SBLC WEEKLY

SMALL BUSINESS LEGISLATIVE COUNCIL

Via E-mail
February 1, 2010

Volume XII, Issue 05

THE PRESIDENT'S PROPOSED FISCAL YEAR 2011 BUDGET

The President will issue his proposed budget for Fiscal Year (FY) 2011 today. For us, the most interesting items are usually the revenue proposals. The State of Union probably gave us a hint of the highlights. We can also expect some repeats. In last year's proposed budget, for example, the President called for the permanent extension of the Research and Development (R&D) credit and a permanent fix for the Alternative Minimum Tax (AMT). The last few presidential proposed budgets have also given us the next round of tax gap-closing initiatives.

The President's proposed budget is just that - a "proposed" budget. There is no requirement that the Congress consider his proposed budget and they usually go their own way. Their goal is to adopt a "Budget Resolution," something they do not always do. The Budget Resolution is their internal general guidance document; it does not require a presidential signature.

ESTATE TAX RELIEF – ALIVE

The Senate has passed a debt ceiling increase bill, H.J Res 45. The bill includes provisions to establish a statutory pay-as-you-go regime for maintaining a balanced budget. The section includes waivers that would allow Congress to pass certain tax and spending measures without providing offsetting revenue. They are Medicare physician payments, estate tax relief, the Alternative Minimum Tax (AMT) patch, and the 2001 and 2003 income tax cuts for the middle class. Unfortunately, the bill only allows for an adjustment for the cost of extending three of the specified individual policies for a defined period (two years for estate tax relief and AMT relief, five years for Medicare physician payments. The middle-class tax cuts can be extended permanently). The House is expected to approve the debt ceiling increase bill this week.

HOWEVER, Congress still must pass an estate tax relief bill in order to take advantage of the "waiver" and it would be subject to a filibuster in the Senate. The "waiver" is for an amount of tax revenue "lost" if a two-year freeze, based on the 2009 top rate of 45 percent and exemption of $3.5 million, is instituted. Congress could devise any variation on the rate and exemption as long as it fits within the revenue lost number. The issue of whether a freeze would be retroactive to the beginning of the year is a matter that would have to be resolved during the legislative debate.

If Congress is able to pass a subsequent freeze bill, it still means in 2012 the top rate goes back up to 55 percent and the exemption down to $1 million. If they do not pass the freeze, we stick with the "status quo" of no estate tax in 2010 but the estate tax comes back into existence, as currently scheduled, in 2011.

One can talk until the cows come home whether it is better to have a two-year freeze or continue the repeal with a severe snap-back looming. Certainly for some small businesses, they come out ahead with a freeze rather than repeal because of the carry-over/stepped up basis anomaly (see Weekly 12-28-09). One school of thought is that Congress will never let the estate tax snap back at the higher top rate and lower exemption and it is better to force them to deal with" improving" it by the end of this year. The other school of thought is the line of expired and expiring tax relief provisions hoping to get renewed by the end of this year, extends out the door. Maybe it would be better to remove the discussion from the chatter for an extra year.

DIRECT EXPENSING OPPORTUNITY CREATED

As noted, while the statutory pay-as-you-go provisions include waivers for short term changes to the AMT patch and estate tax relief, it allows for permanent extensions of expiring middle class relief. There is one small business provision buried among the list of the middle class tax cuts in the new Senate version that was not in the House-passed bill! If Congress passes enabling legislation, - an adjustment to the direct expensing allowance known as “Section 179” which allows businesses to write off equipment and other purchases in the year of purchase – could be made permanent.

The media and Congress uses short-hand references to the “2001 and 2003 middle class tax cuts” so no one really knows exactly to which tax cuts they are referring. So as a public service, here’s the whole list included in the Senate bill, and then I will explain the direct expensing development.

The specific middle-class policies are:

- 10 percent bracket;
- Child Tax Credit, including the expansion in the Recovery Act;
- Marriage penalty relief, including the relevant EITC expansion in the Recovery Act;
- Adoption credit;
- Dependent care credit;
- Employer-provided child care credit;
- Education tax benefits;
- 25 percent and 28 percent brackets;
- 33 percent bracket, but only for individuals with incomes of $200,000 or less, and couples with incomes of $250,000 or less;
- Reduced rates on capital gains and dividends, but only for individuals with incomes of $200,000 or less, and couples with incomes of $250,000 or less;
- Repeal of the personal exemption phase-out and the limitation on itemized deductions, but only for individuals with incomes of $200,000 or less, and couples with incomes of $250,000 or less; and
- Section 179 expensing for small businesses, allowing up to $125,000 of qualified property to be expensed, phasing out for property over $500,000.

So let me explain what that means. Back when the direct expensing allowance was originally enacting, it allowed businesses to write off $25,000 of capital asset purchases in the year of purchase. However, if you spend more than $200,000 on such things as equipment in the year, the direct expensing allowance phased out and you had to use depreciation.

Over the years, we have been able to secure temporary increases in both the allowance and the investment cap. In 2007, the limits were increased to $125,000 and $500,000, respectively, for taxable years beginning in 2007 through 2010. In 2008, the amounts were increased for taxable years beginning in 2008 to $250,000 and $800,000, respectively.

On February 17, 2009, President Obama signed into law the American Recovery and Reinvestment Act. It extended the temporary increases of 2008 through 2009.

In 2010, the amounts have returned to the 2007 levels of $125,000 and $500,000 indexed. In 2011, the amounts revert to pre-2003 levels of $25,000 and $200,000. So if the debt ceiling increase bill is enacted, it does give us the opportunity to at least set the permanent baseline amounts at the 2007 levels rather than the pre-2003 levels – if we can convince Congress to do so. But at least we do not need a revenue offset.

(Because of the indexing, the amounts one read in accounts are the actual amounts for a year. For example, in 2008, the actual allowance was $128,000. For policy purposes, the baseline amounts are used.)

SMALL BUSINESS STOCK

Every time the President says, “Let's also eliminate all capital gains taxes on small business investment,” as he did in his State of the Union, I have to trot out an explanation. Unfortunately, while there is nothing wrong with the proposal, it is not exactly as good as it sounds.

This is a change to a very narrow specialized provision that has been the tax code for years; most small businesses do not utilize this provision. Under long-standing law, individuals were able to exclude 50 percent (60 percent for certain empowerment zone businesses) of the gain from the sale of certain small business stock acquired at original issue and held for at least five years. The portion of the gain includible in taxable income is taxed at a maximum rate of 28 percent under the regular tax. A percentage of the excluded gain is an alternative minimum tax preference; the portion of the gain includible in alternative minimum taxable income is taxed at a maximum rate of 28 percent under the alternative minimum tax.

As a result of the enactment of the American Recovery and Reinvestment Act (ARRA) last year, the percentage exclusion for qualified small business stock sold by an individual was increased temporarily from 50 percent (60 percent for certain empowerment zone businesses) to 75 percent for 2009 and 2010. The President would increase the exclusion to 100 percent.

This is not something the "average" small business owner can take advantage of. Think "venture capitalist." The definition of what constitutes "qualified" small business stock is what takes all the fun out of this. The stock must meets all of the following tests.

1. It must be stock in a C corporation.
2. It must have been originally issued after August 10, 1993.
3. The corporation must have total gross assets of $50 million or less at all times after August 9, 1993, and before it issued the stock. Its total gross assets immediately after it issued the stock must also be $50 million or less. When figuring the corporation's total gross assets, you must also count the assets of any predecessor of the corporation. In addition, you must treat all corporations that are members of the same parent-subsidiary controlled group as one corporation.
4. You must have acquired the stock at its original issue, directly or through an underwriter, in exchange for money or other property (not including stock), or as pay for services provided to the corporation (other than services performed as an underwriter of the stock). In certain cases, your stock may also meet this test if you acquired it from another person who met this test, or through a conversion or trade of qualified small business stock that you held.
5. The corporation must have met the active business test, defined next, and must have been a C corporation during substantially all the time you held the stock.
6. Within the period beginning 2 years before and ending 2 years after the stock was issued, the corporation cannot have bought more than a de minimis amount of its stock from you or a related party.
7. Within the period beginning 1 year before and ending 1 year after the stock was issued, the corporation cannot have bought more than a de minimis amount of its stock from anyone, unless the total value of the stock it bought is 5 percent or less of the total value of all its stock.

JOBS TAX CREDIT

It is too soon to offer a prognosis on the likelihood of the passage of a new job tax credit. While the President has offered his suggestion, the Senate majority has not revealed their proposal.

For the record, here's the President's proposal:

- Employers would receive a tax credit of up to $5,000 against their payroll taxes for every net new employee they hire in 2010. Start-ups would be eligible for half the credit, which provides an incentive for entrepreneurship while avoiding gaming. The credit would be administered off an employer's unemployment insurance wage base (equal to 72 percent of the unemployment insurance wage base increase, or $5,000 credit for each additional worker who earns at least $7,000).

- Businesses will receive a bonus 6.2 percent tax credit on aggregate wages in excess of inflation – reimbursing the employer for the Social Security payroll taxes they pay on those payroll increases. This wage bonus would be calculated off the Social Security payroll tax base, so firms would not get credit for increasing wages for employees making more than the current taxable maximum of $106,800.

- All firms with net employment increases will be eligible for these credits but the maximum credit will be limited to $500,000 per business.

- Businesses that reduce employment or payrolls in 2010 would be ineligible for both the $5,000 credit and the wage bonus. The credit would also include anti-abuse provisions designed to deny or limit the credit to employers that seek to game the system by, for example, replacing full-time employees with part-time employees. This will include

- limiting the maximum jobs credit amount to 25 percent of the increase in a firm's Social Security payroll wage base.

- Employers would have the option of receiving the tax credit on a quarterly estimated basis.

MENTAL HEALTH PARITY

The Mental Health Parity Act of 1996 (MHPA) required parity in aggregate lifetime and annual dollar limits between the categories of benefits in health plans. As a result of the enactment of the MHPA, a plan that does not impose an annual or lifetime dollar limit on medical and surgical benefits may not impose such a dollar limit on mental health benefits offered under the plan. Health plans are not required to include mental health benefits in their benefits package. The MHPA only applies to those plans that do offer mental health benefits. The MHPA did not apply to benefits for substance abuse or chemical dependency.

The Mental Health Parity and Addiction Equity Act of 2008 (MHPAEA) expanded the law. The new law requires that any group health plan that includes mental health and substance use disorder benefits along with standard medical and surgical coverage must treat them equally in terms of out-of-pocket costs, benefit limits and practices such as prior authorization and utilization review. These practices must be based on the same level of scientific evidence used by the insurer for medical and surgical benefits. The Internal Revenue Service and the Departments of Labor and Health and Human Services have just issued rules to implement the changes for plan years beginning on or after July 1, 2010.

The most relevant question for small business is whether there is a small business exemption. The answer is the law applies to employers that provide health benefits and employ an average of 51 (or more) employees on business days during the preceding calendar year and who employee at least 2 employees on the first day of the plan year, unless otherwise provided under State law.