

SMALL BUSINESS AND WORK OPPORTUNITY TAX ACT OF 2007

Congress recently passed the 2007 Small Business Act. The President is expected to sign the bill into law. This new legislation, designed ostensibly to soothe the burden on small business of an increase in the minimum wage, contains an assortment of tax relief and revenue raising provisions. Here are the main tax provisions under the new Act:

THE TAX RELIEF PROVISIONS IN THE SMALL BUSINESS TAX PACKAGE

Extend and liberalize the work opportunity tax credit

The work opportunity tax credit allows employers tax credits for hiring individuals from one or more of nine targeted groups (such as recipients of public assistance, qualified veterans on assistance, and “high risk youth”). The credit was scheduled to expire at the end of this year, but the new law extends the credit for more than 3 years (through September 31, 2011). In addition, the new law expands and enhances the credit by:

- Expanding the qualified veterans’ targeted group to include an individual who is certified as entitled to compensation for a service-connected disability and who (1) is hired by the employer within one year of being discharged or released from active duty in the Armed Forces of the United States, or (2) has been unemployed for six months or more during the one-year period preceding the date of hiring. For these individuals, the amount of first-year wages eligible for the credit is increased from \$6,000 to \$12,000.
- Expanding the definition of high-risk youths to include otherwise qualifying individuals age 18 but not yet age 40 on the hiring date. Also, the provision expands the definition of eligible individuals under this category to include otherwise qualifying individuals from rural renewal counties, defined as a county outside a metropolitan area which had a net population loss during the five-year periods 1990-1994 and 1995-1999.

- Modifying the definition of vocational rehabilitation referral for purposes of the credit to include certain individual work plans developed and implemented by an employment network under the Social Security Act.

Generally, the extension of the credit is effective for wages paid or incurred to a qualified individual who begins work for an employer after December 31, 2007 and before September 1, 2011. The other provisions are effective for individuals who begin work for an employer after the date of enactment of the 2007 Small Business Act in taxable years ending after that date.

Extend and enhance Section 179 small business expensing

A taxpayer, other than an estate, trust, and certain noncorporate lessors, may elect under Code Sec. 179 to deduct as an expense, rather than to depreciate, up to a specified amount of the cost of new or used tangible personal property placed in service during the tax year in his trade or business. Under pre-Act law, the maximum dollar amount that could be deducted annually was \$100,000 (\$112,000 for 2007, as adjusted for inflation). The taxpayer’s maximum annual Code Sec. 179 expensing amount is reduced dollar-for-dollar by the amount of qualified expensing-eligible property that he places in service during the tax year in excess of a phaseout amount. Under pre-Act law, this amount was \$400,000 (\$450,000 for 2007, as adjusted for inflation). The new law increases the expensing limit to \$125,000 and the phaseout level to \$500,000 for 2007 (indexed for inflation) and extends the enhanced expensing provision through 2010.

Enhance the tip credit for certain small businesses

The Federal minimum wage level for purposes of calculating the tip credit is frozen, thereby allowing restaurants to continue claiming the full tip credit despite an increase in the Federal minimum wage.

Simplify family business tax

An unincorporated business that is jointly owned by a married couple in a common law state is permitted to file as a sole proprietorship (under prior law, unless the married couple was located in a community property state, both the married couple and the business were subject to penalties for failing to file as a partnership). The new law also ensures that both spouses receive credit for paying Social Security and Medicare taxes.

Waive individual and corporate AMT limitations on work opportunity tax credits and tip credits

Prior law limited a small business' ability to claim the work opportunity tax credit and the tip credit by imposing a limitation that such credits could not be used to offset taxes that would be imposed under the alternative minimum tax (AMT). The new law provides a permanent waiver of the individual and corporate AMT limitations for the work opportunity tax credit and the tip credit.

Liberalize several S corporation rules

The new law contains several provisions beneficial to S corporations, including measures that:

Elimination of earnings and profits attributable to pre-1983 years

Prior to 1983, income earned by an S corporation gave rise to earnings and profits. Concluding that it was inconsistent with the modern view of S corporations to continue to view pre-1983 S corporation income as giving rise to earnings and profits, in 1996 Congress eliminated pre-1983 earnings and profits for any corporation that was an S corporation prior to 1983, but only if the corporation was an S corporation in its first taxable year beginning after December 31, 1996. However, there seemed to be no policy reason why relief from pre-1983 S corporation earnings and profits should be dependent on whether the corporation continued to be an S corporation after 1996. Accordingly, the new law eliminates pre-1983 earnings and profits arising during an S corporation year, regardless of whether the corporation was an S corporation in its first taxable year beginning after December 31, 1996. This provision applies to taxable years beginning after the date of enactment of the 2007 Small Business Act.

Treatment of disposition of an interest in qualified Subchapter S subsidiary ("QSub")

Under pre-Act law, an S corporation could be required to recognize 100 percent of the gain inherent in a QSub's assets if it sold more than 20 percent of the stock of the QSub. This result was counter to sound tax policy because the S corporation, in effect, was required to recognize gain on assets without making any disposition of those assets. The new law rectifies this situation by providing that the S corporation is

only required to recognize gain proportionate to the percentage of stock sold. The new law applies to taxable years beginning after December 31, 2006.

Deductibility of interest expense of an electing small business trust ("ESBT") on indebtedness incurred to acquire S corporation stock.

The new law eliminates a distinction between an individual purchaser of S corporation stock and a trust purchaser, and makes the ESBT more attractive. Under prior law, the only permissible deductions against an ESBT's income were its administrative expenses, such as costs incurred in the management and preservation of the trust's assets. Interest incurred to acquire S corporation stock was not deductible. The new law permits an electing ESBT to claim an income tax deduction for any interest incurred to purchase S stock. The new rule applies to taxable years beginning after December 31, 2006.

Capital gain not treated as passive investment income

Federal tax law penalizes S corporations if they earn too much passive investment income. Specifically, if an S corporation that previously was a C corporation has undistributed dividends, and earns 25 percent of its gross receipts as passive investment income, then two things will happen. First, the S corporation is taxed on its income at the highest corporate rate. Second, if the S corporation earns too much passive investment income for three consecutive years, then the S election is terminated altogether. Passive investment income generally means gross receipts from royalties, rents, dividends, interest, annuities, and sale or exchanges of stock or securities (to the extent of gains).

However, the corporate-level passive investment income tax is imposed so that C corporations cannot convert to S corporations and thereby avoid the personal holding company (PHC) tax that applies to C corporations. But since PHCs are no longer prohibited from generating passive investment income from gain on the sale of stock or securities, it no longer made sense to impose that restriction on S corporations. Accordingly, the new law eliminates gains from sales or exchanges of stock or securities as an item of passive investment income. The new rule applies to taxable years beginning after the date of enactment of the 2007 Small Business Act.

Treatment of bank director shares

Bank directors often own stock in a bank to comply with national or state banking law. Frequently, a bank director will enter into an agreement under which the bank will reacquire the stock upon the director's ceasing to hold the office of director, at the price paid by the director for the stock ("restricted bank director stock."). However, federal tax law provides that an S corporation may have no more than 100

shareholders and may have only one outstanding class of stock. To clarify the treatment of bank director shares under the S corporation rules, the new law provides that restricted bank director stock will not be taken into account as outstanding stock in applying the S corporation rules. This means that:

- The stock will not be treated as a second class of stock;
- A director will not be treated as a shareholder of the S corporation by reason of the stock;
- The stock will be disregarded in allocating items of income, loss, etc. among the shareholders; and
- The stock will not be treated as outstanding for purposes of determining whether an S corporation holds 100 percent of the stock of a qualified subchapter S subsidiary.

The new provision generally applies to taxable years beginning after Dec 31, 2006, but the provision providing that restricted bank director stock is not treated as a second class of stock is effective for taxable years beginning after December 31, 1996.

Treatment of banks changing from reserve method of accounting

Under current law, banks that use the reserve method of accounting are ineligible to make the S corporation election. If a bank makes an S corporation election, the bank is automatically switched to the specific charge-off method of accounting for bad debts. This change in accounting method results in recapture of the bad debt reserve over four years. The recapture of the reserve by the bank S corporation is treated as built-in gain subject to a special corporate-level tax. Under the built-in gain provisions, tax on the built-in gain must be paid both at the corporate and shareholder level in the year

of recognition. In contrast, a C corporation would pay tax on the recapture amount at the corporate level but the shareholders would not have to pay tax on that amount until the C corporation paid dividends. The new law allows banks to take the recapture of the bad debt reserves into account in the last C corporation year, rather than the first S corporation year, thereby eliminating the imposition of a second layer of tax. The new rule applies to taxable years beginning after December 31, 2006.

THE ACT PAYS FOR THE ABOVE BENEFITS BY:

Raising the kiddie tax age from under-18 to under-19 (under-24 if a student).

Modifying the rule that IRS must stop charging interest and filing related penalties if it fails to notify the taxpayer about a deficiency within 18 months after the taxpayer filed the return-the time limit is extended to 36 months.

- Eliminating the requirement that IRS hold a collection due process hearing before issuing a levy on delinquent employment taxes.
- Expanding preparer penalties to all types of tax returns (e.g., employment, excise, exempt orgs., estate and gift tax) and increasing the penalty amounts.
- Creating a new penalty on claims for refund that are filed without any reasonable basis.
- Increasing the penalty for bad checks and money orders.
- Please keep in mind that I have described only the highlights of the most important changes in the new law. Give me a call if you would like more details on how you may be affected by this important tax legislation.

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