

PKF PERSPECTIVES

SMALL BUSINESS & WORK OPPORTUNITY TAX ACT OF 2007

On May 25, 2007, President Bush signed into law the Small Business and Work Opportunity Tax Act of 2007 (the Act). The Act contains over \$4.8 billion in tax breaks over 10 years for small businesses. It is intended to ease the burden on small businesses due to the increase in the federal minimum wage over a two-year period to \$7.25. To help finance the tax relief provisions, the Act also includes a number of revenue raising provisions. Therefore, some individuals may find their tax bills increased. The following is a summary of the principal provisions in the Act.

TAX RELIEF PROVISIONS

The Work Opportunity Tax Credit (WOTC)

The WOTC broadens employers credits against wages for hiring individuals from one or more of nine target groups, such as recipients of public assistance, qualified veterans on assistance and "high-risk youth." The Act extends WOTC through August 31, 2011.

For individuals who begin work for an employer after May 25, 2007 the Act also:

- expands the qualified veterans target group to include individuals certified as entitled to compensation for service-connected disabilities and increases the amount of qualified first-year wages subject to the credit from \$6,000 to \$12,000 for these individuals.
- expands the definition of "high-risk youth" to include otherwise qualifying individuals who are age 18 but not yet age 40 on the hiring date.
- modifies the WOTC to allow the credit for employers who hire individuals in counties that have suffered significant population losses.

Section 179 Small Business Expensing

In lieu of depreciation, small business taxpayers may elect to deduct (or "expense") the cost of qualified assets (or property) they purchase in the year the qualified assets are placed in service, within certain limits.

The Act extends and increases Section 179 expensing through 2010. It increases the Section 179 dollar amount and investment limitation from \$100,000 to \$125,000 and from \$400,000 to \$500,000 respectively for tax years beginning after 2006. These new thresholds of \$125,000 and \$500,000 are indexed for inflation for tax years beginning *after* 2007 and before 2011.

There is also a one-year extension for both the inclusion of off-the-shelf computer software in the definition of Section 179 property and for the right to revoke a Section 179 election without IRS consent, to tax years beginning before 2011.

Gulf Opportunity (GO) Zone Tax Incentives

The GO Zone was created by the Gulf Opportunity Zone Act of 2005, which provides tax incentives to businesses and residents of Alabama, Louisiana and Mississippi, the states impacted by hurricanes.

The 2007 Act extends and enhances certain tax incentives for businesses in the GO Zone:

Section 179 expensing: The GO Zone allows up to a \$100,000 *additional* Section 179 expense amount and up to a \$600,000 *additional* investment limit amount. (Qualifying property is property whose use is substantially in the GO Zone.) Now, the Act extends for one year, these increased Section 179 amounts for qualifying property located in specified areas in the GO Zone and placed in service on or before December 31, 2008.

Low-income housing credit: The Act extends the placed-in-service date through 2010 for property to qualify for the enhanced low-income housing credit given to the GO Zone areas.

Bond financing for repairs: Certain qualifying repairs and reconstruction can qualify as “rehabilitation” under the tax-exempt bond financing rules. This provision is effective for owner-financing after May 25, 2007 and before January 1, 2011.

Enhancement of the Tip Credit for Certain Small Businesses

Tips received by restaurant employees are treated as wages for purposes of Social Security taxes. As such, employers must pay Social Security taxes on tips received by their employees. These employers receive a business tax credit for taxes paid on tip income exceeding the federal minimum-wage rate.

The Act allows businesses to continue claiming the full tip credit despite an increase in the federal minimum wage. The Act achieves this by freezing the federal minimum wage level for purposes of calculating the credit.

This provision applies to tips received for services performed after December 31, 2006.

Family Business Tax Simplification

Under pre-Act law, if an unincorporated business that is jointly owned by a married couple files as a sole proprietorship (as opposed to a partnership), only the filing spouse will receive credit for paying Social Security and Medicare taxes. Furthermore, unless the married couple is located in a community property state, both the married couple and the business will be subject to penalties for failing to file as a partnership.

The Act allows an unincorporated business that is jointly owned by a married couple in a common-law state to elect to file as a sole proprietorship without penalty as long as each spouse materially participates and they file a joint return. Each spouse will be required to file separate Schedules C (or E or F, as the case may be) rather than a single, combined schedule

in order to preserve proper credits under the Social Security system.

This provision is effective for taxable years beginning after December 31, 2006.

Waiver of Individual and Corporate Alternative Minimum Tax (AMT) Limitations on WOTC and Tip Credits

Pre-Act law limits a small business’s ability to claim WOTC and the tip credit by imposing a limitation that such credits cannot be used to offset the AMT. The Act provides a permanent waiver of the individual and corporate AMT limitations for WOTC and the tip credit.

This provision is effective for credits determined in taxable years beginning after December 31, 2006.

Capital Gain Not Treated as Passive Investment Income

An S corporation is subject to corporate-level tax at the highest corporate tax rate on its excessive net passive income if the corporation (1) has accumulated earnings and profits at the close of the taxable year and (2) has gross receipts for which more than 25% are passive investment income. In addition, an S corporation election is terminated whenever the S corporation (1) has accumulated earnings and profits at the close of each of three consecutive taxable years and (2) has gross receipts for each of those years, more than 25% of which are passive investment income. The Act eliminates gains from sales or exchanges of stock or securities as an item of passive investment income.

This provision applies to taxable years beginning after May 25, 2007.

Treatment of Disposition of an Interest in Qualified Subchapter S Subsidiary

If a subsidiary of an S corporation ceases to be a qualified subchapter S subsidiary (QSub), the subsidiary is treated as a new corporation acquiring all its assets immediately before such cessation from the

parent S corporation in a fully taxable transaction. The Act provides that, where the disposition of stock of a QSub results in the termination of the QSub election, the disposition is treated as a disposition of an undivided interest in the assets of the QSub (based on the percentage of the stock disposed of) followed by a deemed transfer to the QSub. This results in the recognition of gain on underlying assets only to the extent of the proportionate percentage of stock sold.

This provision applies to taxable years beginning after December 31, 2006.

Elimination of Earnings and Profits Attributable to Pre-1983 Years

The Act provides that, in the case of any corporation that was not an S corporation for its first taxable year beginning after December 31, 1996, the accumulated earnings and profits of the corporation are reduced by the accumulated earnings and profits (if any) accumulated in a taxable year beginning before January 1, 1983, for which the corporation was an electing small business corporation under subchapter S.

This provision applies to taxable years beginning after May 25, 2007.

REVENUE RAISERS

Increase in Age of Minor Children Whose Unearned Income is Taxed as Parents' Income

The Act raises the age from 18 to 19 (24 if a student) under which the unearned income of minors who provide less than half their support with earned income is taxed at their parents' tax rate. This provision applies to all unearned income (not just dividends and capital gains) and allows the lower dividends and capital gains rates to apply if the parents are eligible for the lower rates.

Some individuals were transferring large amounts of unearned income, including dividend and capital gains proceeds, to their children's accounts so it would be taxed at their children's lower tax rates. In 1986, Congress shut down this strategy for children under age 14. The *Tax Increase Prevention and Reconciliation Act of 2005* (TIPRA) expanded this treatment to children ages 14 to under 18.

This provision is effective for taxable years beginning after May 25, 2007. Thus, for most taxpayers, it does not apply until 2008.

Modify Interest Suspension Rules

In general, the IRS may charge interest and certain penalties on tax deficiencies that are determined after a tax return is filed, e.g., as the result of an audit. The IRS must stop charging interest and certain penalties if a taxpayer is not notified of the deficiency within 18 months of filing. Only after the taxpayer is notified of the deficiency do the interest charges start up again. This provision was enacted in the *IRS Restructuring and Reform Act of 1998* in response to complaints the IRS acted too slowly, causing unnecessary interest charges to build up on taxpayers. The Act modifies the 18-month rule by extending the period to 36 months.

This provision is effective for IRS notices issued after November 25, 2007.

Modification of Collection Due Process Procedures for Employment Taxes

The Act eliminates the requirement that the IRS hold a collection due process hearing before issuing a levy on delinquent employment taxes.

This provision applies to levies served on or after September 22, 2007.

Permanent Extension of IRS User Fees

The Act makes permanent the fees the IRS is authorized to charge for private letter rulings and other forms of guidance.

Penalty for Bad Checks

The Act increases the penalty imposed on any bad check used for the payment of taxes. The penalty is now 2% of the amount of the check if it is for \$1,250 or more (previously this was assessed if the check was \$750 or more). If the check is for less than \$1,250, the penalty is the lesser of \$25 (previously the penalty was \$15 for checks less than \$750), or the amount of the check.

This provision is effective for checks or money orders received after May 25, 2007.

Understatement of Taxpayer Liability by Return Preparers

The Act expands the application of preparer penalties to all types of tax returns, including employment, excise, exempt organizations, estate and gift.

It increases the amount of the penalty for the understatement of a taxpayer's liability by a tax return preparer to the greater of \$1,000 or 50% of the income derived by the tax return preparer with respect to the return or claim.

It establishes an "unreasonable position" standard—if the preparer knew, or reasonably should have known, of the position; there was not a reasonable belief the position would more likely than not be sustained on its merits; and the position was not disclosed or there was not reasonable basis for the position. An exception applies if there was reasonable cause for the understatement and the tax return preparer acted in good faith.

The penalty for an understatement due to willful or reckless conduct is increased to \$5,000 or 50% of the income derived.

This provision applies to returns prepared after May 25, 2007; however, the IRS has granted transitional relief under which the substantive portions of this new provision are effective for income tax returns due after December 31, 2007.

Erroneous Refund Claim Penalty

The Act creates a 20% penalty on claims for refund that are filed without any reasonable basis. The penalty is applied to the "excessive amount" of the claim, the amount by which the claim exceeds the amount allowable. Under current law, penalties apply to understatements but not to claims for refund. Claims for the earned income tax credit are excluded from this provision.

This provision does not apply to any portion of the excessive amount of the claim to which other penalties apply.

This provision applies to claims filed or submitted after May 25, 2007.

COSTS AND OFFSETS

Costs of tax relief and revenue raising provisions are summarized as follows:

Tax Relief Provisions	10-Year Cost
The Work Opportunity Tax Credit	\$2.571B
Section 179 Expensing	\$70M
GO Zone Low Income Housing	\$221M
GO Zone Repairs and Reconstruction	\$16M
Tip Credit	\$457M
Family Business Tax Simplification	\$0
Waiver of AMT Limitation on WOTC and Tip Credit	\$617M
S Corp Package	\$892M
Total Tax Relief	\$4.844B

Revenue Raising Provisions	10-Year Revenue
Increase in Minimum Wage (Reduction in credits claimed)	\$457M
Increase in Age of Minor Children	\$1.432B
Modified Interest Suspension Rules	\$2.430B
Collection Due Process	\$288M
Permanent IRS User Fees	\$90M
Bad Checks	\$22M
Expand Preparer Penalty	\$82M
Erroneous Refund Claim Penalty	\$98M
Total Revenue Raise	\$4.899B

Items in this publication should not be considered official statements of position, nor advice for individuals or organizations without consulting a professional advisor. This information is not intended to be, nor can it be, used by any taxpayer for the purpose of avoiding tax penalties. For more information, please contact tax directors Leo Parmegiani or Joe Lee.

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