FEATURE

Small Business Jobs Act of 2010: Impact on the Real Estate Market

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CONGRESS ACTED SWIFTLY IN SEPTEMBER 2010 to pass what is known as the Small Business Jobs Act of 2010 (hereafter called the Act). Signed by President Obama on Sept. 27, 2010, the Act means more business tax relief for small businesses and emphasizes the need to provide additional support in the process of economic recovery.

Summarized below are some key changes made by the Act that are important for small businesses and real estate owners. Much of the material for this article was drawn from and supported by comments made from the Joint Committee on Taxation, Technical Explanation (Sept. 16, 2010). The new tax rules apply beginning in 2010. Therefore, taxpayers may find they have additional deductions for 2010 and 2011 than anticipated.

SUMMARY OF CHANGES MADE BY THE ACT

Some of the Act's changes are especially relevant to real estate practitioners, be they investors or representatives for clients. The changes provide for small business relief in various areas. For example, the Act allows for more capital, since less is paid in taxes. The theory is that tax relief from gains on small business stock will encourage investing more capital in small businesses.

Another change that can aid the real estate investor relates to a shorter time frame to obtain the benefits of business credits. There is now a 5-year carryback of general business credits. For example, a business that paid taxes last year but has tax credits in the current year can file, currently, for a refund of taxes by applying the current year's credits to the prior year's gain. As an example, if Business X has a credit of $100,000 for the year, an amended return for a prior year can be made resulting in using the $100,000 credit to reduce the taxes for a prior year. This would result in an immediate refund to Business X.

The Act allows business credits for eligible businesses without requiring payment of the Alternative Minimum Tax (AMT). The AMT subjects taxpayers to not only the regular tax calculation, but also to a potentially higher tax result by applying the AMT rules. In essence, these rules require a calculation of the current tax under what are the "normal rules" and a calculation under an alternative system. The AMT approach denies some deductions that are allowed for the normal tax rules. The taxpayer pays the greater of the two calculations. As an example of AMT, if the normal tax calculated was $200,000 due, but the AMT calculation denied certain deductions and resulted

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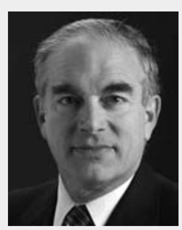

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in tax calculated of $220,000, the taxpayer would have to pay the additional $20,000.

To encourage more access to capital, the Act provides for avoiding a secondary or additional tax on S Corporations, which are entities that have the traditional corporate protection for shareholders, but normally are not taxed at the corporate level; thus it avoids the "double tax." That is, with an S Corporation, there is normally only a tax at the individual shareholder level. Congress created S Corporations to allow for an entity with corporate protection and with no corporate tax. However, in some instances, there could be a tax at the corporate level if the corporation sells property. To avoid this corporate tax, the Act allows for corporations that were C Corporations (regular corporations that pay corporate taxes), to elect to become S Corporations (corporate level and individual level) if the S Corporation can show it held the property being sold for at least five years. (Since a C Corporation pays corporate tax and an S Corporation normally pays no corporate tax, some C Corporations attempted to switch their status to S Corporations right before they sold property. To prevent such action, Congress provided that S Corporations would be taxed on the gain from the sale of such property, unless they showed a longer holding period, such as the five years noted.)

To encourage more investments in small businesses, the Act allows a more accelerated write-off of tangible personal property used in the trade or business. This write-off was generated by changes in a number of Internal Revenue Code sections. For example, Code §179 allows a current deduction for "qualified property," within certain dollar limits, to be expanded. This deduction was expanded to $500,000 of the cost for qualified, tangible personal property used in the trade or business.

In some instances, real estate leasehold improvements may qualify for additional current deductions. Also regarding tangible personal property, deductions for equipment used in business, cellular phones and other telecommunications equipment are allowed a current deduction, in most cases, under the new Act.

DETAILS OF THE SBJ ACT OF 2010:

The Small Business Stock rule: This law allowed for the exclusion of 50 percent of the gain on the sale of small business stock, but such provision was scheduled to expire. As provided in the Act, this was changed to allow an exclusion of 100 percent. The exclusion applies to both the regular tax and the AMT.

Tax Credits: If a taxpayer qualifies for the general business credit, but does not have current taxable income to use all of the credits, the taxpayer is allowed, in certain instances, to carry back those credits to prior tax years, to receive a refund for taxes paid in a prior year. These credits include the investment credit, energy credit, low-income housing credit, etc. Qualifying or "eligible small businesses" are sole proprietorships, partnerships and non-publicly traded corporations with $50 million or less in average annual gross receipts for the preceding three years. The Act allows eligible businesses to carry back the credits to up to five prior years. If not consumed within the carryback period, the credits may be carried forward for use in future years. It is important to note that these small business credits can be used to reduce the AMT liability as well as the regular tax liability.

S Corporations: One issue with an S Corporation has been the potential of having to pay a corporate tax on the sale of assets by the corporation. Under the Code, S Corporations may have to pay tax on gain that is referred to as "built-in" gain. For example, if a regular C Corporation bought a building for its business and subsequently changed to an S Corporation, then sold the building five years later, the S Corporation would generally have to pay a tax on the gain. Under the new rule; the S Corporation is not taxed on the gain as long as it held the property for at least five years.

Depreciation: Generally speaking, the tax law, under Code §179, allows one to expense (take a current deduction) what is referred to as "qualified Code §179 property." Such property is personal property, not real estate, that is acquired for use in a trade or business. A cash register and furniture in a restaurant or brokerage office are examples of this Code §179 property.

Although Code §179 has existed for many years, the amount that one could deduct in a given year for qualified property has changed over the years. Under the new Act, the definition of "qualified Code §179 property" as explained under the Joint Committee on Taxation Explanation of Sept. 16, 2010, was expanded. This expansion includes real property that is referred to as "qualified leasehold improvement property." It also includes qualified restaurant property and other qualified retail improvement property.

There are limits on what can be expensed under Code §179. In general, the maximum amount that could be expensed was $250,000 of qualified Code §179 property.

The Act increases the amount to $500,000. Therefore, taxpayers have the flexibility of expensing that much more Code §179 property, which is qualified trade or business personal property. As an example, if a construction development company purchased $300,000 of equipment, the company can deduct this entire cost. Prior to the act the company would have to depreciate the property over many years.

Under a depreciation section of the Code, in addition to Code §179 deductions noted above and where applicable, taxpayers have been accustomed to claiming a bonus depreciation amount for the year in question. Thus, if a taxpayer claimed the Code §179 deduction and that did not use all of the potential deductions, the taxpayer might claim a *bonus deduction*, which allows for a 50 percent deduction or depreciation amount for the balance of the property.

As an example, if the taxpayer had acquired $1.2 million of personal business-use property (excluding passenger cars and trucks, in most cases), the taxpayer would calculate the current deduction as follows:

1. The taxpayer would claim $500,000 (the maximum noted above).
2. The balance of $700,000 would be eligible for a deduction of $350,000, (50 percent of $700,000). Thus the total deduction would be $850,000.
3. The taxpayer would then claim the balance of $350,000 over given years; this would be claimed by normal depreciation deductions.

As stated in the Joint Committee on Taxation Explanation, the property that qualifies for the 50 percent deduction must meet the following tests:

a. It must be property subject to the Modified Accelerated Cost Recovery System with a life of 20 years or less.

b. The taxpayer must show that the original use is with the taxpayer and that the property was acquired by purchase within the proper time periods, generally after 2007.

Because of the Act, the qualified 50 percent deduction continues to apply to qualified property placed in service during 2010.

The Act allows for a more generous depreciation amount for cars and trucks used in a business. This is important for all types of businesses, real estate or otherwise. In general, the Code limits the amount of depreciation write-off that a taxpayer might claim in a given tax year, even with the deduction rules noted above. However, under the Act, additional write-offs are allowed for business vehicles, such as passenger automobiles, with a potential write-off of an additional $8,000 in the year acquired and put into service.

For example, prior to the Act, the maximum deduction allowed under Code §280F for a passenger automobile was $3,060 in the year of acquisition; the Act increases this by $8,000, making the overall deduction limit $11,060. Thus a taxpayer claiming a business auto that cost $40,000 may deduct $11,060 in that tax year. The balance of $28,940 would be depreciated over future years.

For a van or truck, the general first-year allowance limit was $3,160; the same increase of $8,000 makes the overall total $11,160 maximum possible depreciation that could be allowed in the applicable tax year.

Start-up Expenses: Expenses to start a new business can generally be deducted. The Act increases the maximum deduction limit from $5,000 to $10,000. This rule change applies only for 2010. ■

RECOMMENDED READING

Emerging Market Real Estate Investment: Investing in China, Brazil and India

by David J. Lynn, Ph.D., CRE, with Tim Wang, Ph.D. (©2010, John Wiley & Sons, Inc., 236 pages)

REVIEWED BY MARY C. BUJOLD, CRE

As the title indicates, this book focuses primarily on the opportunities and potential risks of investing in what are projected to become the three of the four largest economies in the world, along with the United States, by 2050. As of 2008, China was the third largest economy and Brazil was the eighth largest. India was not on the list of the top 10 largest world economies as of 2008. Russia was excluded from the authors' analysis because of a much older demographic profile, a shrinking population, less diverse economy, and continued significant corruption.

The authors' approach uses what they refer to as the LCG Framework. The framework posits that the desirability of direct real estate investment in emerging markets is a function of three variables: locational factors; competitive environment factors; and growth factors.

Locational factors include geographic location, natural features, and institutional/legal factors such as natural endowments (i.e. in labor, raw materials). It can also mean controlling or owning specific locations within an urban market that confer special advantages (i.e. local monopolies). Real estate tends to be very site- and market-specific.

Competitive factors include core competencies of specific firms. Firms with advantages relative to domestic competitors may achieve higher returns or lower costs, thus leading to more total profit. These factors may include greatest access to investment capital, better practices and processes, better management, and superior technology. Branding and brand equity are also factors in this category.

Growth factors are related to locational factors, but are considered separately in the book. All other things being equal, local, regional and national markets that are characterized by sustainable growth are typically preferred over those with minimal or diminishing growth. In many mature countries, long-term growth prospects in terms of the economy and real estate markets appear to be limited.

According to the authors, China, India and Brazil encompass a significant percentage of the world's land, 30 percent of the world's population, and amount to a combined GDP of U.S. $12.4 trillion.

In selecting these economies as some of the most promising for real estate investment, the authors started with an examination of growth factors.

About the Reviewer

Mary C. Bujold, CRE, *president, Maxfield Research Inc., Minneapolis, Minnesota, is considered a market expert in the field of residential real estate and in market analysis for financial institutions. As well as providing strategic, direction for the firm, Bujold heads project assignments for large-scale land use and redevelopment studies, including downtown revitalization for private developers and municipalities in the Twin Cities and in the Upper Midwest. Her work spans public and private sector clients, including institutional clients. Bujold also regularly testifies as an expert witness for eminent domain, tax appeal and other types of real estate litigation. She holds a bachelor's degree in business administration from Marquette University and a master's degree in business administration from the University of Minnesota.*