

Small Business Jobs Act: Big Benefits for Small Businesses

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Although the reduction in the alternative minimum tax limitation on general business credits has been one of the least discussed provisions of the Small Business Jobs Act of 2010, it may be one of the most important for small and medium-size businesses. This article examines the section 38(c) limitation in depth and analyzes the potential impact of allowing eligible small business credits to offset the AMT.

The recently passed Small Business Jobs Act of 2010¹ (Jobs Act) has received much attention for its \$12 billion in tax incentives.² Included in the bill are provisions to increase and expand section 179 expensing limits for 2010 and 2011 and to extend bonus depreciation, as well as more controversial measures such as those to require recipients of rental income to issue Forms 1099 to every vendor paid at least \$600 during the year.

However, the provision of the bill that has received arguably the least amount of attention is the one that may have the greatest positive impact on small business. Traditionally, section 38(c) has limited the use of general business credits, including the section 41 credit for increasing research activities, to the amount by which a business's regular tax liability (RTL) exceeds its tentative minimum tax

(TMT).³ Thus, taxpayers that are subject to the alternative minimum tax must carry all general business credits back one year and forward for 20 years.⁴ The reality is that small and medium-size businesses often will not take a general business credit if they are unable to use a substantial amount of the credit in the year it is generated.

The new law changes all that — to the enormous benefit of small and medium-size businesses. Section 2013 of the Jobs Act allows some small and medium-sized businesses to apply general business credits, such as the research credit, against the AMT, thus greatly improving the ability of eligible businesses to actually see a cash benefit from their business credits in the year that they generate them. The change in law will also encourage many businesses to claim general business credits for the first time. This is a monumental difference, as the time value of money for these businesses goes far beyond the discount rate; in an uncertain economy the ability to benefit from credits today has a huge effect on whether a business will be around tomorrow. This article will offer a detailed discussion of section 38(c) and the provision that allows small businesses to avoid its damaging effect.

History of Section 38(c)

To fully understand the significance of the Jobs Act's rollback of the section 38(c) AMT limitation, it is necessary to have a general understanding of the evolution of the statute and the policy, to the extent it exists, behind the limitation and the credits subjected to it.

Congress initially enacted section 38(c) as part of the Deficit Reduction Act of 1984 (1984 act).⁵ The 1984 act organized tax credits into four categories: nonrefundable personal credits, the foreign tax credit, refundable credits, and business-related credits.⁶ Before the 1984 act, business credits were added to the code on an ad hoc basis and contained different use limitations and carryover provisions.⁷

¹P.L. 111-240, *Doc 2010-17635*, 2010 TNT 152-65.

²Joint Committee on Taxation, "Estimated Revenue Effects of the Revenue Provisions Contained in Title II of the Small Business Jobs Act of 2010" (July 28, 2010), at 2, *Doc 2010-16831*, 2010 TNT 145-19.

³See section 38(c)(1). There is also a second limitation that may apply when a taxpayer is not subject to the AMT. This limitation will be discussed in more detail below.

⁴See section 39(a)(1).

⁵See P.L. 98-369, section 473.

⁶*Id.* at section 471.

⁷JCT, "General Explanation of the Revenue Provision of the Deficit Reduction Act of 1984" (Dec. 31, 1984), at 763.

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Often the application of business credits had unintended consequences, such as when credits with carryover provisions were used before those without carryover provisions.⁸ The 1984 act extended uniform carryover provisions to business credits and imposed a uniform limitation on the amount of credits allowed.⁹ In so doing, Congress believed it could achieve a more rational and equitable application of business credits.¹⁰

Under the 1984 act, credits could offset 100 percent of the first \$25,000 of a taxpayer's RTL and 85 percent of additional tax.¹¹ For example, if a taxpayer had a tax liability of \$100,000, it could use credits to offset \$88,750 (\$25,000 + 85 percent * (\$100,000 - \$25,000)). At the time of the 1984 act, Congress believed that the research credit should be excluded from the business credit reorganization and the section 38(c) limitation, and it should be allowed to offset 100 percent of RTL.¹² Although the original enactment of section 38(c) did not have a provision limiting credits based on TMT, that does not mean that credits were able to offset AMT. Business credits could be used to reduce a taxpayer's RTL below TMT, but doing so would only cause the taxpayer's TMT to rise higher above its RTL and subject the taxpayer to increased AMT.¹³ The goal of the 1984 act was to simplify and organize tax credits in the code and to unify the provisions affecting their use.

Two years later, the Tax Reform Act of 1986¹⁴ significantly altered the construction of section 38(c). Moreover, the TRA constituted a substantial reorganization of the tax code. Among other provisions, the TRA reduced the research credit and narrowed the definition of qualifying research,¹⁵ subjected the research credit to section 38(c) treatment, and added a second provision to section 38(c) limiting business credits to the excess of a taxpayer's RTL over its TMT.¹⁶ Also, the TRA increased the original section 38(c) limitation to 25 percent of

a taxpayer's tax liability exceeding \$25,000.¹⁷ The provisions of the TRA represented a simplification of business credit limitations. Rather than allowing credits to take RTL below TMT and then subjecting taxpayers to additional AMT, the revised section 38(c) simply cut the credits off at TMT.¹⁸

Interestingly, the TRA revision of section 38(c) included a provision allowing the investment credit under section 46 to offset 25 percent of a taxpayer's minimum tax as a transition rule.¹⁹ Although the legislative history contains a detailed explanation of the mechanics of the investment credit provision, nothing is said regarding why the investment credits were permitted to offset AMT.²⁰ Similarly, nothing in the legislative history of the 1984 act or the TRA explains the policy behind preventing business credits from offsetting AMT. The lack of an explanation leads us to suspect, as is often the case in the tax code, that section 38(c) was enacted to limit the loss of revenue to Treasury (and perhaps to help realize the policy goals of the AMT). There is nothing in the record to indicate that policymakers considered the significant detrimental effect that section 38(c) would have on small and medium-sized businesses seeking to claim general business credits.

Section 38(c) Before Amendment by Jobs Act

Section 38(c) limits the use of 36 business credits,²¹ determining whether taxpayers will actually be able to realize a benefit from their credits or will be forced to carry them over to another tax year. Before the enactment of the Jobs Act, the statute included the basic limitations that were put in place by the TRA. As it was then written, section 38(c) stated that general business credits "for any taxable year shall not exceed the excess (if any) of the taxpayer's net income tax over the greater of (A) the tentative minimum tax for the taxable year, or (B) 25 percent of so much of the taxpayer's net RTL as exceeds \$25,000" (the 25/25 test).²² Net income tax liability is defined as RTL plus AMT reduced by

⁸*Id.*

⁹P.L. 98-369, section 473.

¹⁰JCT, *supra* note 7, at 763-764.

¹¹P.L. 98-369 at section 473.

¹²JCT, *supra* note 7, at 763-764.

¹³Sections 38 and 26, before amendment by P.L. 99-514; see also JCT, General Explanation of the Tax Reform Act of 1986 (May 4, 1987), at 466. For example, assume a taxpayer had \$50,000 in credits, an RTL of \$100,000, and a TMT of \$80,000. Before the Tax Reform Act of 1986, the taxpayer could reduce regular tax to \$50,000 but would then be subjected to \$30,000 of AMT. After the TRA, the taxpayer would simply be limited to \$20,000 in credits with the remainder carrying over to other tax years.

¹⁴P.L. 99-514.

¹⁵*Id.* at section 231.

¹⁶*Id.* at section 701(c).

¹⁷*Id.* at section 221.

¹⁸See section 38(c), as in effect on December 31, 1986.

¹⁹See H.R. Rep. No. 99-841 (1986), *reprinted in* 1986 U.S.C.A.N. 4075, 4368.

²⁰This provision was eliminated two years later in P.L. 100-647. At that time, minor adjustments were made to the mechanics of the section 38(c) limitation, although the effect of the rule remained the same.

²¹Section 38(b). This figure counts the investment credit, which itself is made up of six separate incentives, as a single credit.

²²Section 38(c)(1).

personal, nonrefundable credits and the FTC, while net regular tax liability is defined as RTL reduced by those same credits.²³

A common misunderstanding encountered in the operation of the first test of section 38(c) is illustrated by the following example: Astrojet Industries LLC had qualified research expenses that produced a \$25,000 credit. The business owner of Astrojet has RTL of \$100,000 and TMT of only \$95,000 (that is, the owner “is not in AMT,” as it is typically stated). Under section 38(c), the research credit can only reduce the owner’s tax by \$5,000 to \$95,000, the TMT amount, not the full \$25,000 of the research tax credit. The additional \$20,000 must be carried forward (or back one year). When explaining this part of the section 38(c) rule to business owners, we find it a best practice to ensure that there are no small breakable objects within arm’s reach.

The second limitation in section 38(c), the 25/25 test based on 25 percent of a taxpayer’s RTL exceeding \$25,000, rarely comes into play. (However, the new law may make this test more relevant for some taxpayers.) The limitation is approximately 8.75 percent of taxable income exceeding \$71,500.²⁴ Because the AMT rate is 20 percent for corporations and 28 percent for individuals, the AMT limitation in section 38(c) is almost always greater and is thus the applicable limitation in nearly every instance in which the taxpayer is subject to TMT. In practice, the only time the 25/25 test applies is in the case of a C corporation with less than \$7.5 million in revenue but more than \$25,000 in tax liability.²⁵

For most taxpayers, the provision that more drastically reduced the ability to use general business credits was the AMT limitation in section 38(c). For small businesses in AMT, the effect of this limitation is substantially greater than most realize. Although business credits carry back one year and carry forward for 20 years,²⁶ the detriment for taxpayers goes far beyond the loss associated with the time value of money. Many general business credits and the research credit in particular are not simple to compute or to substantiate. The research credit requires extensive record keeping and documentation analysis to survive the scrutiny applied to the credit. Most small businesses, already

strapped for resources, simply cannot afford the outlay, in both time and money, required to calculate their credits if they will not see an immediate return on their investment. The section 38(c) limitation thus dissuaded many taxpayers from claiming business credits and weakened the overall incentive effect that the credits are supposed to have.

Given that section 38(c) works against the desired policy of providing tax incentives for small and medium-size businesses, it is no surprise that Congress has started to exempt some credits and taxpayers from the section 38(c) AMT limitation. Currently, empowerment zone employment credits under section 1396 may offset 25 percent of AMT,²⁷ and eight other credits may offset AMT entirely.²⁸ Notably, section 48 energy property credits for 2009 and 2010 may now be claimed as grants, allowing even those taxpayers that are in a loss situation to take advantage of the incentive.²⁹ Similarly, Congress has allowed taxpayers that have been awarded a qualifying therapeutic discovery project credit, under section 48D, to elect to receive the credit in the form of a grant.³⁰ As Congress increased the number of incentives capable of offsetting AMT, the next logical step was to allow small businesses to use all of their business credits against AMT.

The Jobs Act Provision

Section 2013 of the Jobs Act significantly improves the ability of small businesses to use their business credits by allowing the credits to offset AMT. The bill works by letting eligible small businesses treat their TMT as being zero for the purpose of calculating the section 38(c) limitation.³¹ To qualify as an eligible small business, a company must have average gross receipts of \$50 million or less in the previous three years.³² Thus, if a company had gross receipts of \$55 million in 2007, \$46 million in 2008, and \$48 million in 2009, it will qualify as an eligible small business in 2010 because it will have average gross receipts of \$49,666,667 for the period of 2007-2009. In applying the gross receipts test, the aggregation rules of section 448(c)(2) and (3) come into play.³³ Owners of small businesses that are eligible for passthrough treatment are also eligible to use their passthrough

²³*Id.*

²⁴At the top individual and corporate rate of 35 percent, approximately \$71,429 in taxable income is required to generate a tax liability of \$25,000 (\$25,000/35 percent). The 8.75 percent figure is derived by multiplying the 35 percent tax rate by 25 percent.

²⁵Under section 55(e), the TMT of any corporation with average gross receipts for the prior three tax years of less than \$7.5 million is zero.

²⁶See section 39.

²⁷Section 38(c)(2).

²⁸See section 38(c)(3) and (4).

²⁹See American Recovery and Reinvestment Act of 2009, P.L. 111-5, section 1603.

³⁰See Patient Protection and Affordable Care Act, P.L. 111-148, section 9023(e).

³¹See section 38(c)(5)(A)(ii).

³²Section 38(c)(5)(C).

³³*Id.*

credits to offset AMT as long as they meet the same \$50 million gross receipts test.³⁴

The provision is effective for credits determined in tax years beginning in 2010 and for carrybacks of those credits.³⁵ Thus, taxpayers will be able to use the carryback of 2010 credits to offset AMT in prior years. Further, because the Jobs Act also allows eligible small businesses to carry back 2010 credits for five years, taxpayers will actually be able to use 2010 credits to offset AMT as far back as 2005.³⁶ Carryforwards of pre-2010 credits will not be eligible to offset AMT in 2010. However, these credits will be applied first in 2010 to reduce tax liability to TMT, allowing 2010 credits to decrease liability below that point.

It is important to note that the second section 38(c) limitation, the 25/25 test preventing credits from reducing tax below 25 percent of the amount by which RTL exceeds \$25,000, is still in place. This limitation, which previously had little effect on most taxpayers, will now be the only thing preventing small businesses from using credits to reduce their tax liability to zero.

To illustrate the effect of the Jobs Act, assume that X, a C corporation meeting the requirements to qualify as an eligible small business, generates \$150,000 in small business credits in 2010. X has taxable income of \$500,000, RTL of \$170,000, and TMT of \$100,000. Under previous law, X could only use \$70,000 in credits (\$170,000 - \$100,000), leaving \$80,000 in credits to carry over to other tax years. Under prior law, X could use \$133,750 in credits and reduce its tax liability to \$36,250 (\$36,250 being the limitation under the 25/25 test in section 38(c)) ((\$170,000 - \$25,000) * 25 percent). This means that X must carry over only \$16,250 to other years. Compared with the earlier law, X may use an additional \$63,750 in the current tax year, over 90 percent more than what it could use previously.

For companies in or near AMT, the Jobs Act will have a far bigger impact than most people realize — allowing small and medium-size companies to take greater advantage of the credits immediately and encouraging many businesses to take the credits for the first time.

³⁴See section 38(c)(5)(D). It is not entirely clear as to how this limitation will be applied to individuals. For example, the limitation may include a pro-rata portion of gross receipts from an individual's passthrough holdings, or may be based on other criteria, such as AGI. The authors expect that guidance on this provision will be forthcoming from Treasury or the IRS. See RIA Checkpoint, *Analysis of the Tax and Pension Provisions of the Small Business Jobs Act of 2010*, para. 301 (2010).

³⁵P.L. 111-240, section 2013(d).

³⁶*Id.* at section 2012.

Conclusion

The Jobs Act provides small businesses in AMT much-needed good news by allowing those taxpayers to substantially increase their business credit use. Credit is due to Senate Finance Committee Chair Max Baucus, D-Mont., Finance Committee ranking minority member Chuck Grassley, R-Iowa, Finance Committee member Olympia J. Snowe, R-Maine, and Sen. Mary L. Landrieu, D-La., who put together the bipartisan Jobs Act that included this provision. In particular, Grassley should be recognized for first proposing an end to the AMT limitation in a bill he introduced — the Small Business Tax Relief Act of 2009³⁷ — on June 25 of last year.

The only downside is that the provision is solely applicable to credits generated in 2010, meaning that in 2011, taxpayers will once again be limited in the amount of credits they can use. Given the strong positive impact that the provision can have on small businesses, it should be a priority to permanently extend the new law. In its next session, Congress should ensure that small businesses do not lose the substantial ground that they have gained.

³⁷S. 1381.