Louis Plung & Company

Four Gateway Center, 9th Floor, Pittsburgh, PA 15222
Tel: 412-281-8771 • Fax: 412-281-7001
email: info@louisplung.com

New Small Business Law Provides Tax Incentives

After several failed attempts to arrive at a consensus, Congress finally passed the *Small Business Jobs and Credit Act*. This vital new legislation, which President Obama signed on September 27, provides various tax incentives targeted to small business owners.

Here are several key provisions in the new law:

Enhanced Section 179 Depreciation Deductions: Under Section 179 of the Internal Revenue Code, a business can currently deduct the cost of qualified property placed in service during the year, within an annual limit. Prior to the new law, the limit for 2010 was $250,000, and the maximum deduction was subject to a phase-out for annual purchases above $800,000. The new law increases the maximum deduction to $500,000 for 2010 and 2011 with a phase-out threshold of $2 million. Eligible assets include computers, office equipment, and furniture. Certain real estate improvement costs now qualify for Section 179 deductions of up to $250,000.

"Bonus Depreciation" is Back for 2010: The new law also restores bonus depreciation, which expired after 2009. A business may claim a deduction equal to 50 percent of the cost of qualified assets, which include vehicles. (An additional year of bonus depreciation through 2011 is allowed for property with a cost recovery period of 10 years or longer and certain transportation property.)

Qualifying new assets must be placed in service by December 31, 2010.

Note: There is a tax-saving opportunity for businesses that are able to take advantage of both Section 179 and 50 percent first-year bonus depreciation. These two breaks can be combined to offset a large part, or perhaps all, of a company's major acquisitions for the year. While larger businesses may be ineligible for the Section 179 deduction, 50 percent first-year bonus depreciation is available to any business regardless of size.

More Stimulus for Job Creation

The *Small Business Jobs and Credit Act* aims to create as many as 500,000 jobs through a $30 billion fund that will provide local community banks with capital to lend small business owners.

The idea is to provide capital to start-up businesses and small enterprises that want to expand and hire new workers. Currently, large banks generally are not lending to small businesses, which create many of America's jobs.

The law includes provisions to:

- Boost the Small Business Administration (SBA) maximum amount available to help start a business or help cover short-term capital requirements.
- Increase to 90 percent from 75 percent the amount of the loans that the SBA will guarantee. If a small business owner defaults, the bank that lent the money would take a maximum hit of 10 percent. This is aimed at encouraging local banks to lend to businesses that may be in trouble.
- Extend the elimination of SBA fees charged to originate loans.

Even if a business appears small, it may not qualify for loans. A small business is determined by annual sales, number of employees, and the industry. To see if an enterprise qualifies, click here to go to the SBA table of standards.

While most business organizations applauded the law, some criticized it. Critics argue the money will go to more mature businesses rather than start-ups and small enterprises. They note that while the law gives access to capital, it doesn't require banks to lend and, in the current economic climate, many businesses don't want to borrow or hire.

S Corporation Disposition Rules are Eased: After a C corporation converts to S corporation status, it may be liable for the "built-in gains" (BIG) tax if it sells or otherwise disposes of appreciated property within a specified time period. The normal recognition period of 10 years was shortened to seven years for dispositions in tax years beginning in 2009 and 2010. The new law reduces this period still further to only five years for dispositions in tax years beginning in 2011.

Start-Up Expense Deductions Increase: Prior to the new law, a taxpayer could deduct up to $5,000 of qualified business start-up expenditures for new ventures just getting off the ground. The maximum $5,000 deduction was phased out for expenses over $50,000. The new law doubles the maximum deduction for 2010 to $10,000 with a $60,000 phase-out threshold. Note that these figures are scheduled to revert to their prior amounts in 2011.

Restrictions on Business Credits Removed: With limited exceptions, general business credits cannot be used to offset a taxpayer's alternative minimum tax (AMT) liability. The new law removes this restriction for "eligible small businesses." To qualify, average annual gross receipts of a non-public corporation, partnership, or small proprietorship can't exceed $50 million for the prior three years. In addition, beginning in 2010, an eligible small business may carry back general business credits for five years instead of one year.

Qualified Small Business Stock Gets Better Tax Treatment: Assuming certain requirements are met, an investor in "qualified small business stock" may exclude part of the gain from the sale of the stock after a five-year holding period. Normally, the tax exclusion is 50 percent for QSBS, which is taxed at the 28 percent rate, but the 2009 stimulus law increased the exclusion to 75 percent for acquisitions after February 17, 2009, and before January 1, 2011. The new law allows 100 percent exclusion for acquisitions from the date of enactment through December 31, 2010.

Cell Phone Recordkeeping is Less Burdensome: Previously, cell phones were treated as "listed property" for tax purposes, therefore triggering the same strict substantiation rules that apply to business use of vehicles. In other words, in order to claim deductions, taxpayers had to track business and personal use. The new law removes these requirements for cell phones and similar communication devices and treats employer-provided devices as tax-free fringe benefits.

Self-Employed Taxpayers Get a Break on Health Insurance Costs: A self-employed individual must pay self-employment tax comparable to the Social Security tax paid on employee wages. For 2010, eligible self employed people can deduct health insurance premiums from the self-employment income subject to employment tax. This tax break is a limited one-year window of opportunity.

Contributions to Roth Accounts are Made Easier for Some Taxpayers: Roth IRAs provide tax-free treatment for qualified distributions. Beginning in 2011, participants in state and local government-operated 457 plans (other than employees of non-profits) can contribute deferred amounts to designated Roth accounts. Participants in 401(k) and 403(b) plans already have this ability. Also, participants in 401(k), 403(b) and 457 plans can roll over account balances to a Roth, subject to tax on pre-tax contributions and earnings. This provision takes effect on the date of enactment. For rollovers in 2010, account owners can opt to have the taxable income split between 2011 and 2012.

Businesses and individuals may want to take action before the end of the year based on these significant new law changes.

Revenue-Raisers: How Did Congress Pay for the New Law?

To offset the cost of the tax incentives in the new law, revenue-raisers were imposed, including:

- New information reporting requirements on rental real estate activities for annual payments of $600 or more made after December 31, 2010. In other words, landlords will have to file 1099 forms for service providers, such as plumbers, painters, and landscapers.
- Increased failure-to-file penalties on information returns.

- Allowing levies to be issued against federal contractors prior to a collections due process hearing.
- Treatment of debt guarantees by certain foreign entities as U.S. source income.
- Increased estimated tax penalties in 2015 for large corporations.

Improve the Chances of M&A Success

It may be hard to believe, but recessions can produce positive results. During the recent deep and long economic slump, some companies realized that to thrive, and even survive, they had to slash expenses and shed operations.

These enterprises, now leaner, stronger, and more efficient, have piles of cash sitting on their balance sheets. But that money isn't generating returns, so it's increasingly being used to acquire other businesses, resulting in a thriving global M&A industry. Mergers and acquisitions volume jumped 18 percent to nearly $2 trillion in the first nine months of this year, according to research firm Dealogic. During that same period, cross-border M&A volume soared 60 percent to $728.4 billion.

Drivers of Activity

Other forces fostering the surge in M&A activity during recent months were:

- Looser credit and attractive lending rates.
- More bargains because valuation levels have generally dropped over the past three years.
- A jump in cross-border mergers as foreign companies bid aggressively. The top three target nations in cross-border activity were the U.S. ($139.3 billion), the U.K. ($79.7 billion), and Canada ($70.2 billion), according to Dealogic.

Taking a Determined Strategic View

This time around, many companies are taking a prudent stand and focusing on strategic deals that support their core direction and produce measurable returns. They are not purchasing simply for the sake of growth. Instead, they are searching for products and services related to their core businesses.

Strategic focus is something businesses may want to concentrate on if they are planning mergers or acquisitions, or if they are in industries where they may become takeover targets. The top industries in global M&A activity recently were finance, oil and gas, telecommunications, health care, and utility-energy.

Tax Court: Payments Must Reflect Reality

A business sale typically involves various assets -- and in some cases, the seller stays on board to provide consulting services for a period of time. The assets can include stock, intellectual property, equipment, and a non-compete agreement. With careful structuring, the buyer and the seller can reduce taxes. But as one Tax Court case illustrates, agreements must be based on economic reality.

Facts of the Case: James P. Kennedy owned an employee benefits consulting business called KCG International, Inc., which was based in Illinois. In addition to Kennedy, KCG had one other employee.

Kennedy sold his business to Mack & Parker, Inc. Early in the negotiations, the parties contemplated a price of 150 percent of the predicted annual income generated by KCG clients, reduced by certain amounts. It would be payable in installments with 40 percent paid at closing.

Later, after considering the tax implications, it was determined that 25 percent of the purchase price would be designated as payment for consulting services that would be provided by Kennedy, and 75 percent would be designated as payment for Kennedy's goodwill.

That way, Kennedy would be taxed at capital gains rates for the goodwill, and Mack & Parker could amortize the cost over 15 years.

After the sale, Kennedy began work at Mack & Parker. He was given a cubicle, computer, business cards, and the title of Consulting Practice Director. For more than a year, he did not receive wages, but did receive payments under the sale agreement.

The IRS and the Tax Court agreed the payments for goodwill, for which Kennedy paid tax at capital gains rates, were really compensation for services, subject to the higher tax rates on ordinary income.

"The allocation of 75 percent of the total consideration paid by Mack & Parker to goodwill was a tax-motivated afterthought that occurred late in the negotiations," the Tax Court noted.

The total amount, the court added, "appears not to be grounded in any business reality." It did not reflect the value of the goodwill in relation to the other aspects of the transaction, such as Kennedy's post-sale services. (*Kennedy,* TC Memo 2010-206)

In an M&A environment highlighted by strategic purchases, it is critical to emphasize risk management and ensure that due diligence is well directed. Otherwise, business combinations could become failures.

In many cases, it's not the deal that goes wrong – it's the implementation. Many failures occur in transactions that make perfect business sense. The difficulty is that due diligence often concentrates only on the financial and legal implications of a proposed transaction. Less time and effort goes toward critical people issues such as corporate cultures, compatible customer bases, values, work habits, and attitudes that may have been developed over many years.

Cultural Due Diligence

These issues are important to the remaining employees of companies on both sides of a transaction. Failing to deal with them effectively and early on can result in crucial employees leaving and productivity slowing. In extreme cases, the corporation may wind up unable to function effectively.

A cultural evaluation has become a high priority when a merger or acquisition is on the agenda. Among other qualitative factors, these evaluations help reveal each company's:

- Values, management style, work environment, and founding philosophies.
- Strategic visions to determine areas of compatibility and synergy.
- Assessments of employees, customers, and other stakeholders, as well as evaluation of areas of common ground and avenues of potential conflict.

With the rise in international M&A transactions, complex, cross-cultural factors need to be evaluated.

While no integration between two organizations is ever seamless, significant obstacles can be identified early, making it easier to determine if potential culture clashes might outweigh the benefits. It used to be that the predominant focus of a pre-merger or acquisition evaluation was the quantitative side of the equation. The financial issues were thought to far outweigh the qualitative issues. But companies have learned the importance of focusing on the whole picture with the goal of ending up with an integrated plan in which all of the divergent puzzle pieces eventually fit together.

New Whistleblower Rewards under the *Dodd-Frank Act*

The new *Dodd-Frank Wall Street Reform and Consumer Protection Act* includes numerous reforms that will likely affect the business and financial communities for years to come. But at least one change might make you sit up and take immediate notice: Buried in the massive 2,300-page legislation is a series of "whistleblower" provisions that could jeopardize some companies' very existence.

Because of the way the law is structured, employees have a strong incentive to report suspicions of corporate fraud to the Securities and Exchange Commission (SEC) as soon as possible. Awards under the whistleblower program could easily reach into the millions of dollars, and that's only a fraction of what a firm must pay. In the current economic environment, even corporate heavyweights may not be able to absorb such a blow so it is a good time to prepare for the provisions.

Background: The new Dodd-Frank whistleblower program is modeled after similar efforts designed to thwart tax fraud and insider trading. Under the law, employees may be rewarded for providing information to law enforcement authorities concerning violations of federal securities laws. This includes violations of the *Foreign Corrupt Practices Act,* the *Investment Advisers Act,* and the *Investment Company Act* as well as inaccurate disclosures and improper accounting practices by public companies.

The "bounties" can be substantial. If the government recovers more than $1 million from an alleged wrongdoer, the whistleblower is entitled to 10 to 30 percent of the amount. With penalties in SEC cases routinely reaching tens of millions of dollars and even higher, whistle blowing employees could become instant millionaires. Thus, they may be encouraged to bypass the regular corporate channels and go straight to the SEC. The agency has already indicated it is seeing significant increases in whistleblower activities.

The *Dodd-Frank Act,* which was enacted in July of 2010, also expands some of the whistleblower provisions contained in the *Sarbanes-Oxley Act.* For example, it allows employees more time to file complaints.

Obviously, some of the tips will provide reliable information about violations. However, others won't be as accurate, but will nevertheless trigger time-consuming and costly investigations. Either way, the companies could suffer. To help protect your clients' firms, management should consider these practical suggestions:

- Focus on the effectiveness of the company's current legal and regulatory compliance programs relating to federal securities laws. Nipping potential violations in the bud is one of the best ways to avoid a lengthy enforcement proceeding.
- Look for additional ways to pinpoint alleged frauds. For instance, many companies already have internal anonymous "hotlines" for reporting allegations. But simply maintaining a hotline is not enough. Consider what more can be done to encourage employees to come forward with concerns about wrongdoing.
- Shore up training in human resources, legal, and compliance departments. Make sure that employees in the key roles are up-to-speed on the new requirements in the *Dodd-Frank Act.*
- React swiftly to the mere hint of fraud. Consult with an attorney about whether to notify the government of potential problems while a firm is still conducting its initial investigations. Follow through on disciplinary actions when warranted.

Summary: In the wake of the *Dodd-Frank Act,* employers must encourage internal reporting of improper conduct. If a company learns about complaints, it must take prompt and appropriate action to address the situations. This reduces exposure to serious charges. Keep in mind that employees are less likely to pursue such claims with the SEC if they have faith in the company.

New Consumer Protections in the *Dodd-Frank Act*

In addition to the whistleblower provisions, the *Dodd-Frank Act* includes numerous provisions designed to provide greater protection to consumers. Here are some of the highlights.

New Financial Agency: The new law establishes the Consumer Financial Protection Bureau (CFPB). President Obama recently named Elizabeth Warren, a Harvard professor, to build the agency.

As the name implies, the CFPB is intended to protect consumers from predatory lending practices, "disguised" credit card fees, and other abuses in the financial services industry. In creating this agency, oversight of various types of debts -- including mortgages, student loans, credit card charges, and "payday loans" -- is finally consolidated under a single roof.

One of the agency's tasks is to combine and simplify two mortgage disclosure forms into one consolidated document that homeowners will sign. The *Dodd-Frank Act* gives a July 2012 deadline for the form to be used, although the Treasury Department has stated that it will be ready "well ahead" of that.

Caveat: In a late modification to the law, auto financing transactions were excluded.

Supervisory Council: A new 10-member Treasury Department council will assess threats to the country's financial system. It will pinpoint specific companies, or inter-connected entities, that could harm the U.S. economy if they collapse. If appropriate, the council may liquidate a company to prevent catastrophes.

Mortgage Practices: A number of provisions protect consumers from lending practices spotlighted by the recent mortgage crisis. Specifically, the law eliminates prepayment penalties for adjustable rate mortgages, requires lenders to disclose the

Law Increases the Maximum Cash Amount for Each Investor

Similar to the protection offered by the FDIC when a bank fails, the Securities Investor Protection Corporation (SIPC) reimburses investors when a brokerage firm fails and cash or securities are missing.

The *Dodd-Frank Act* increases the amount of SIPC protection available for cash claims to $250,000 (from $100,000). This brings the protection in line with that provided by the FDIC.

The total SIPC protection available for each customer is now $500,000 to replace missing cash and securities.

maximum amount borrowers might pay on adjustable rate mortgages, prohibits approval of so-called "liar mortgages" that don't require documentation of income, and bans bonuses for lenders based on loan types. The latter practice often resulted in borrowers being pushed into homes they couldn't afford.

Credit Rating Agencies: Because credit rating agencies are paid by the banks that issue the securities they rate, they could be targets of coercion. Under the law, credit rating agencies that recklessly or purposely provide flawed advice may be held liable for investor losses. Such agencies will be required to register with the Securities and Exchange Commission (SEC).

Fiduciary Responsibilities: High professional standards already apply to accredited financial planners who advise clients about financial products and services. In general terms, they must act "in the client's best interests." Pending a six-month study of the issue, the SEC is expected to extend this fiduciary standard to stockbrokers.

Executive Compensation: The pay received by executives and officers of public companies has been a "hot button" issue in recent years. Although shareholders will be permitted to vote on executive compensation packages at least once every three years, the votes aren't legally binding. However, the Federal Reserve will maintain oversight to protect against excessive risk-taking.

Credit Card Limits: The law imposes new limits on fees that banks can charge merchants for accepting debit cards. Furthermore, all types of merchants are allowed to set minimum and maximum transaction amounts, as long as the restrictions apply to all issuers and payment networks. Governments and colleges may also establish maximums for credit payments. This could affect parents who charge tuition in order to garner frequent-flyer rewards.

Credit Scores: If a consumer is denied a loan or otherwise suffers because of a poor credit score, he or she can request a free copy of the score. The score provided must be the score that was used to make the adverse decision.

Tax Court Approves Favorable Estate Tax Valuation

In a closely-watched new case, an estate was allowed to reduce the value of its interest in a corporation based on the full amount of a potential capital gains tax. This Tax Court decision could have far-reaching implications for families owing estate tax after 2010. (Under current law, the federal estate tax has been repealed for decedents dying in 2010, but is revived in 2011 with modifications.)

Background: The so-called "General Utilities Doctrine," which avoided imposition of corporate-level capital gains as part of a tax-free liquidation, was repealed by a 1986 tax law. Subsequently, taxpayers and the IRS have been at loggerheads over the estate tax liability of certain business interests, although recent cases have generally favored taxpayers.

For estate tax purposes, the value of a business is generally determined by finding the price at which the assets would change hands between a willing buyer and a willing seller, with both having reasonable knowledge of all the relevant facts.

If the business interest is represented by stock in a closely-held C corporation, the value of the stock is generally determined by an appraisal. The appraisal may take into account various factors that will reduce or "discount" the value of the stock. One such factor is the amount of built-in gains (BIG) tax that a willing buyer would have to pay upon liquidation of the corporation.

Tax Court Explains its Position on Expert Witnesses

"Each party relies on an expert opinion to determine the discount for built-in (long term capital gains) tax that the estate is entitled to. In deciding valuation cases, courts often look to the opinions of expert witnesses. We evaluate expert opinions in the light of all the evidence in the record, and we are not bound by the opinion of any expert witness...

We may reject, in whole or in part, any expert opinion. Because valuation necessarily involves an approximation, the figure at which we arrive need not be directly traceable to specific testimony or a specific expert opinion if it is within the range of values that may be properly derived from consideration of all the evidence."

Facts of the Case: Marie Jensen owned an 82 percent interest in the stock in Wa-Klo, Inc., a closely-held C corporation. The principal asset was a 94-acre parcel of waterfront real estate used as a girls' summer camp. In 2003, Jensen created a revocable trust that held her Wa-Klo shares. She died in 2005.

The IRS determined there was a tax deficiency of $333,245. Both the estate and the IRS agreed that the value of the 82 percent interest was subject to a 5 percent discount for lack of marketability. The main point of contention between the estate and the IRS was the amount of the BIG tax liability. The estate deducted the full amount of capital gains tax that would be due upon the sale of the parcel since a buyer would likely demand this amount as a discount. But the IRS said the discount should be less than 100 percent because there are several ways that potential buyers of the stock could avoid or defer the tax.

At trial, the estate's valuation expert witness applied a dollar-for-dollar approach to the BIG tax liability. It cited the following reasons for not using an earnings-based approach:

- Wa-Klo did not generate substantial cash flows from its operations.
- The best use of Wa-Klo could be derived from the sale of its assets due to the company's poor historical performance.
- There was substantial value in the appreciated value of Wa-Klo's underlying assets.
- The estate's 82 percent interest in Wa-Klo was a controlling interest.

In contrast, the IRS' expert used a methodology where closed-end fund data was analyzed for exposure to BIG tax. Based on the analysis, the expert determined that only BIG tax exposure above 41.5 percent of net asset value should be discounted on a dollar-for-dollar basis. The expert also discussed possible BIG tax avoidance methods, such as converting to S corporation status after the 10-year waiting period.

The Ruling: The Tax Court rejected the IRS analysis based on closed-end fund data, concluding that it wasn't relevant. It also dismissed the potential methods discussed for avoiding the BIG tax on the property. Finally, the court performed its own calculation of BIG tax liability, using a present value analysis. The eventual calculation approximated the amount derived by the estate's expert under the dollar-for-dollar approach. The end result was a tax victory for the estate. (*Estate of Jensen,* TC Memo 2010-182)