



On Second Try—Tax Law Changes Come Back After Veto  
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## Small Business Tax Law Provisions—And Ways to Pay for Them

Congress this week sent back to the President for signature a set of small business tax breaks and revenue raisers that had previously been part of a vetoed bill that had unrelated provisions the President objected to. After failing to override the veto, the Congress removed the offending provisions and has sent the bill back to the President who now has indicated he expects to sign the bill. Thus, we now have our first significant tax legislation from the new Congress, and the bill has items that will both make many clients happy, and provisions that will prove a bit upsetting to others.

We will look at a few of the provisions in this bill that both reduce taxes for taxpayers, and those offsetting provisions that will raise client's tax bills.

These provisions are in the bill largely due to the increase in the federal minimum wage, offered as an offset to the increased costs on small businesses. But since the bill was required to be “revenue neutral” under budget rules, there are a number of revenue raisers in the bill.

We’ll look first at some of the tax breaks in this bill, and then look at some of the revenue raisers. We aren’t going to cover the entire bill, both because we want this podcast to be of a relatively reasonable length and because we are still just getting a good look at the final bill. But we need to begin preparing our clients, because some of these provisions take effect immediately.

## Tax Breaks

We’ll take the good news first—a number of tax breaks ended up in the bill. Some of the items are extensions of current provisions along with enhanced benefits. And many take effect immediately.

### **Section 179 Expensing**

[Bill Section 8212] The bill immediately increases the amount available for expensing under §179 to \$125,000 for 2007, to be indexed for inflation beginning in 2008. As well, the phase out level increases to \$500,000 for §179 expensing as well, again indexed for inflation. The bill also extends the increased limits for one more year, picking up 2010 before the expensing limit is scheduled to be reduced back down to its old \$25,000 limit.

Arizona practitioners should note that this is a provision that would not come into Arizona automatically should the legislature pass their standard form conformity bill next year. Since Arizona law already restricts §179 expensing to \$25,000 per year, that difference would remain valid even after they roll forward the conformity date to January 1, 2008 (as they likely will next year).

### **FICA Tip Credit**

[Bill Sections 8213 and 8214] Restaurants get a credit based on the special rules that apply to them under minimum wage rules. Restaurants are allowed to pay a lower than minimum wage amount, so long as the total of the amount paid (subject to a different minimum) plus tips received exceeds the minimum wage amount. Employers have to treat those tips as employer paid wages for FICA purposes, but get a credit for FICA paid on any tips reported as wages for federal tax purposes that end up being in excess of the minimum wage amount. The idea is that the restaurant gets back that “extra” FICA that would not have been paid had they actually been employers paying the minimum wage.

The bill provides that for purposes of computing this credit, restaurants will be able to use the older (lower) minimum wage amount in computing this credit. This will serve to keep the credit from decreasing due to the increase in the minimum wage amount. The provision applies to services performed after December 31, 2006

As well, both this credit and the work opportunity credit are allowed to be used to offset alternative minimum tax liabilities. The offset against AMT liabilities is effective for tax years beginning after December 31, 2006.

### **Husband/Wife Businesses**

[Act Section 8215] The bill addresses what has become a quirk in the tax law that treated married couples in community property states differently from those in other jurisdictions if the couple jointly owns a business. Community property proved to be troublesome to deal with in the context of single member LLCs. In a community property state such an interest would, by default, tend to be treated as community property owned by both spouses in a marriage. Regulation §301.7701-2(c)(1) provides:

1) The term partnership means a business entity that is not a corporation under paragraph (b) of this section and that has at least two members.

Thus, it would appear, that by definition this single member LLC has two members (owners) and thus would be a partnership.

The IRS granted relief in this situation under Revenue Procedure 2002-69. That procedure allowed a “qualified entity” to either file as a disregarded entity (treated as if it had a single owner) or a partnership if it met the following criteria:

- (1) The business entity is wholly owned by a husband and wife as community property under the laws of a state, a foreign country, or a possession of the United States;
- (2) No person other than one or both spouses would be considered an owner for federal tax purposes; and
- (3) The business entity is not treated as a corporation under §301.7701-2.

However, the ruling gave no relief to spouses outside of community property states who might have titled the interests in a joint form.

The bill addresses this issue by creating a new type of entity known as a “qualified joint venture” which meets the following criteria:

- The only members of the joint venture are a husband and wife;
- Both spouses materially participate in the trade or business as defined by §469(h) without regard to participation by the other spouse *and*
- Both spouse elect to treat the entity as a qualified joint venture

If the entity meets that criteria, then the entity will not be treated as a partnership for federal tax purposes, all items of income and deduction will be split between the spouses based on their interests in the venture and each spouse will treat his/her share of the items as if the entity were a sole proprietorship conducted by that spouse. That will be true both for income tax and self-employment tax purposes.

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

### ***Elimination of Gains on Sale of Stock or Securities from Treatment as S Corporation Passive Income***

[Act Section 8231] Capital gains from the sale of stock or securities is removed from the definition of “passive income” for purposes of the excess passive income tax and potential revocation of S election under §1362(d)(3) for an corporation with earnings and profits. This particular issue, as noted above, not only imposed a tax on the offending S corporation but also, if repeated for three consecutive years, resulted in automatic loss of S status. This provision could end up forcing a corporation exposed to the provision to make an elective distribution of its earnings and profits (and subject the shareholder to dividend income) in order to preserve the S election.

This change would appear to open up planning opportunities for certain corporations to move their investments over to trading stock from investments that generate dividends, interest, royalties, annuities and “passive” rents, all of which remain “tainted” items of income.

It is important to note that this provision applies to taxable years beginning after the date of enactment—not after December 31, 2006 like many other provisions in the bill. So for calendar year 2007 capital gains from the sale of stock or securities will continue to count as passive income for purposes of the §1362(d)(3) issues.

### ***Improved Treatment of Sale of QSUB Shares***

[Act Section 8234] Prior law had a trap for the unwary if an S corporation sold off the shares of a subsidiary for which it had made a QSUB election. The Joint Committee’s explanation of the law outlines an example from the Treasury regulations that provided that if an S corporation sold off 21% of the stock of a QSUB to an unrelated party, the corporation was deemed to transfer all of the assets to a “new” corporation (since it no longer qualified as a QSUB)—and since the S corporation failed to have over 80% control of the corporation at the end of the day, Section 351 did not apply and gain was recognized on 100% of the value of the assets transferred to the “new” corporation.

Under the new law, the transaction will be treated in the following manner:

- The parent S corporation will be deemed to sell an undivided interest in all assets of the subsidiary for the amount of the purchase price of the stock, and a gain or loss computed on that basis
- The new shareholder(s) and the S corporation will then “form” a new corporation that will be taxed under the principles of Section 351.

The provision does not change the treatment if the transaction would have been tax free under current law.

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

## The Bad News

In order to pay for the above items, Congress enacted a number of revenue raising provisions, many dealing with penalties or taxpayer rights provisions.

### ***Kiddie Tax Extended Yet Again***

[Act Section 8241] Congress has returned to the scene of the crime from a year ago, and once again extended the kiddie tax, this time in two ways. First, the tax is extended for all children for one year to apply to children through the age of 18 (so you can vote for one year, but you still get to pay tax at Mom and Dad's rates).

*Correction: While the JCT's report continues to refer to the extension of the Kiddie Tax for one year to all taxpayers, the final bill removed that language. In the final bill, only the next provision applies.*

Second, and more onerous for much of our family tax planning, the tax is extended to cover students by continuing the tax through age 23 if the following conditions are met:

- The child is over age 18 [*Correction: Make that is age 18 or over at the end of the year*] but under age 23 and
- The child's earned income for the taxable year does not exceed ½ of the child's support for that year

This provision greatly diminishes the effectiveness of using UGMA accounts or traditional trusts with the child as beneficiary to invest for and pay for college. As well, planning that revolved around the upcoming 0% capital gain rate and children also appears to be very negatively impacted by this change. This may increase the attractiveness of vehicles such as 529 plans and Coverdell IRAs as education savings vehicles.

The only good news is that the change is effective for years beginning after the date of enactment—so 2007 will still be taxed under the old rules.

### ***IRS Gets More Time to Assess Tax Before Interest is Suspended***

[Act Section 8242] One of the taxpayer rights benefits enacted back in the 1990s suspended the running of certain interest and penalties if the IRS had not notified the taxpayer within 18 months after the filing of the return of the liability and the basis for the liability. The running of interest and penalties would begin again 21 days after the IRS sent the required notice.

The new law pretty much guts this provision, by extended out the suspension period to three years (which just happens to be the normal statute of limitations period).

The new rule will come into effect for IRS notices issued six months after the date of enactment. Interestingly enough, it would therefore appear the IRS might come out ahead by delaying the issuance of notices until after that date if they are more 18 months

past the original filing, but less than 36 months.

### ***Reduced Right to Collection Due Process Hearings in Payroll Tax Cases***

[Act Section 8243] The new law removes the right of a taxpayer to request a collection due process hearing prior the issuance of a levy on an employment tax matter if the taxpayer had previously requested a collection due process hearing with regard to unpaid employment taxes arising in the two year period prior to the beginning of the period for which the current levy is served. Rather, the taxpayer is now to be provided with an opportunity for a hearing within a reasonable time after the levy is served.

The provision is effective for levies issued 120 days after the date of enactment.

### ***User Fees Made Permanent***

[Act Section 8244] The IRS authority to charge user fees for a letter ruling, determination letter, opinion letter or similar items is made permanent. Previously the authority only ran through September 30, 2014, though not many observers really believed that user fees would really “go away” at that point.

### ***Expansion of Scope of, and Increase in, Preparer's Penalty for Understatement of Taxpayer's Liability***

[Act Section 8246] The new law expands the two tier penalty structure that was imposed on income tax return preparers to preparers of estate, gift, excise and employment tax returns. The first tier penalty, imposed for an undisclosed position for which there was not a realistic possibility of the position being sustained on its merits or which is frivolous, is increased to the greater of \$1,000 or 50% of the income derived or to be derived by the preparer from the preparation of the return. Previously the penalty had been \$250. As before, the penalty applies only if the preparer was aware, or reasonably should have been aware, of the position.

The second tier penalty, imposed on a preparer who engages in specified willful or reckless conduct is raised to the greater of \$5,000 or 50% of the income derived (or to be derived) by the preparer. Previously this penalty had been set at \$1,000.

### ***Penalty for Filing Erroneous Refund Claims***

[Act Section 8247] The act provides for a 20% penalty to be imposed on erroneous claims for refund or credit. The penalty is imposed on the disallowed portion of the claim unless the taxpayer shows there was a reasonable basis for the claimed tax treatment. This extra penalty does not apply to claims related to the earned income credit or any portion of the claim that is subject to accuracy related or fraud penalties.

The provision applies to claims filed after the date of enactment.

### ***Change in Time for Payment of Corporation Estimated Taxes***

[Act Section 8248] Whenever Congress needs to “fudge” a bill to move tax revenues from one period to another, they play with due dates and amounts of estimated taxes. This bill is no exception. Corporations with assets of at least \$1 billion were required to pay 106.25% of the amount otherwise due on their estimates due in July, August and September 2012 (just, coincidentally, the payments due just before the end of the federal government’s fiscal year), with the following payment reduced accordingly.

Congress, again needing money for that 2012 fiscal year, has now raised the payment percentage to 114.25% of the amount otherwise due, again reducing the following payment.

### ***And There’s More...***

The bill contains other provisions we aren’t discussing, including technical corrections related to the Pension Protection Act of 2006 and extension of GO Zone tax incentives.