# Small Business and Work Opportunity Tax Act of 2007: Analysis and Tax Planning Opportunities

*By Cherie J. Hennig, William A. Raabe and John O. Everett*

Cherie J. Hennig, William A. Raabe and John O. Everett discuss some of the more salient provisions of the Small Business and Work Opportunity Tax Act of 2007, including small business tax relief provisions; revenue provisions; and the Gulf Opportunity Zone and Work Opportunity Tax Credit incentives.

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The Small Business and Work Opportunity Tax Act of 2007 ("Small Business Tax Act"),[1] which includes the U.S. Troop Readiness, Veterans' Care, Katrina Recovery and Iraq Accountability Appropriations Act of 2007, expands and extends many small business tax relief provisions. The Small Business Tax Act also includes some surprising revenue raisers. Taxpayers and tax practitioners should assess the impact the Small Business Tax Act will have on the preparation of 2007 tax returns and tax planning strategies for 2007 and beyond. The Small Business Tax Act is designed to help businesses faced with increased wage costs from the increase in the minimum wage to $7.25 over the next two years, and to offer tax incentives to help taxpayers living in the gulf states rebuild from the damage caused by Hurricane Katrina. Under the current Congressional "pay-go" rules the estimated revenue cost of the act is offset with some unexpected revenue raisers. Provisions relating to the extension of the "kiddie tax," payment of self-employment tax by married couples, and changes to certain penalty provisions offer tax planning opportunities and potential tax traps. This article discusses some of the more salient portions of the Small Business Tax Act including small business tax relief provisions; revenue provisions; and the Gulf Opportunity (GO) Zone and Work Opportunity Tax Credit (WOTC) incentives. A summary of the provisions of the Small Business Tax Act and its various effective dates are found in Table 1.

**Cherie J. Hennig,** Ph.D., CPA, M.B.A., is a Professor and Director of the Master of Science in Taxation Program at Florida International University.

**William A. Raabe,** Ph.D., CPA, is a Tax Professor at Ohio State University in Columbus.

**John O. Everett,** Ph.D., CPA, is a Professor of Accounting at Virginia Commonwealth University in Richmond.

## Small Business Tax Relief Provisions

### Incentives to Offset Higher Federal Minimum Wage

#### *FICA Tip Credit*

Employers in the food and beverage industry may claim a nonrefundable income tax credit for a portion of the employer social security taxes paid or incurred on employee cash tips.[2] The credit, which is available whether or not the employee reported the tips, will continue to

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## Table 1. Small Business and Work Opportunity Tax Act of 2007

| | Act Section | Effective Date | Summary |
|---|---|---|---|
| **I. Small Business Tax Relief Provisions** | | | |
| **a. Incentives to offset cost of higher federal minimum wage** | | | |
| 1. Determination of FICA tip credit | 8213 | tips received after 12/31/2006 | Credit will continue to be based on minimum wage of $5.15 per hour |
| 2. AMT relief for FICA tip credit | 8214 | tax years beginning after 12/31/2006 | FICA tip credit may offset alternative minimum tax |
| 3. Increase in Sec. 179 Deduction | 8212 | tax years beginning after 12/31/2006 | Increased to $125,000, phase-out increased to $500,000, indexed for inflation |
| **b. Family business tax simplification** | | | |
| 1. Qualified joint venture between husband and wife can elect out of partnership rules. | 8215 | tax years beginning after 12/31/2006 | Each spouse may account for his/her share of joint venture income on a Schedule C |
| **c. Subchapter S provisions** | | | |
| 1. Certain capital gains not treated as passive investment income | 8231 | tax years beginning after 5/25/2007 | Gains from sales/exchanges of stock or securities are excluded from the definition of passive investment income |
| 2. Elimination of pre-1983 E&P | 8235 | Immediate | Extends elimination of pre-1983 S corp. E&P from the accumulated E&P of a C corp. |
| 3. Treatment of sale of an interest in a Q-Sub | 8234 | tax years beginning after 12/31/2006 | A sale of more than 20% of the stock of a Qsub is treated as a sale of an undivided interest in the assets that will not result in the termination of the Qsub election |
| 4. Treatment of bank director shares | 8232 | tax years beginning after 12/31/2006 | Restricted bank director stock is not treated as a second class of stock; a director is not treated as an S shareholder |
| 5. Treatment of banks changing from reserve method of accounting | 8233 | tax years beginning after 12/31/2006 | A change from the reserve method of accounting for bad debt can be taken in the last taxable C corporation year |
| 6. Deductibility of interest expense | 8236 | tax years beginning after 12/31/2006 | Interest paid or accrued on indebtedness to acquire stock in an S corporation is deductible in computing taxble income of an electing small business trust (ESBT) |
| **II. Revenue Provisions** | | | |
| a. Increase in age limit for "kiddie tax" | 8241 | tax years beginning after 5/25/2007 | Kiddie tax extended to children who are 18 years old or who are full-time students over age 18 but under age 24; applies only to children whose earned income is <1/2 of their support |
| b. Tax Preparer Penalties | 8246 | returns prepared after 5/25/2007 | Tax preparer definition broadened; realistic possibility standard for an undisclosed position is replaced with a "more likely than not" standard; first-tier penalty increased to the greater of $1,000 or 50% of the income derived; second-tier penalty increased to the greater of $5,000 or 50% of the income derived |
| c. Penalty for filing erroneous refund claims | 8247 | claims filed after 5/25/2007 | A new penalty of 20% is imposed on the disallowed portion of a claim for refund or credit for which there is no reasonable basis. |
| d. Permanent extension of IRS user fees | 8244 | requests made after 5/25/2007 | The statutory authorization for IRS user fees has been made permanent |
| e. Increase in penalty for bad checks | 8245 | checks/money orders received after 5/25/2007 | The penalty for a bad check or money order is the greater of 2% of the amount of $25 |
| f. Suspension of penalties and interest | 8242 | notices issued six months after 5/25/2007 | Suspension of accrual of interest and penalties is extended to 36 months after the filing of the tax return when the taxpayer has not been notified of a change in the tax liability |

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| | Act Section | Effective Date | Summary |
|---|---|---|---|
| **g. Other Revenue Provisions** | | | |
| 1. Modification of collection due process procedures | 8243 | levies issued on or after 120 days after 5/25/2007 | The requirement to notify taxpayers that they have a right to an impartial collection due process (CDP) hearing is suspended if the taxpayer had previously requested a CDP hearing within a prior two-year period |
| 2. Time for payment of corporate estimate tax | 8248 | payments due in July/August/ September, 2012 | Large corporations with assets of at least $1 billion must increase their estimated tax payments from 105.25% to 114.25%. |
| **III. Gulf Opportunity (GO) Zone Incentives and Work Opportunity Tax Credit (WOTC)** | | | |
| a. Increase Code Sec. 179 deduction | 8221 | tax years beginning after 5/25/2007 | In the GO Zone, the Code Sec. 179 deduction increased by $100,000, and the phase-out is increased to $1,000,000 |
| b. Extension/expansion of low-income housing credit | 8222 | effective 5/25/2007 | Carryover allocation rule modified; extends placed in service dates; modifies definition of below market federal loan; treats rehabilitation expenses as separate new building |
| c. Special tax-exempt bond financing rules | 8223 | after 5/25/2007 and before 1/1/2011 | GO Zone repair or reconstruction loan treated as qualified rehabilitation loan |
| d. Modification of WOTC | 8211 | begin work after 5/25/2007 | Expands qualified veterans' group to include an individual certified as entitled to compensation for a service-co9nnected disability |
| e. AMT relief for WOTC | 8214 | tax years beginning after 12/31/2006 | WOTC may offset alternative minimum tax |
| f. GAO report on allocation and utilization of tax incentives | 8224 | report due before 5/25/2008 | GAO is required to conduct a study of the practices employed by State and local governments and its subdivisions in allocating and utilizing tax incentives provided under the Gulf Opportunity Act of 2005 |

be based on the previous minimum wage of $5.15 per hour even though it is scheduled to increase to $7.25 over the next two years. Since the tip credit only applies to tips in excess of those treated as wages for purposes of satisfying the federal minimum wage provision, this effectively freezes the minimum wage level so as to not reduce the tip credit. No change was made to the requirement that employers must pay a minimum cash wage of at least $2.13 per hour in order to claim the tip credit against their minimum wage obligation.[3] The credit is claimed as a nonrefundable general business credit on Form 8846.[4]

**Example 1**. Employer pays wages of $37,500 to its wait staff who also declare tip income of $35,000. Wages paid at the current minimum wage would have been $51,500. Employer is entitled to a credit of $1,610 computed as follows:

| | |
|---|---|
| $37,500 | Wages paid |
| $35,000 | Tips reported |
| $72,500 | Total |
| –$51,500 | Wages @ old minimum wage |
| $21,000 | Wages eligible for credit |
| x 0.0765 | |
| $1,610 | Tip Credit |

If the minimum wage level is not frozen, the employer would receive $0 tip credit.

| | |
|---|---|
| $37,500 | Wages paid |
| $35,000 | Tips reported |
| $72,500 | Total |
| –$72,500 | Wages @ new minimum wage |
| $0 | Wages eligible for credit |

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## *Alternative Minimum Tax (AMT) Relief for Tip Credit*

Generally, the only tax credit that directly offsets the AMT is the AMT foreign tax credit.[5] Even if there is no AMT because regular tax exceeds the tentative minimum tax (TMT), most business credits do not reduce the TMT. The WOTC permits the tip credit to be used to offset the taxpayer's AMT liability. The general business credit limitation rules are applied separately and the TMT is set at zero, so that the credit can be taken against both the regular and alternative minimum tax liabilities.

## *Increase in Code Sec. 179 Deduction*

The most expensive provision of the Small Business Tax Act is the expansion of the Code Sec. 179 election to expense, which is extended through 2010 and indexed for

inflation.[6] For the 2007 tax year, the maximum expense amount is $125,000 and the phase-out does not begin until qualifying purchases exceed $500,000, with the deduction fully phased out once qualifying purchases exceed $625,000.[7] These limits are indexed for inflation for tax years beginning after 2007 and before 2011. The deduction is not available to estates, trusts and certain noncorporate lessors. The deduction and any qualifying purchase limitations are determined at the partner/S shareholder level. Small business owners can now structure acquisitions of qualifying assets so as to maximize their annual Code Sec. 179 deductions.

**Example 2**. In 2007, Taxpayer plans to purchase four new delivery trucks costing $120,000. Prior to the WOTC taxpayer would have been limited to a Code Sec. 179 deduction of $112,000. Taxpayer is now able to expense the entire $120,000.

## Family Business Tax Simplification

The Small Business Tax Act permits a married couple who jointly operate a business as a joint venture to forego filing a partnership tax return and report their respective shares of earned income on separate Schedule Cs.[8] The spouses can be the only members (owners) of the joint venture, and both must materially participate in the business to make this election.[9] While this provision is not scored as a revenue raiser, married couples who in the past attributed all of the income of a joint venture to one spouse should carefully consider this new provision, especially if the earned income of the business exceeds the FICA limit, $97,500 for 2007. Audits of Schedule C taxpayers in which all of the self-employment income is attributed to one spouse may result in an IRS agent asking for information regarding the level of participation by both spouses in the business.[10]

**Example 3**. Susan is self-employed and operates an unincorporated business in which her husband Sam materially participates. The business has a profit of $60,000 for the 2007 tax year. If all the income is attributed to Susan, the self-employment tax is $8,478 ($60,000 x 0.9235 x 0.153). If one-half of the income is attributed to Susan and Sam, the total self-employment tax is still $8,478 ($30,000 x 0.9235 x 0.153 x 2).

**Example 4**. Assume the business has a profit of $120,000. If all the income is attributed to Susan, the self-employment tax is $15,304.

| | | |
|---|---|---|
| $120,000 | | |
| x 0.9235 | | |
| $110,820 | | |
| –$97,500 | x 0.153 = | $14,918 |
| $13,200 | x 0.029 = | $ 386 |
| SE Tax | | $15,304 |

If one-half of the income is attributed to Susan and Sam, the total self-employment tax is $16,956 ($8,478 + $8,478), an increase of $1,652.

Attributing all the income to one spouse may result in Social Security or Medicare benefits not being property attributed to the nonreporting spouse. While a nonreporting spouse may be entitled to Social Security benefits based upon one half of the working spouse's earnings, the benefits may be higher if the self-employment income had been attributed to both spouses. The Social Security Web site, *www.ssa.gov,* has a Retirement Planner and Benefits Calculator that can be used to determine the benefits each spouse may be entitled to.

**Example 5**. In the previous examples, if all the income is attributed to Susan, and Sam has no other earned income, Sam's Social Security benefits would be based upon a portion of Sue's Social Security income. In the case of a divorce, the nonreporting spouse may be hard pressed to argue that he or she is entitled to a portion of the business assets.

**Example 6**. In the previous examples, if all the income is attributed to Susan, and Sam files for divorce, he would likely receive a smaller property settlement since he cannot establish that the value of the business is at least partially attributable to his efforts.

## Subchapter S Provisions

### *Certain Capital Gains Not Treated As Passive Investment Income*

The most significant of the Subchapter S reform provisions is the elimination of gains from the sale or exchange of stock or securities from the definition of passive investment income. An S corporation can be subject to a corporate-level tax of 35 percent on excessive net passive income if the corporation holds E&P and more than 25 percent of its gross receipts come from passive investment sources. Its S corporation elec-

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tion is terminated when it has excess passive income in three consecutive tax years.[11] While this provision will permit S corporations so dispose of appreciated stock and securities over multiple tax years without fear of triggering the Net Passive Income tax, these gains may be subject to the built-in gains tax if the sales occur within 10 years after a C corporation elects S corporation status.[12]

**Example 7**. Charlie Corporation elects to be treated as an S corporation starting January 1, 2007. On December 31, 2006, Charlie has a built-in gain of $1 million consisting of $600,000 attributable to goodwill and $400,000 attributable to appreciated common stock. It has sufficient E&P to be subject to the passive investment income rules. Under prior law, if Charlie were to recognize 1/4 of the gain on the common stock in its first four years as an S corporation, it could be subject to the passive investment income tax. After the Small Business Tax Act, the corporation no longer is subject to the passive investment income tax, but it may be subject to the built-in gains tax since the stock was sold within ten years of electing S corporation status.

### *Elimination of Pre-1983 E&P*

A corporation that was an S corporation prior to 1983, but was not an S corporation for its first tax year beginning after December 31, 1996, may reduce its accumulated E&P by the amount of any Accumulated E&P from the corporation's pre-1983 S corporation years. This change corrects an oversight in the 1996 tax act which eliminated pre-1983 accumulated E&P but only if the corporation were also an S corporation for its first tax year beginning after December 31, 1996.[13] Thus relief is extended to pre-1983 accumulated E&P for any corporation that was an S corporation prior to 1983, regardless of whether it continued to be an S corporation after 1996.

**Example 8**. Early Corporation, an S corporation, has accumulated E&P of $10,000 from its pre-1983 tax years and $5,000 from its post-1982 through 2006 tax years. Early Corp. revoked its S election on January 1, 2007. It has no E&P in 2007 and had current E&P of $7,000 in 2008. Cash distributions up to $12,000 made to the shareholders in 2008 are taxed as a dividend ($7,000 current E&P plus $5,000 accumulated E&P). Distributions in excess of $12,000 are treated as a reduction in the basis of the stock.

### *Treatment of Sale of an Interest in a Q-Sub*

Another significant S corporation relief provision is the favorable tax treatment afforded to the sale of an interest in a Q-Sub. Under prior law, the sale of more than a 20-percent interest in a Q-Sub is treated as a taxable sale, since the S corporation was no longer in control of the Q-Sub immediately after the transfer and thus the sale did not qualify for nonrecognition treatment under Code Sec. 351.[14] If the sale of stock in a Q-Sub results in the termination of the Q-Sub election, it is treated as a sale of an undivided interest in the assets of the Q-Sub based upon the percentage of the stock sold, followed by a deemed transfer to a Q-Sub in a transaction to which Code Sec. 351 applies.

**Example 9**. S corporation sells a 21-percent interest in a Q-Sub to an unrelated party followed by a transfer of all the assets to a new corporation in which Code Sec. 351 applies. The S corporation recognizes 21 percent of the gain (loss) in the assets of the Q-Sub. Any built-in gain (loss) in the remaining assets transferred to the new corporation is deferred under Code Sec. 351.

## Revenue Provisions

### Increase in Age Limit for "Kiddie Tax"

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The kiddie tax is expanded to include children under age 19 (previously under age 18) and students over age 18 and under age 24.[15] Students whose earned income is greater than 1/2 of their support are exempt from the kiddie tax. Under these rules the net unearned income of the child over $1,700 (for 2007) is taxed at the parents' tax rates if higher than the tax rates of the child.[16] Remaining income, unearned income of $1,700 plus earned income, is taxed at the child's rates.[17] The good news in this provision is its effective date, which is for tax years beginning after May 25, 2007. A brief window of opportunity exists for the 2007 tax year for parents to transfer investment assets to the children to take advantage of the old rules. The bad news in this provision is that after 2007 college age students will not be able to sell off appreciated investment assets at favorable or zero tax rates to pay for college expenses.

**Example 10**. John is a 21-year-old full-time college student who is supported by his parents who have taxable income of $80,000 per year. John's only source of income is $4,000 from investments given to him by his parents. Assume the $4,000 is qualified dividend or long-term capital gain income. For 2007, John is not subject to the kiddie tax and has taxable income of $3,150 ($4,000 – $850) and a tax expense of $158. If the kiddie tax were applicable, John would have a tax expense of $388, which is an increase in his tax liability of 246 percent.

**Example 11**. Assume the facts of the previous example, except that the $4,000 is interest income. For 2007, John is not subject to the kiddie tax and has taxable income of $3,150 ($4,000 – $850) and a tax expense of $318. If the kiddie tax were applicable, John would have a tax expense of $661, which is an increase in his tax liability of 208 percent.

## Tax Preparer Penalties

Sections 8242 through 8248 of the Small Business Tax Act include some fine-tuning provisions as to interest, penalty and fee provisions of the Code. Most of these rules increase the cost to the taxpayer of doing business with the IRS. One of the most important provisions of the Act, though, increases the preparer penalties that apply when a tax advisor signs a tax return that includes an "unreasonable position." Post-Act law includes somewhat of an anomaly: The standards for taking aggressive positions on tax returns now are higher for the tax preparer than they are for the taxpayer itself.[18] And the Code Sec. 6694 preparer penalty sets a higher disclosure standard for the tax advisor than currently is the case in the various applicable professional codes of conduct and ethics, such as the AICPA Statements on Standards for Tax Services and the Treasury's Circular 230, although it is speculated that these other documents quickly will be modified so as to adopt the higher standard imposed under the Act.

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Effective for all tax returns filed as of May 25, 2007, the potential for a tax professional to incur preparer penalties has increased. The Act accomplishes this result in three ways:

1. The preparer penalties apply to a larger group of tax professionals.
2. The standards of conduct that apply to tax professionals have been raised.
3. The dollar amounts of related preparer conduct penalties have increased.

Some observers believe that these provisions are designed to enlist the community of tax professionals into the IRS audit function, providing stricter sanctions and requiring additional disclosures, so as to reduce the aggressiveness of the tax advisor in assisting the taxpayer to take return positions that may challenge the boundaries of the existing tax law. As a result of all of these effects, tax collections likely will increase.

First, the tax preparer penalties now apply to a larger group of tax professionals. The prior term "income tax return preparer" has been replaced by "tax return preparer," such that the sanctions now apply to those who advise taxpayers with respect to employment, excise, estate, gift and generation-skipping tax returns, as well as to those who work with exempt organizations.[19] As under prior law, the preparer must be compensated for the tax work to fall under this definition. Tax return preparers also include the employers of those who prepare returns, but not clerical assistants, those acting in a fiduciary capacity, or those preparing the return of his/her employer.

Second, the most significant conduct penalty for tax return preparers now includes higher standards which must be met for filing positions that are taken on returns that the preparer works on. Prior language has been replaced, and the new system underlying the penalty features the following:

- The penalty applies when the preparer works on a return where the tax liability is understated due to the taking of an "unreasonable position."
- An unreasonable position is one that either:[20]
    - is not disclosed on the return (say, using Forms 8275 or 8275-R), and for which there was not a reasonable belief that the position was "more likely than not (MLTN)" (a greater-than-50-percent likelihood) to be sustained by its merits upon review. This is a strengthening of the prior "realistic possibility" (probably a one-in-three likelihood) standard; or,
    - is disclosed on the return, and for which there was a "reasonable basis" (probably a one-in-four likelihood) for the position. This is a strengthening of the prior "non-frivolous" (probably a one-in-twenty) standard.

The penalty is waived if the tax return preparer acted in good faith and had reasonable cause for taking the unreasonable position.[21] Thus, infrequent and isolated errors by the preparer will not attract the penalty, but errors that are frequent or repeated, flagrant or material in amount will violate the "good faith" standard.[22] If the preparer's office practices include systems that promote accurate and consistent reporting, the good-

faith standard probably is met.[23]

The likely results of the new preparer conduct language is that a higher number of aggressive return positions will be disclosed by the taxpayer, and/or fewer aggressive return positions will be taken.

Both the National Association of Tax Professionals (NATP) and the American Institute of Certified Public Accountants (AICPA) have voiced their concern regarding the new penalty threshold for tax return preparers.[24] These organizations are urging the Congress to rethink this legislation and to amend Code Sec. 6694 so that the standards applicable to tax return preparers be equalized with the standards applicable to taxpayers, the "substantial authority" requirement, rather than the higher "more-likely-than-not" standard. Their rationale is that taxpayers may engage in "opinion shopping" to find a tax return preparer who is willing (or perhaps less knowledgeable) about the merits of a position to sign the taxpayer's return. Also, both organizations envision the IRS being flooded with an avalanche of disclosure forms to protect the tax return preparer from potential imposition of penalties Tax practitioners with strong opinions regarding this topic are urged to contact their representative in Congress.

Third, a new formula is used to compute the preparer penalty for understatement of tax liability due to the taking of an unreasonable position. The amount of the penalty is not tied to the amount of the understatement or the tax on it, but is the greater of:

- $1,000; or
- one-half of the income of the tax return preparer that is attributable to the return or claim that violated the conduct standard.[25]

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**Example 12**. Josie is the tax return preparer for Hal's 2008 Form 1040. The return included a deduction that had a 60-percent chance of being sustained on its merits, because it was contrary to an applicable tax regulation. The deduction was denied in a court action. Josie is not assessed a Code Sec. 6694 penalty.

**Example 13**. Josie is the tax return preparer for Hal's 2008 Form 1040. The return included a deduction that had a 40-percent chance of being sustained on its merits, because it was contrary to an applicable tax regulation. The deduction was denied in a court action. Josie is assessed a Code Sec. 6694 penalty, unless the disputed position was disclosed on the return with a Form 8275-R. The penalty amount is the greater of $1,000 or one half of Josie's fees for preparing Hal's Form 1040.

**Example 14**. Josie is the tax return preparer for Hal's 2008 Form 1040. The return included a deduction that had a 20-percent chance of being sustained on its merits, because it was contrary to an applicable tax regulation. The deduction was denied in a court action. Josie is assessed a Code Sec. 6694 penalty, even if the disputed position was disclosed on the return with a Form 8275-R. The penalty amount is the greater of $1,000 or one-half of Josie's fees for preparing Hal's Form 1040.

If it is shown that the preparer's conduct was willful, or that it entailed a reckless disregard of tax rules or regulations, the penalty instead is the greater of:

- $5,000; or
- one half of the income of the tax return preparer that is attributable to the return or claim that violated the conduct standard.[26]

Under rules of transitional relief, the prior "realistic possibility" rules will be applied to tax returns, including employment, estate/gift and other nonincome tax returns, as they relate to the 2007 tax year, or are filed before the end of 2007.[27] No transitional relief is provided in the case of the penalty for willful or reckless conduct, though.

The MLTN standard matches that required for recognizing a tax return benefit under FIN 48[28] rules for generally accepted accounting principles. But it is higher than the standards that apply to taxpayers themselves (where a one-in-three substantial-authority standard still is in effect),[29] and higher than the current rules for most tax professionals' codes of conduct and ethics. Until these various conduct standards again become coordinated, tax advisors will have difficulty in applying them, and in working with taxpayers to choose among competing tax return positions and disclosures.

**Example 15**. Josie is the tax return preparer for Hal's 2008 Form 1040. The return included a deduction that had a 40-percent chance of being sustained on its merits, because it was contrary to an applicable tax regulation. The deduction was denied in a court action. Josie will be assessed a Code Sec. 6694 penalty, unless the disputed position was disclosed on the return with a Form 8275-R. But no penalty would apply if Josie had taken the same deduction on her own Form 1040 for the year. The rules as to taxpayer understatements of tax, and not of those for Josie as a tax return preparer, would be pertinent, and there was Code Sec. 6662 substantial authority for the deduction that Josie took on her return.

## Penalty for Erroneous Refund Claims

The cost has gone up when the IRS disallows a claim for refund or credit that the taxpayer files. Any amount of refund requested by that taxpayer that the IRS disallows is subject to a 20-percent penalty, effective for all claims filed after May 25, 2007.[30]

The Treasury had become concerned that the IRS could not accurately process massive amounts of certain claims for refund or credit and, because there was no taxpayer penalty specifically aimed at discouraging the filing of wrongful claims, there was an incentive for taxpayers to "take a chance" that a false or aggressive claim would be approved without adequate IRS review.

As of this date, there is no materiality threshold for this penalty. Thus, if even a single dollar of the refund claim is disallowed, the penalty applies. The penalty is waived, though, if there was a "reasonable basis" for the claim. Usually, this means that there was a one-in-four chance that the claim would be upheld on its merit after a review by the government. Thus, the new penalty may be seen as an attempt to discourage the filing of refund and credit claims of dubious merit.

The new penalty cannot be applied on top of other penalty provisions of the Code. For instance, claims concerning the earned income tax credit (EITC) are not subject to this penalty, as the EITC is subject to its own enforcement and penalty regime. The new penalty[31] cannot be applied if the accuracy-related (negligence and understatement) or fraud penalties also apply.[32] The accuracy-related penalty usually is equal to 20 percent of the understatement, or 30 percent for an undisclosed understatement involving a reportable transaction. The civil fraud penalty usually is equal to 75 percent of the fraudulent underpayment of tax.

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## IRS User Fees Made Permanent

The Code allows the IRS to charge a series of processing fees with respect to requests for rulings, determination letters and other written determinations.[33] The fees are payable by the requesting taxpayer when submitting the request for determination, and the IRS is charged to set these fees based on the personnel time incurred and difficulty of processing the typical such request. The IRS is authorized to allow exemptions and discounts for specified taxpayers and types of document requested.[34] The Code specifies target amounts for the fees, and Congress prohibits the IRS from spending the fees that it collects, except through the usual Congressional appropriations process.[35] The user fee program had been scheduled to expire on September 30, 2014. The Act immediately makes the fee program permanent. Current IRS user fees to process selected ruling requests are shown in Table 2.

**Table 2.**

| | |
|---|---|
| Most letter rulings | $10,000 |
| Accounting method change | $2,500 |
| Exempt organization determination letter | $300 and up |
| Pre-filing agreement | $50,000 |

## Increase in Penalty for Bad Checks and Money Orders

When a taxpayer writes a bad check or money order to the IRS, *e.g.*, one with insufficient funds, a penalty equal to two percent of the amount of the remittance applies.[36] The minimum penalty under this provision has been the lesser of $15 or the full amount of the check or money order. The Act immediately increases the amount of this minimum penalty, to the lesser of $25 or the full amount of the check or money order. The two percent penalty still applies to checks and money orders for more than $1,250.

## Suspension of Penalties and Interest

Prior to the 1986 Tax Reform Act, the IRS had no authority to waive interest charges on tax underpayments, even if the IRS had committed an error in applying the law or otherwise carrying out its duties. Adopted as part of the second Taxpayer Bill of Rights, Code Sec. 6404(d) through (g) gives the IRS the authority to suspend the running and collection of interest, tax underpayments, and related penalties where the IRS committed unreasonable errors or caused unreasonable delays in carrying out an audit or other engagement with the taxpayer. The suspension also applied when the taxpayer relied on erroneous written advice from the IRS, and where the IRS had not issued a notice of deficiency to the taxpayer in a timely manner.

Under law effective after 2003, collection of interest, unpaid tax and penalties is suspended starting 18 months after the filing of a tax return, if the IRS has not sent the taxpayer a notice of deficiency stating the amounts due and the basis for the assessments.[37] The suspension is ended and interest and penalties are resumed 21 days, then, after the required notice is sent by the IRS to the taxpayer.

The 18-month period begins at the later of the unextended due date of the return or the date on which it actually was filed. The suspension is available only to individual taxpayers, and to returns that are filed in a timely manner. No suspension is allowed relative to the failure-to-pay or gross misstatement penalties, to

most listed or reportable transactions or to instances of tax fraud or criminal tax penalties.[38]

**Example 16**. Harriet filed her 2004 Form 1040 on April 15, 2005. An audit of the return occurred in mid-2006, and the IRS completed all of its conferences with Harriet during the summer. But no notice of deficiency had been issued by October 15, 2006, so no interest could be assessed of Harriet from the filing date until 21 days after a notice actually was issued. This suspension of interest and penalty would not have been available to Harriet if she had filed her return on May 15, 2005, even if a notice of deficiency had not been issued by November 15, 2006, *i.e.*, 18 months later. Relief under Code Sec. 6404 is available only to timely filed returns.

Applying the 18-month rule has presented problems for the IRS, as its audit cycles sometimes do not correspond with the time period. In addition, to make up for some of the revenue lost to the Treasury when the 18-month rule is applied, the suspension period now begins 36 months after the later of the unextended due date of the return or the date on which it actually was filed. The 36-month rule is effective for notices issued by the IRS after November 25, 2007, *i.e.,* six months after the effective date of the Act.

**Example 17**. Continue with the facts of the previous example. The IRS would have until April 15, 2008, before interest and penalty amounts would be suspended for Harriet.

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## Gulf Opportunity (GO) Zone Incentives and Work Opportunity Tax Credit (WOTC) Incentives

In addition to offering tax incentives to small businesses in order to offset the tax costs of the increased minimum wage, the Small Business Tax Act also offers a package of tax incentives to taxpayers recovering from Hurricane Katrina, and in some cases, Hurricanes Rita and Wilma as well. These incentives enhance three existing incentives added by the Gulf Opportunity Zone Act of 2005 and the Katrina Emergency Tax Relief Act of 2005: (1) extending the enhanced Code Sec. 179 expensing rules of specified GO Zone property, (2) broadening the low-income housing tax credit rules, and (3) simplifying the tax-exempt bond financing rules.

### Extension of GO Zone Code Sec. 179 Expensing Rules

The Gulf Opportunity Zone Act of 2005 previously added Sec. 1400N(e) to the Code, which increased the maximum limit on Code Sec. 179 deduction for GO Zone property by the lesser of $100,000 or the cost of additional GO Zone property placed in service during the year. And since the $100,000 already was raised to $125,000 (as mentioned earlier), the limit for 2007 is a total of $225,000 for such GO Zone property. This maximum deduction is reduced by all qualifying property placed in service during the year that exceeds $1.1 million in 2007 and 2008 ($600,000 above the normal investment limit of $500,000 applicable to 2007 under the new legislation). This provision was scheduled to expire on December 31, 2007. Both the $125,000 and $500,000 amounts are adjusted for inflation each year.

Act Sec. 8221 of Small Business Tax Act extends the increased deduction for qualified GO Zone Code Sec. 179 property for one year. Thus, the increased limits apply to qualifying property placed in service after December 31, 2007, and before January 1, 2009.

Unlike the 2005 Acts that also applied to GO Zone areas hit by hurricanes other than Katrina, these enhancements apply only to those portions of the GO Zones where the 2005 hurricanes damaged more than 60 percent of the occupied housing units. These include the Louisiana parishes of Calcasieu, Cameron, Orleans, Plaquemines, St. Bernard, St. Tammany and Washington, as well as the Mississippi counties of Hancock, Harrison, Jackson, Pearl River and Stone.[39]

**Example 18**. Milo Manufacturing placed into service $1.17 million of qualifying Code Sec. 179 property during the year in Wiggins, Mississippi (a city in Stone County). Milo's maximum Code Sec. 179 deduction is $155,000 ($225,000 maximum less $70,000 investment total exceeding the $1.1 million limit applicable to 2007).

### Extension/Expansion of the Low-Income Housing Tax Credit Rules

The Small Business Tax Act contains three provisions that extend and broaden certain incentives of Code Sec. 1400N(c), related to the low-income housing tax credit. Code Sec. 1400N was originally added by the Gulf Opportunity Zone Act of 2005 as a means of enhancing the existing Code Sec. 42 credit provisions, which permit a tax credit for 10 consecutive years on certain qualifying

expenditures. The original provision enacted in 2005 applied not only to the GO Zone for Hurricane Katrina, but also to Hurricane Rita and Hurricane Wilma GO Zones as well. The 2007 legislative changes also apply to all three zones. Each change is described briefly below.

- The Small Business Tax Act extends the permitted placed-in-service dates for buildings eligible for the enhanced credit under the 2005 legislation for two additional years, 2009 and 2010. Under the enhanced rules of the Gulf Opportunity Zone Act of 2005, the "GO Zones" are treated as high-cost areas and thus qualified for 91-percent and 39-percent credits, as opposed to the normal Code Sec. 42 credit rates of 70 percent and 30 percent, respectively.[40]
- The Small Business Tax Act repeals the 10-percent basis requirement and the placed-in-service rule for carryover allocations of the low-income housing tax credit for GO Zone properties. This rule, part of the original Code Sec. 42 provisions, allowed a credit carryover only if (1) 10 percent of the taxpayer's reasonably expected basis of the property was incurred as of the later of six months after the allocation was made or the end of the calendar year in which the allocation was made; and (2) the building was placed in service no later than the close of the second calendar year following the year of the allocation. This repeal applies only to GO Zone properties that received credit allocations in 2006, 2007 or 2008 on properties placed in service prior to January 1, 2011.[41]
- The Small Business Tax Act modifies the definition of a below-market federal loan by explicitly excluding additional forms of federal assistance from the definition of such a loan. Specifically, a below-market federal loan related to properties in GO Zones will not include community development assistance grants as defined under Act Secs. 106, 107 or 108 of the Housing and Community Development Act of 1974 by reason of (1) Section 22 of that Act, (2) any provision of the Department of Defense Appropriations Act of 2006 (P.L. 109-41), or (3) any provision of the Emergency Supplemental Appropriations Act for Defense, the Global War on Terror, and Hurricane Recovery Act of 2006 (P.L. 109-234).

In addition to the modifications noted above, Congress explicitly stated in the new legislation that the current rules for treating rehabilitation expenditures as a separate new building for purposes of the low-income housing credit will continue to apply in the case of buildings destroyed in the GO Zones. Thus, only the only the costs exceeding the original eligible basis of a destroyed building will qualify as a new building for purposes of the credit.

**Example 19**. Minor Development Company rebuilds an apartment building in Gulfport, Mississippi that was destroyed by Hurricane Katrina in 2005. The building was placed in service in 2003, and $300,000 of the cost qualified for a nine-percent credit (the "70 percent-credit" amount, since no subsidized financing was involved). If the new structure costs $450,000, Minor continues to take the nine-percent credit on the old structure (for the remainder of the 10-year period), and it treats the additional $150,000 cost as a new structure, qualifying for the "91 percent-credit" amount in each of the ten years beginning in 2007, assuming no subsidized financing is involved.

## Simplifying the Tax-Exempt Bond Financing Rules for Repairs and Reconstruction of Residences in GO Zones

Act Sec. 8223 of the Small Business Tax Act provides that any qualified GO Zone repair or reconstruction loans are automatically treated as a "qualified rehabilitation loan" for purposes of the qualified mortgage bond rules, without regard to the holding period and existing walls tests of present law. Under the Gulf Opportunity Zone Act of 2005, such loans would not be treated as qualified mortgage loans eligible for tax-exempt status unless (1) a period of at least 20 years had elapsed between the date the building was first used and the date that rehabilitation work began; and (2) existing walls and basis requirements were met (50 percent of walls retained as external walls and 75 percent of walls retained as external or internal walls, and rehabilitation expenditures are at least 25 percent of the mortgagor's adjusted basis in the residence). Although such projects will no longer have to meet the 20-year and existing walls tests, they must still meet the 25-percent adjusted basis requirement.[42] Since the 2005 provision treated loans to finance personal residences as "qualified mortgage bonds," such bonds will no longer need to meet the 20-year and existing walls tests.[43]

In addition to the changes noted above, Act Sec. 8224 of the Small Business Tax Act requires the Government Accountability Office (GAO) to study and report on the utilization of tax incentives in the GO Zones. This report must be submitted to the House Ways & Means Committee and the Senate Finance Committee no more

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than one year after the enactment of the legislation. Public hearings will then be required if the GAO report includes findings of significant fraud, waste or abuse. Undoubtedly, this requirement was added in the wake of reports of massive fraud related to other forms of government assistance for hurricane victims.

## Modification of Work Opportunity Tax Credit (WOTC)

Act Sec. 8211 of the Small Business Tax Act extends and modifies the work opportunity tax credit of Code Sec. 51. This provision generally allows a tax credit for employers hiring individuals from one or more of nine targeted groups. The credit is generally 40 percent of the first $6,000 wages paid to qualified hires in the first year of employment (25 percent of the first $3,000 wages in the case of qualified summer youth employees). This credit was set to expire for employees hired after December 31, 2007. The major provisions of the 2007 legislation are summarized below, and are effective for individuals who begin work for an employer after the date of enactment of the Small Business Tax Act, May 25, 2007.

- **Extension of the WOTC**. The Small Business Tax Act extends the WOTC for 44 months, covering qualified individuals hired before September 1, 2011. This is a welcome planning change long sought by taxpayers and tax professionals, as the WOTC had seemed to be perpetually on life-support each year, only to be extended at the last minute (sometimes retroactively) by Congress. Such uncertainty each year discouraged incentive hires near the end of the tax year.
- **Expansion of the Qualified Veterans Targeted Group**. The definition of a qualified veterans targeted group was expanded to include an individual who is certified as entitled to compensation for a service-connected disability (*e.g.*, a disability rating of 10 percent or greater) and (1) having a hiring date which is not more than one year after having been discharged or released from active duty in the Armed Forces of the United States; or (2) having been unemployed for six months or more (whether or not consecutive) for the one-year period ending on the date of hiring. Previously, certain qualified veterans had to qualify under certain tests related to food stamp eligibility for a period of at least three months during the one-year period ending on the hiring date. In addition, the qualified first-year wages for veterans qualifying under the new classification is doubled, from $6,000 to $12,000. This increase does not apply to veterans qualifying under the existing food-stamp test.

**Example 20**. Taylor Manufacturing, a calendar-year taxpayer, hires two veterans on June 1, 2007, paying each an annual salary of $24,000. Veteran Al qualifies under the new Small Business Tax Act provision, and Veteran Barb qualifies under the previously-existing food-stamp test. Taylor may take a total WOTC of $7,200 for these two hires, 40 percent of the first $12,000 wages paid to Al and 40 percent of the first $6,000 wages paid to Barb.

- **Expansion and Renaming of the High-Risk Youth Targeted Group**. The Small Business Tax Act also expands the definition of the high-risk youth group to include any otherwise qualifying individual age 18 but not yet age 40 on the hiring date (prior law established an age limit of at least 18 but less than 40 years). In addition, eligible individuals under this category include otherwise qualifying individuals from rural renewal counties (those certified by the Office of Management and Budget having population decreases during the five-year periods of 1990–1994 and 1995–1999). Because of these changes in qualifications, Congress changed the name of this category to "designated community residents."
- **Expansion of the Vocational Rehabilitation Referral Targeted Group**. The Small Business Tax Act expands the definition of a vocational rehabilitation referral to include any individual who is certified by a designated local agency as having a substantial handicap (physical or mental disability) to employment, and who has been referred while receiving (or after completing) an individual work plan pursuant to Act Sec. 1148(g) of the Social Security Act. Previously, such work plans could only be under certain State plans or certain veterans plans as defined by Title 38, Chapter 31 of the U.S. Code.
- **Streamlining Certification Procedures**. To streamline the certification process, Congress mandated in the Small Business Tax Act that the Department of Defense, the Department of Veterans Affairs, and the Social Security Administration should work with the designated local agencies to facilitate the certification process. Previously, confidentiality agreements had hampered local employment agencies in working with these organizations.

## AMT Relief for the WOTC

Under pre–Small Business Tax Act law, business tax credits generally cannot offset the alternative minimum

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tax liability, since such credits do not reduce the tentative minimum tax. However, Act Sec. 8214 of the Small Business Tax Act treats the tentative minimum tax as being zero for purposes of determining the tax liability limitation with respect to the work opportunity tax credit (as well as for the credit for taxes paid with respect to employer cash tips described earlier). This rule effectively permits the WOTC to offset the alternative minimum tax liability.

## Summary

Although the Small Business and Work Opportunity Tax Act of 2007 expands and extends many small business tax relief provisions, it also includes some important revenue raisers. Taxpayers and tax practitioners alike should be aware of these changes when mapping tax planning strategies for 2007 and later years.

### Endnotes

[1] Small Business and Work Opportunity Tax Act of 2007 (P.L. 110-28).
[2] Code Sec. 45B.
[3] Note that several states require higher minimum wage rates for tipped employees.
[4] Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips.
[5] Code Sec. 901.
[6] The estimated revenue loss from this provision in the first five years is $5 billion. *CCH Tax Briefing: Small Business And Work Opportunity Tax Act of 2007*, May 29, 2007, at 5.
[7] The 2007 amounts would have been $112,000 and $400,000 without the law change. Rev. Proc. 2006-53, IRB 2006-48, 996.
[8] Code Sec. 761(f)(1)(B) permits all items of income, gain, loss, deduction and credit shall be divided between the spouses in accordance with their respective interests in the venture. Code Sec. 761(f)(1)(C) requires each spouse to take into account his/her respective share of items as if they were attributable to a trade of business conducted by each spouse as a sole proprietor.
[9] Code Sec. 761(f)(2)(B) requires both spouses to materially participate within the meaning of Code Sec. 469(h).
[10] *C.R. Hefti*, 54 TCM 1555, Dec. 44,527(M), TC Memo. 1988-22 in which a spouse was held liable for self-employment tax since she was responsible for the financial and recordkeeping aspects of the business. *See also A.N. Gilreath*, 57 TCM 1375, Dec. 45,960(M), TC Memo, 1989-445.
[11] Code Sec. 1375(a).
[12] Code Sec. 1374(a).
[13] Act Sec. 1311(a) of the Small Business Job Protection Act of 1996 (P.L. 104-88).
[14] Reg. §1.1361-5(b)(e), Example 1.
[15] Code Sec. 1(g).
[16] Attach Form 8615 to the return. In some cases the parent may elect to report the child's unearned income on the parent's return.
[17] Under Code Sec. 1(h), the child is eligible for preferential tax rates for qualified dividends and capital gains.
[18] To avoid the substantial understatement of tax penalty the taxpayer need only meet the "substantial authority" standard which is less stringent than the Code Sec. 6694 "more likely than not" requirement but more stringent than the "reasonable basis" standard. The taxpayer's position need only be stronger than one that is arguable but fairly unlikely to prevail in court (Reg. §1.6662-3) while the tax return preparer must have a greater than 50-percent likelihood the position will be upheld.
[19] Code Sec. 7701(a)(36)(A).
[20] Code Sec. 6694(a)(2).
[21] Code Sec. 6694(a)(3).
[22] Reg. §1.6694-2(d)(2).
[23] Reg. §1.6694-2(d)(4).
[24] *www.natptax.com/2007section6694comments.pdf, www.aicpa.org/download/news/2007/AICPA_Urges_Congress_to_Modify_More_Likely_Than_Not_Provision.pdf.*
[25] Code Sec. 6694(a)(1).
[26] Code Sec. 6694(b).
[27] Notice 2007-54, IRB 2007-27.
[28] Financial Accounting Standards Board (FASB) Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*.
[29] Code Sec. 6662(d).
[30] Code Sec. 6676.
[31] Code Sec. 6676(c).
[32] Code Secs. 6662, 6662A and 6663.
[33] Code Sec. 7528(a).
[34] Code Sec. 7528(b)(2).
[35] Current fee schedules are set forth in Rev Proc 2007-1, IRB 2007-1, 1; Rev Proc 2007-8, IRB 2007-1, 230; and Rev Proc 2006-9, IRB 2006-2, 278.
[36] Code Sec. 6657.
[37] Code Sec. 6404(g)(1). The period of delay was 12 months from 1996 through 2003.
[38] Code Sec. 6404 (g)(2). A few other exceptions to the suspension rules also can apply.
[39] As defined by Code Sec. 1400N(d)(6) and identified by the Secretary of the Treasury in Notice 2007-36, IRB 2007-17, 1000.
[40] Normally, the Code Sec. 42 credit is limited to a credit rate that would provide an investment return, on a present-value basis, of either 70 percent of qualifying cost (projects with no federal subsidies) or 30 percent of qualifying cost (projects with federal subsidies).
[41] Since the repeal covers allocations for the 2006 tax year, such allocated credits no longer are contingent on these two former restrictions.
[42] For purposes of the adjusted basis test, the mortgagor's adjusted basis is determined as of the later of (1) the completion of the repair or reconstruction, or (2) the date on which the mortgagor acquires the residence.
[43] Apparently, the Code Sec. 143(k) requirement that the mortgagor to whom such financing is provided become the first resident of the building after the rehabilitation is completed will no longer apply to owner-financing after the date of enactment of the Small Business Tax Act. Several commentators have noted that this may encourage some developers to use such proceeds to acquire and rehabilitate GO Zone properties and then sell them. *See CCH Tax Briefing: Small Business And Work Opportunity Tax Act of 2007*, May 29, 2007, at 5.

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