WATKINS

Number 1089 October 11, 2010

Client Alert

Latham & Watkins
Tax Department

Important Tax Law Provisions of the Small Business Jobs Act of 2010

On September 27, 2010, President Obama signed the Small Business Jobs Act of 2010 into law (the 2010 SBJA). The legislation includes approximately $12 billion of tax breaks intended to spur small business growth, plus various revenue provisions aimed at offsetting the cost of the tax breaks. Among the tax provisions included in the bill are:

- A temporary exclusion of 100 percent of the gain from dispositions of certain small business stock
- A temporary reduction in the recognition period for the S-corporation built-in gains tax
- An increase and expansion of expensing on certain depreciable small business assets
- Increased information return penalties

This *Client Alert* summarizes the changes made to existing law relating to these provisions by the 2010 SBJA.

"The legislation includes approximately $12 billion of tax breaks intended to spur small business growth, plus various revenue provisions aimed at offsetting the cost of the tax breaks."

Temporary Exclusion of 100 Percent of the Gain from Dispositions of Certain Small Business Stock

The 2010 SBJA amends Section 1202 of the Internal Revenue Code of 1986, as amended (the Code), to permit the temporary exclusion of 100 percent of any gain realized on the sale of certain "qualified small business stock" (QSBS). Generally, QSBS includes stock of a small business corporation holding under $50 million of gross assets, provided the corporation satisfies certain active business requirements.

Under prior law, non-corporate stockholders were generally permitted to exclude from recognition 50 percent of the capital gain from the sale of QSBS (or 60 percent in the case of certain empowerment zone businesses), provided the stock was acquired at original issue and held for at least five years. A temporary increase permitted the exclusion of 75 percent of the capital gain from the sale of QSBS acquired after February 17, 2009 and before January 1, 2011. For all periods, seven percent of the excluded amount was an includible tax preference subject to the alternative minimum tax (AMT).

The 2010 SBJA amends prior law regarding the QSBS exclusion amount, resulting in a potentially significant federal income tax benefit to non-corporate investors. The 2010 SBJA increases the exclusion to 100 percent of the gain from the sale of QSBS, but only for QSBS acquired between September 27, 2010 and December 31, 2010. In addition, if the 100 percent exclusion applies to a sale, no part of

Latham & Watkins operates worldwide as a limited liability partnership organized under the laws of the State of Delaware (USA) with affiliated limited liability partnerships conducting the practice in the United Kingdom, France, Italy and Singapore and an affiliated partnership conducting the practice in Hong Kong and Japan. Latham & Watkins practices in Saudi Arabia in association with the Law Office of Mohammed Al-Sheikh. Under New York's Code of Professional Responsibility, portions of this communication contain attorney advertising. Prior results do not guarantee a similar outcome. Results depend upon a variety of factors unique to each representation. Please direct all inquiries regarding our conduct under New York's Disciplinary Rules to Latham & Watkins LLP, 885 Third Avenue, New York, NY 10022-4834, Phone: +1.212.906.1200. © Copyright 2010 Latham & Watkins. All Rights Reserved.

the excluded amount will be subject to AMT. The exclusion remains subject to certain limitations, however, including a limitation on the total amount of gain excluded by a particular taxpayer from the sale of QSBS issued by any single issuer, which is generally limited to the greater of $10 million or ten times the basis of the QSBS.

Temporary Reduction in the Recognition Period for the S-Corporation Built-in Gains Tax

The 2010 SBJA includes a provision amending Section 1374 of the Code to reduce temporarily the recognition period for the built-in-gains tax imposed on certain S-corporations that hold assets previously held by a C-corporation. A corporation that meets certain eligibility requirements, including limitations on the number and type of shareholders, may elect to be taxed as an S-corporation. Generally, an S-corporation is not subject to entity-level tax but instead passes income through to its shareholders, who include their pro-rata shares of the S-corporation's income on their annual tax returns. Shareholders adjust their tax basis in their S-corporation stock to prevent any further taxation of that income.

An S-corporation is subject to an entity-level income tax, however, on certain built-in gains attributable to periods when the assets were held by a C-corporation (Built-in Gains Tax). S-corporations potentially exposed to the Built-in Gains Tax include former C-corporations and S-corporations that hold assets received from a C-corporation in a carry-over basis transaction, such as a tax-free asset reorganization or a statutory merger.

Under prior law, if an S-corporation sold a built-in gain asset during the "recognition period," then it would be subject to the Built-in Gains Tax unless it could prove the asset had not been held by a C-corporation, or that the gains were attributable to the period after the corporation had become an S-corporation. The recognition period was the corporation's first 10 years as an S-corporation or the 10-year period since receiving the carry-over basis assets from a C-corporation. The 2009 Recovery Act temporarily reduced the recognition period to seven years for tax years 2009 and 2010.

Under the 2010 SBJA, asset dispositions by an S-corporation in tax year 2011 will not be within the recognition period if the disposition is more than five years after the corporation became an S-corporation (or received carry-over basis assets from a C-corporation). Thus, S-corporations holding significant built-in gain assets may be incentivized to dispose of such assets in 2011 (assuming the five-year recognition period has elapsed).

Increase and Expansion of Expensing on Certain Depreciable Small Business Assets

The 2010 SBJA includes a provision amending Section 179 of the Code to increase temporarily and expand expensing of certain depreciable business assets. Section 179 permits taxpayers to elect to deduct immediately the cost of certain depreciable tangible assets (Section 179 Property) rather than to depreciate those assets over time. The Code defines Section 179 Property to include certain depreciable tangible assets purchased for use in a trade or business.

Under prior law, the Code included limitations for the aggregate cost of the Section 179 Property in service that could be immediately expensed. The 2010 SBJA changes these limitations as follows:

- Under prior law, for tax years beginning in 2008, 2009 and 2010, up to $250,000 could be expensed, subject to a phase-out when total cost of Section 179 Property placed in service during the year exceeds $800,000. Also under prior law, for tax years 2011 and following, up to $25,000 could be expensed, subject to a phase-out when total Section 179 Property placed in service during the year exceeds $200,000.
- Under the 2010 SBJA, for tax years 2010 and 2011, up to $500,000 may be expensed, subject to a phase-out when total Section 179 Property placed in service during the year exceeds $2 million. For tax years 2012 and following, the rule remains as it was under prior law.

The 2010 SBJA also expands the definition of "Section 179 Property" to include certain qualified real property. As expanded, Section 179 Property will include certain qualified leasehold improvements, qualified restaurant property and qualified retail improvement. Limitations are imposed on the amount of qualified real property costs that may be expensed, and excess deductions from 2010 may be carried over to tax year 2011. Taxpayers may also elect not to include qualified leasehold improvements in the definition of Section 179 Property.

Increase in Information Return Penalties

The 2010 SBJA amends Sections 6721 and 6722 of the Code to increase permanently certain information return penalties.

Under prior law, Section 6721 of the Code prescribed penalties for taxpayers who failed to file complete information returns before the filing date. The amount of the penalty varied based on how quickly the taxpayer corrected the failure. The 2010 SBJA increases the penalties as follows:

- Generally, the penalty for failure to file is increased from $50 to $100 per return, and the maximum penalty is increased from $250,000 to $1,500,000.
- The penalty for failures corrected within 30 days is increased from $15 to $30 per return, and the maximum penalty is increased from $75,000 to $250,000.
- The penalty for failures corrected after 30 days but before August 2 is increased from $30 to $60 per return, and the maximum penalty is increased from $150,000 to $500,000.

Under prior law, Section 6722 of the Code imposed a penalty on taxpayers who failed to furnish a correct payee statement to other taxpayers. The penalty was $50 for each failure to furnish a payee statement, up to a $100,000 maximum. The 2010 SBJA now provides for penalties that increase based on when the failure is corrected. In addition to increased penalties for cases of intentional disregard, the new penalties for failure to file a correct payee statement are as follows:

- Generally, the penalty for failure to file is $100 per return, and the maximum penalty is $1,500,000.
- The penalty for failures corrected within 30 days is $30 per return, and the maximum penalty is $250,000.
- The penalty for failures corrected after 30 days but before August 2 is $60 per return, and the maximum penalty is $500,000.

Taxpayers interested in exploring the availability of, or restrictions on, the tax benefits provided by the 2010 SBJA, or who have questions about this *Client Alert*, should contact one of the authors listed below or the Latham attorney with whom you normally consult:

Sam Weiner
+1.213.891.8298
sam.weiner@lw.com
Los Angeles

David Kahn
+1.213.891.8675
david.kahn@lw.com
Los Angeles

Michelle Layser
+1.213.891.8408
michelle.layser@lw.com
Los Angeles

Client Alert is published by Latham & Watkins as a news reporting service to clients and other friends. The information contained in this publication should not be construed as legal advice. Should further analysis or explanation of the subject matter be required, please contact the attorney with whom you normally consult. A complete list of our *Client Alerts* can be found on our website at www.lw.com.

If you wish to update your contact details or customize the information you receive from Latham & Watkins, please visit www.lw.com/LathamMail.aspx to subscribe to our global client mailings program.

Abu Dhabi
Villiers Terblanche
+971.2. 495.1700

Barcelona
Jordi Domínguez
+34.93.545.5000

Beijing
Allen C. Wang
+86.10.5965.7000

Brussels
Howard Rosenblatt
+32.2.788.6000

Chicago
Diana S. Doyle
+1.312.876.7700

Doha
Villiers Terblanche
+974.4406.7700

Dubai
Villiers Terblanche
+971.4.704.6300

Frankfurt
Hans-Jürgen Lütt
Anders Kraft
+49.69.6062.6000

Hamburg
Tobias Klass
Götz T. Wiese
+49.40.4140.30

Hong Kong
Joseph A. Bevash
+852.2522.7886

Houston
Michael E. Dillard
+1.713.546.5400

London
Daniel Friel
+44.20.7710.1000

Los Angeles
Laurence J. Stein
Samuel R. Weiner
+1.213.485.1234

Madrid
Jordi Domínguez
+34.91.791.5000

Milan
Fabio Coppola
+39.02.3046.2000

Moscow
Mark M. Banovich
+7.495.785.1234

Munich
Thomas Fox
Stefan Süss
+49.89.2080.3.8000

New Jersey
David S. Raab
+1.212.906.1200

New York
David S. Raab
+1.212.906.1200

Orange County
David W. Barby
+1.714.540.1235

Paris
Christian Nouel
+33.1.40.62.2000

Riyadh
Mohammed Al-Sheikh
+966.1.207.2500

Rome
Fabio Coppola
+39.06.98.95.6700

San Diego
David O. Kahn
+1.619.236.1234

San Francisco
Kirt Switzer
+1.415.391.0600

Shanghai
Rowland Cheng
+86.21.6101.6000

Silicon Valley
Kirt Switzer
+1.650.328.4600

Singapore
Mark A. Nelson
+65.6536.1161

Tokyo
Hisao Hirose
+81.3.6212.7800

Washington, D.C.
Joseph D. Sullivan
Cheryl M. Coe
+1.202.637.2200

* In association with the Law Office of Mohammed A. Al-Sheikh