

Washington Tax Report

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Material discussed is meant to provide general information and should not be acted on without obtaining professional advice appropriately tailored to your individual needs.

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On May 25, 2007, the President signed the "Small Business and Work Opportunity Tax Act of 2007" (the "Act") included as part of the Iraq war funding and federal minimum wage increase legislation (H.R. 2206). As with all tax legislation, the Act contains both tax relief and tax revenue provisions. This *Washington Tax Report* summarizes provisions of the Act that we believe may be of significance to our clients.

Tax relief provisions include the following:

Expense Allowance for Small Businesses

For taxable years beginning in 2007 through 2010, the maximum cost of tangible personal property (including off-the-shelf computer software) that businesses may elect to deduct in the year the property is placed in service is increased from \$100,000 under prior law to \$125,000. The cost of qualifying property after which the expense allowance begins to phase out is also increased from \$400,000 to \$500,000. As under prior law, these amounts are indexed for inflation.

Election to Not Treat Husband and Wife Joint Venture as a Partnership

For taxable years beginning in 2007 and thereafter, a qualified joint venture owned by a husband and wife filing a joint return is not treated as a partnership for Federal tax purposes. A qualified joint venture is a trade or business with respect to which (1) the only owners are a husband and wife, (2) both spouses materially participate, and (3) both spouses elect for the joint venture not to be treated as a partnership. Instead of reporting as a partner of a partnership, the husband and wife are treated as sole proprietors, each reporting on a Schedule C of their joint Federal income tax return.

Favorable S Corporation Changes

For taxable years beginning after the date of enactment (May 25, 2007), the following changes have been made:

- (1) Gains from the sale of stock or securities are not treated as passive investment income with respect to S corporations having accumulated earnings and profits that

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may be subject to corporate-level tax on excess net passive income and the possible termination of its S election.

- (2) Any accumulated earnings and profits of an S corporation that was not an S corporation for its first taxable year beginning after December 31, 1996 is reduced by the accumulated earnings and profits (if any) accumulated in an S corporation taxable year beginning before January 1, 1983.

For taxable years beginning after December 31, 2006, the following changes have been made:

- (1) Restricted bank director stock of a bank or bank holding company is not treated as outstanding stock for purposes of Subchapter S. Instead, the corporation and the director are essentially treated as if such stock were a debt instrument. (This provision also provides that bank director stock is not treated as a second class of stock for taxable years beginning after December 31, 1996.)
- (2) A financial institution that changes from the reserve method of accounting for bad debts in order to elect to be an S corporation may also elect to take into account all adjustments required under Section 481 of the Internal Revenue Code (IRC) as a result of the method change in the last tax year it was a C corporation instead of in the first year it becomes an S corporation. This election eliminates income to the S corporation shareholders on account of the Sec. 481 adjustment as well as the potential imposition of the built-in gains tax under IRC Section 1374.
- (3) An S corporation that sells a percentage interest in the stock of a qualified subchapter S subsidiary (QSub) to a purchaser is treated as having sold that percentage of the assets of the QSub to the purchaser and transferred the remaining percentage interest of the

QSub to a new corporation in a tax-free exchange under IRC Sec. 351.

- (4) Interest paid or accrued by an electing small business trust (ESBT) on indebtedness to acquire stock of an S corporation is deductible in computing the taxable income of the S corporation portion of an ESBT.

Work Opportunity Tax Credit

The Work Opportunity Tax Credit, the elective credit available to employers on generally first-year wages of employees from certain targeted groups, has been extended with respect to qualified individuals who begin work before September 1, 2011. The Act also expands the qualified veterans' and high-risk youth (renamed "designated community residents") targeted groups with respect to individuals who begin work after May 25, 2007. For taxable years beginning after December 31, 2006, the Work Opportunity Tax Credit may offset alternative minimum tax (AMT) liability.

Gulf Opportunity Zone Tax Incentives

Under the Act, the present law expensing for qualified Gulf Opportunity (GO) Zone property has been extended; the low-income housing credit rules for newly constructed or substantially rehabilitated housing in the GO Zones have been extended and expanded; and the present rules with respect to qualifying GO Zone tax-exempt bonds have been liberalized.

Tax revenue provisions include the following:

Children's Unearned Income Taxed at Parents' Rate ("Kiddie Tax"):

For tax years beginning after May 25, 2007, the age of a child whose net unearned income (for 2007, unearned income in excess of \$1,700) is taxed at his or her parents' rate is increased from under age 18

to under age 19 or under age 24 if the child is a full-time student. This expansion of the kiddie tax does not apply to children whose earned income exceeds one-half of the amount of their support.

Tax Return Preparer Penalty

Under prior law, for income tax returns prepared on or before May 25, 2007, a "tax return preparer" was subject to penalty for preparing a return with respect to which there was an underpayment of tax as a result of a "frivolous position" (patently improper) or an undisclosed position that did not have a "realistic possibility of being sustained on its merits" (at least a one-in-three chance of being sustained). Under the Act, for tax returns prepared after May 25, 2007, tax return preparers subject to preparer penalties are expanded to include preparers of estate and gift tax, employment tax, and excise tax returns, and returns of tax exempt organizations. In addition, a tax return preparer is now subject to penalty on an underpayment of tax with respect to a tax position that does not have a "reasonable basis" (arguable, but fairly unlikely to prevail in court) or an undisclosed position with respect to which there is not a reasonable belief that the tax treatment of the position is "more likely than not" (greater than 50 percent) the proper treatment. Finally, the amount of the penalty is increased to 50 percent of the income derived (or to be derived) from the preparation of the return if that percentage exceeds a specified dollar amount (\$1,000 in most cases).

This *Washington Tax Report* does not describe all the provisions of the Act; only those we believe may be of significance to our clients. After reviewing this Report, we encourage you to contact your BDO Seidman, LLP or BDO Seidman alliance firm client service professional concerning provisions that may affect you or your business.