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Small Business and Work Opportunity Tax Act of 2007

After months of political wrangling, Congress has passed a small business tax incentives bill coupled with an increase in the federal minimum wage. The *Small Business and Work Opportunity Tax Act of 2007 (2007 Small Business Tax Act)* is part of a much larger and more controversial bill, H.R. 2206, U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act of 2007.

The legislation passed the House on May 24, by a 280-142 vote, followed immediately the same day by Senate approval, 80-14. President Bush signed the bill into law on May 25.

The *2007 Small Business Tax Act* targets nearly $5 billion in tax incentives principally to small businesses. It also includes tax incentives to help taxpayers recovering from Hurricane Katrina, as well as an important package of S corporation reforms.

Revenue raising provisions totaling nearly $5 billion mean more taxes for certain taxpayers (and penalties for tax practitioners in some cases). One of them - an expansion of the kiddie tax to apply to children who are under age 19 or who are full-time students up to age 24 – will impact millions of families.

SMALL BUSINESS TAX INCENTIVES

The small business tax incentives are designed to help businesses absorb the cost of a higher federal minimum wage. The new law gradually raises the minimum wage to $7.25 over two years. The 3-step increase is scheduled as follows**:**

$5.85 - July 2007
$6.55 – July 2008
$7.25 - July 2009

The impact of this increase in the minimum wage is irrelevant in Ohio as the Ohio minimum wage was raised to $7.25 in January 2007 following the November 2006 election.

Highlights of the small business tax incentives are:

(1) an extended and enhanced small business Code Sec. 179 expensing;

(2) a FICA tip credit calculation that ignores the new hike in the minimum wage; and
(3) an extended and enhanced Work Opportunity Tax Credit.

Small Business Expensing

Almost every new tax law over the past few years has tweaked small business expensing under Code Sec. 179 and the *2007 Small Business Tax Act* is no exception. The dollar and investment limitations are increased. The small business expensing or "Section 179 depreciation expense" is the provision that allows small business to expense capital purchases as they place that property in service.

Because of the extension of enhanced Section 179 expensing, taxpayers now have more certainty. The significantly more generous tax break is not only extended through 2010, it is also indexed for inflation. If Congress had not acted, the dollar limitation would have plummeted to $25,000 and the investment limitation to $200,000 after 2009. But since the deduction is completely phased out under the new levels for qualifying purchases above $625,000, the deduction continues to be confined generally to the relatively small business.

Dollar limitation. Under the new law, the base $100,000 limit ($112,000 as indexed for inflation for 2007) is increased to $125,000 for tax years beginning in 2007 through 2010. This means that businesses can deduct the first $125,000 of annual capital purchases (equipment, furniture, computer equipment, etc.).

Investment limitation. The maximum deduction is phased out by the amount by which all qualifying property placed in service during the tax year exceeds the investment limitation. The investment limitation for property placed in service in tax years beginning in 2007 was formerly $450,000, as indexed for inflation. The new law retroactively raises the investment limitation to $500,000 for tax years beginning in 2007 through 2010. The $500,000 amount is indexed for inflation in tax years beginning after 2007 and before 2011.

The deduction is disallowed if the taxpayer did not have taxable income in the year in which the property is placed in service. However, the amount of the deduction disallowed for this reason may be carried forward to a non-loss year. The deduction is not available to estates, trusts, and certain noncorporate lessors.

FICA Tip Credit

Under the *2007 Small Business Tax Act*, the FICA tip credit (also known as the Sec. 45B credit) will continue to be based on the old minimum wage of $5.15 per hour, rather than the new minimum wage, which will reach $7.25 over the next two years. As a result, even though the minimum wage has increased, the amount of the tip credit will not be reduced. The provision applies with respect to tips received for services performed after December 31, 2006.

For the FICA tip credit, the new law in effect freezes the minimum wage level so that the scheduled increase in the hourly minimum wage will not lower the credit amount.

An employer may claim a credit for FICA tax paid on tips received by employees for serving or delivering food or beverages consumed on the employer's premises if tipping is customary. Employers may claim the Code Sec. 45B credit even if employees do not report the tips. The credit equals the employer's FICA obligation (7.65 percent) attributable to tips that exceed those

tips treated as wages for purposes of the minimum wage requirements of the *Fair Labor Standards Act (FLSA).*

Employers of tipped employees must pay a cash wage of at least $2.13 per hour if they claim a tip credit against their minimum wage obligation. Some states have higher minimum wage rates for tipped employees than the FLSA rate of $2.13 per hour. Other states have the same rates for tipped and non-tipped employees. Some states have different rates for tipped employees based on their occupation.

AMT treatment. The new law treats the tentative minimum tax as being zero for purposes of determining the tax liability limitation with respect to the FICA tip credit. The FICA tip credit may offset AMT liability.

Work Opportunity Tax Credit

The *2007 Small Business Tax Act* extends the Work Opportunity Tax Credit (WOTC) through August 31, 2011. It had been set to expire for employees hired after December 31, 2007. The new law also broadens the scope of the credit. The expanded WOTC is effective starting May 26, 2007.

The WOTC provisions are in large part companions to the portion of the larger bill that raises the minimum wage. They help employers hire entry-level workers at the new minimum wage.

The WOTC encourages employers to hire individuals from various economically-challenged populations. Traditionally the credit, which is a percentage of qualified wages paid during each of the first two years of employment, targeted individuals receiving public assistance, high-risk youth, ex-felons, veterans, and others similarly situated.

The *2007 Small Business Tax Act* expands the targeted veterans' community. It now includes veterans with service-connected disabilities who have been unemployed for six months or more during a one year period ending on the hire date (the six months does not have to be consecutive) and are hired within one year after having been discharged from the military or released from active duty. Additionally, the new law raises the qualified wage threshold for the expanded veterans' groups (from $6,000 to $12,000).

The high-risk youth and vocational rehabilitation referral targeted groups have also been expanded.

The new law adds some certainty to tax planning. The WOTC, like so many temporary tax incentives, has been renewed year after year but not always early enough for employers to make strategic tax plans.

More employers in rural areas may now be able to take advantage of the WOTC. The new law expands the high-risk youth target group to include individuals from rural renewal counties. These are counties outside of metropolitan areas that experienced population losses in the 1990s.

The *Tax Relief and Health Care Act of 2006 (TRHCA)* combined the WOTC and the Welfare-to-Work credits into one credit for 2007. The combined credit applies to individuals who begin work for the employer after December 31, 2006.

AMT Treatment. The new law treats the tentative minimum tax as being zero for purposes of determining the tax liability limitation with respect to the WOTC. The WOTC may offset AMT liability.

FAMILY BUSINESS TAX SIMPLIFICATION

Under the *2007 Small Business Tax Act*, a married couple who jointly operates an unincorporated business and who files a joint return can elect **not** to be treated as a partnership for federal tax purposes. This treatment is available for tax years beginning after December 31, 2006.

Each spouse would take into account his or her share of income, gain, loss, and other items as a sole proprietor. They would not have to file a partnership return (Form 1065) and report two Schedule K-1s. Instead, couples would each report their share of income on Form 1040, Schedule C.

The husband and wife can be the only members of the joint venture. If there are other individuals in the enterprise, the provision does not apply. Additionally, both spouses must materially participate in the business.

Married couples who in the past attributed all of the income from a joint venture to one spouse need to carefully consider this new provision, especially as it impacts Social Security benefits. The new law aims to ensure that when a married couple jointly own and participate in a small business they both get credit for paying Social Security and Medicare taxes.

S CORPORATIONS

The *2007 Small Business Tax Act* includes a package of S corp reforms. The changes impact the treatment of passive investment income, partial sale of quailed subchapter S subsidiaries (QSubs), interest deduction by electing small business trusts (ESBT), reduction of earnings and profits (E&P), and banks operating as S corps.

The new S corp provisions are designed to make it easier for small businesses to retain S corp status. In two cases—ESBT interest and E&P reduction—they also encourage use of the S corp business entity by effectively reducing the taxes owed by shareholders.

Passive Investment Income

The passive investment income test has long been a trap for S corps that convert from C corp status. The *2007 Small Business Tax Act* eliminates some of that worry and does an about-face by no longer treating capital gain from the sale or exchange of stock or securities as an item of passive investment income.

An S corp has to pay corporate level tax at the highest rate on its excess net passive income, if the corporation has accumulated earnings and profits left from C corp years and has gross receipts that are more than 25 percent passive investment income. Worse yet, if more than 25 percent of the S corp's gross receipts are passive investment income for three consecutive years, it loses its S corp status.

Gross receipts from more regular income streams (those derived from royalties, rents, dividends, interest, and annuities), remain subject to the passive investment income limitations.

The provision applies to tax years beginning after May 25, 2007 (2008 for calendar year taxpayers.)

Partial Sale of QSubs

A qualified subchapter S corporation is a wholly-owned subsidiary that an S corp elects to treat as a "QSub." Once the QSub is no longer wholly-owned by the S corp, it ceases to be a QSub and is treated as a new corporation that acquired all its assets from the parent S corp in exchange for stock. The Treasury regulations apply general tax law principles to determine the tax consequences of the change in status.

Under the *2007 Small Business Tax Act*, a sale of QSub stock that terminates the QSub election and creates a deemed new corporation will be treated as a sale of an undivided interest in the assets of the QSub. The new treatment takes effect for tax years beginning on or after December 31, 2006.

This provision eliminates the danger of an avalanche of gain being recognized by a sale of only a partial, but substantial (that is, more than 20 percent), interest in the subsidiary. Now, if an S corp sells 25 percent of its QSub stock, for example, it would recognize only a maximum 25 percent of the gain, saving the S corp substantial tax on the deemed sale.

Interest Deduction by ESBTs

The *2007 Small Business Tax Act* allows an electing small business trust (ESBT) to deduct interest paid on money borrowed to acquire S corp stock. Current Treasury regulations allocate the interest to the S corp portion of the ESBT but do not allow a deduction. The treatment is effective retroactively, for tax years beginning on or after January 1, 2007.

Leveraging S corp ownership in an ESBT just got less expensive, given its newly-allowed deductibility against income otherwise taxed at the 35 percent rate.

ESBTs were first allowed under the *Small Business Job Protection Act of 1996* to permit interests in family-owned corporations to be transferred to a trust in which the trustee has the discretion to accumulate income, rather than distribute income as in a qualified subchapter S trust (QSST), and retain its status as a subchapter S corporation. The S corp stock held by an ESBT is treated as held in a separate trust. Income on the S corp stock is taxed at the highest individual rate (35 percent for 2007).

Reduction of E&P

The new law allows an S corp to reduce its accumulated earnings and profits (E&P) by its pre-1983 accumulated E&P for which the corporation was an S corp. This benefit involving pre-1983 E&P had previously been available only to a corporation that was an S corp for its first taxable year after 1996. This provision takes effect for tax years beginning after May 25, 2007.

Banks as S Corps

Director stock. The *2007 Small Business Tax Act* eliminates the treatment of restricted bank director stock as outstanding stock that threatened S corp status under the single-class-of-stock rule. This provision generally applies for tax years beginning after December 31, 2006.

Accounting methods. The new law also alters the treatment of accounting adjustments resulting from a bank that changes its method of accounting. A bank that uses the reserve method of accounting for bad debts cannot be an S corp. However, the bank can change its method of accounting and elect to become an S corp.

The new law allows a bank that changes its method of accounting to take its first-year adjustments into account in the last taxable year that the bank was a C corporation. Otherwise, the first year changes would be included both in the income of the shareholders and taken into account in computing the tax on built-in gain under Code Sec. 1374.

KATRINA RECOVERY TAX INCENTIVES

The *2007 Small Business Tax Act* extends and enhances some of the tax incentives in the *Gulf Opportunity Zone Act of 2005* and *Katrina Emergency Tax Relief Act of 2005*. These include the extension of special expensing for qualified property, an enhanced low-income housing credit, and flexible tax-exempt bond financing rules.

GO Zone Expensing

The *2007 Small Business Tax Act* extends Code Sec. 179 small business expensing for "specified GO Zone property" (those continuing to rebuild and recover from Hurricane Katrina and other recent hurricanes) through 2008. The specified areas in the GO Zone include seven Louisiana parishes and five Mississippi counties. Under the new law, the 2007 annual dollar limitation is $225,000 ($100,000 plus the regular Code Sec. 179 limit, which was raised elsewhere under the new law to $125,000). The increased limits apply to qualifying property placed in service after December 31, 2007, and before January 1, 2009.

The maximum deduction is reduced by the amount by which all qualifying property placed in service during the tax year exceeds an investment limitation. The inflation-adjusted investment limitation for property placed in service in tax years beginning in 2007 has been $1.05 million. The *2007 Small Business Tax Act* raises the investment limitation to $1.1 million for 2007 and 2008 ($600,000 plus the investment limit for regular Code Sec. 179 expensing).

Low-Income Housing Credit

The *2007 Small Business Tax Act* expands the scope of, and loosens the rules for, the low-income housing credit as applied to buildings in the GO Zones.

Extended placed-in-service dates. Under the *Gulf Opportunity Act of 2005*, the GO Zone, the Rita GO Zone, and Wilma GO Zone were all treated as high-cost areas for property placed into service during calendar years 2006, 2007 and 2008. Property placed in service in these areas during the applicable tax years qualified for the enhanced low-income housing credit. The placed-in-service date is now extended for the enhanced credit in these areas through 2010.

Carryover allocations. Previously, the owner of a qualified building could only claim a credit installment if the owner received a housing credit allocation from the state or local housing credit agency before the end of the year. An exception to this existed where a builder could carry over an allocation because:

(1) More than 10 percent of the taxpayer's reasonably expected basis was incurred as of the later of six months after the allocation from the government was made or the end of the calendar year in which the allocation was made; and
(2) The building was placed in service in the GO Zone before the end of the second calendar year following the calendar year of allocation.

The *2007 Small Business Tax Act* repeals these two requirements, allowing owners of a qualified building to more easily carry over a credit installment for the 2006, 2007 and 2008 tax years.

This removes all obstacles for taxpayers, who have not yet received low-income housing credit allocations from the state and local government, to carry over credits from the 2006 calendar year.

Community developments grants. The *2007 Small Business Tax Act* modifies the definition of below-market federal loan for GO Zone buildings by excluding community development grants from the definition of a federal subsidy that would disqualify the building from an enhanced low-income housing credit.

GO Zone Mortgage Bonds

The *2007 Small Business Tax Act* treats "qualified GO Zone repair or reconstruction loans" as qualified rehabilitation loans under Code Sec. 1400N(a) and 143(k) and the mortgage bond rules under Code Sec. 143. However, this new category of loan continues to require expenditures to be 25 percent or more of the mortgagor's adjusted basis in the residence as of the later of when the repair/reconstruction is finished or the date on which the mortgagor acquires the residence.

Unlike the qualified rehabilitation loans of Code Sec. 143(k), there is no clear requirement that the mortgagor to whom such financing is provided become the first resident of the building after the completion of the rehabilitation. The rule only applies to "owner-financing provided after the date of the enactment…before January 1, 2011." This may encourage private land developers to use proceeds from tax-exempt bonds to acquire and rehabilitate properties in the GO Zone before selling them to homebuyers.

REVENUE RAISERS

Not all provisions in the *2007 Small Business Tax Act* are pro-taxpayer. Some of the revenue raisers will hit a lot of taxpayers' wallets. The measures are expected to raise almost $5 billion over 10 years, making the new law fully offset.

The *2007 Small Business Tax Act* balances tax breaks having a revenue cost of $4.8 billion fairly evenly with $4.44 billion gain from revenue raisers over the mandatory 10-year budget scoring period. However, the immediate impact –over the next five years—tells a different story: $8.4 billion in tax breaks versus only $1.3 billion in revenue.

Major "Kiddie Tax" Changes

The *2007 Small Business Tax Act* extends the reach of the "kiddie tax" by raising the age limit to include (1) all children under age 19 (previously under age 18) and (2) students under age 24. Both changes are effective for tax years beginning after May 25, 2007.

The actual computation of the kiddie tax remains the same. The net unearned income of the child (for 2007, generally unearned income over $1,700) is taxed at the parents' marginal tax rates, if the rates are higher than the child's tax rates. Only last year, *TIPRA* raised the reach of the kiddie tax from under age 14 to under age 18.

College age students will no longer be able to sell off their appreciated investment accounts set up by the parents to cover current tuition. At a minimum, taking out student loans with interest until the year the student turns 24 will be necessary now to carry forward such a plan. However, the maximum tax of capital gains imposed on any stock sales might rise from 15 to 20 percent after 2010, adding another price tag to postponing income recognition.

The effective date for the new kiddie tax provision brings with it some good news and some bad news. For calendar year taxpayers, the higher age limit starts in 2008. The last hike in the kiddie tax, from age 14 through age 17, in TIPRA was made retroactive to the beginning of 2006. This time, the change is not retroactive and, for most taxpayers, does not take effect until next year. Parents have the option to sell quickly in 2007, while the old rule is still in effect.

However, because this provision is effective for tax years beginning after May 25, 2007, there is also some bad news. It is not until 2008 that capital gain for those in the 15 percent or lower tax brackets fall to zero rather than 10 percent. That zero no-tax rate remains through 2010. Many lawmakers earlier this year called for preventing dependents under age 24 from using the zero percent rate. The new law covers this "loophole" and more by expanding the kiddie tax.

The new age limit for the kiddie tax generally tracks the age test for a "qualifying child" under the uniform definition of child first put into place by the *Working Families Tax Relief Act of 2004*. At the end of the calendar year, a qualifying child under the uniform definition and for purposes of the new kiddie tax is an individual under the age of 19, or a student under the age of 24. Unlike the uniform definition, however, a child who is permanently and totally disabled will not be excluded from the age test for kiddie tax purposes.

If the earned income of a student over age 17 exceeds half of the student's support, the kiddie tax no longer applies. Scholarships are not counted in the support test for this purpose.

Interest and Penalty Suspension

The *2007 Small Business Tax Act* doubles the period before which accrual of interest and certain penalties are suspended, from 18 months to 36 months, after the filing of a tax return if the IRS has not sent the taxpayer a notice specifically stating the liability and the basis for the liability. The 36-month period is effective for IRS notices issued after November 25, 2007.

As has been the case since 1998, the suspension is available only for individuals and only for income taxes.

The *IRS Restructuring and Reform Act of 1998* changed the period during which interest could accrue from unlimited to 18-months, as an interim measure, until the IRS could get more organized. Starting in 2004, the 18-month period was to be shortened to one year. As it turned out, the one-year period was deleted by the *American Jobs Creation Act of 2004*, in favor of keeping the 18-month period after 2003. Now, Congress has doubled it, effectively having taxpayers pay $2.4 billion more in interest over the next 10 years.

Return Preparer Penalties

The *2007 Small Business Tax Act* expands preparer penalties to apply not only to income tax returns, but also to estate and gift, excise, exempt organizations, and employment tax returns. The new law also alters the standards of conduct that must be met in order to escape penalties for preparing a return with an understatement of tax:

- The realistic possibility standard for undisclosed positions is replaced by the requirement that there be a reasonable belief that the tax treatment of the position was more likely than not the proper treatment; and
- The not-frivolous standard for understatements involving a disclosed position is raised to the requirement that there be a reasonable basis for the tax treatment.

Finally, the dollar amounts of preparer penalties are being raised:

- For an "unreasonable position," from $250 to the greater of $1,000 or half the income derived by the preparer; and
- For "willful or reckless conduct," from $1,000 to the greater of $5,000 or half the income derived by the preparer.

Part of Congress's strategy to close the tax gap is to curb abuse by unscrupulous return preparers. The new standards are applied whether or not the preparer approaches his or her responsibility with bad intentions. The higher standards and penalties apply to tax returns prepared after May 25, 2007, including 2006 returns filed on extension.

Erroneous Refunds

Erroneous refund claims are subject to a new penalty. The penalty does not apply to earned income credit claims (which have their own set of rules) or the claims for refund or credit already subject to accuracy-related or fraud penalties.

This penalty plugs a loophole used by some taxpayers who over-withhold and claim credits that technically might be sheltered from accuracy-related penalties.

Employment Tax Levies

The *2007 Small Business Tax Act* excludes certain employment tax levies from collection due process (CDP) hearings. The IRS may deny a pre-levy CDP hearing for employment taxes anytime when a previous CDP hearing request has been made for unpaid employment taxes arising in the two-year period before the beginning of the tax period for which the more recent employment tax levy is served. The new CDP rules for employment tax levies go into effect for levies issued on or after November 23, 2007.

Employment taxes make up the bulk of federal tax revenues. Congress suspected that some employers use the pre-levy CDP hearing to delay or prevent collection. More than $288 million could be collected from the new crackdown, according to Congressional tax writers.

In most cases, the IRS must inform taxpayers of their right to a CDP hearing before the levy is issued. When making a jeopardy levy or a levy against state tax refunds, however, the IRS can provide notice of the right to a CDP hearing after the levy is issued.

Bounced Check Fee

The new law raises the IRS bad check fee to $25 and applies this amount to checks and money orders of $1,250 or less. The minimum fees had been $15 on amounts of $750 or less. The penalty is two percent for higher amounts. The new fee goes into effect for checks or money orders received after May 25, 2007.

Permanent User Fees

The *2007 Small Business Tax Act* makes permanent the IRS's authority to charge user fees related to requests for letter rulings, determination letters, opinion letters, or other similar rulings or determinations. The IRS's authority to charge user fees was originally granted by the *Revenue Act of 1987* and has been extended since.

User fees have become so institutionalized that it was inevitable that they would be made permanent. While the current authorization for user fees was not scheduled to expire for another seven years, Congress clearly saw an opportunity to raise revenue to offset the small business tax cuts.

Permanent authority does not mean the fees will remain unchanged. According to the IRS, user fees do not entirely cover its costs.

Corporate Estimated Tax

The *2007 Small Business Tax Act* increases the corporate estimated tax payments from corporations with assets of at least $1 billion that will be due in July, August, and September 2012 from 106.25 to 114.25 percent of the payment otherwise due, with the next payment being reduced accordingly. TIPRA had previously increased those payments to 106.25 percent.

This budgeting "wizardry" is designed to increase revenues and keep the tax cuts offset by accelerating tax payments.

PENSION-RELATED CHANGES

As a last minute addition, several amendments to the *Pension Protection Act of 2006 (PPA)* were added. They principally extend special PPA treatment to pension funds sponsored by additional struggling airlines.

Among the PPA-related provisions, the new law:

- Modifies the effective date of an election to revoke treatment as a multi-employer plan;
- Modifies the minimum cost requirements for qualified transfers for retire health benefits;
- Extends the alternative deficit reduction contribution rules for one year and three days, to plan years beginning before January 1, 2008; and
- Specifies the interest rate sponsors must use in amortizing a shortfall amortization base.