Summary
Small Business and Work Opportunity Act of 2007
January 17, 2007

Small Business Tax Provisions

I. General Provisions

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 when the assets are placed in service, within certain limits. Under the Jobs and Growth Tax Relief Reconciliation Act of 2003, the amount that small businesses may expense under section 179 was increased from $25,000 to $100,000 for tax years beginning after 2002 through the end of 2005 and indexed for inflation. The American Jobs Creation Act of 2004 extended a slightly expanded version of small business expensing (with higher phase-out levels for small business) through 2007. The Tax Increase Prevention and Reconciliation Act of 2005 extended that enhanced provision through the end of 2009. In 2007, small business taxpayers are allowed to expense $112,000 (indexed for inflation), and the phase-out threshold is $450,000 (indexed for inflation). The proposal extends the present-law rules for one year, through the end of 2010. The proposal is effective for taxable yeas beginning after December 31, 2009. *The proposal is estimated to cost $4.861 billion over five years and $257 million over ten years.*

Fifteen-Year Straight-Line Cost Recovery for Qualified Leasehold Improvements and Qualified Restaurant Improvements. In the American Jobs Creation Act of 2004, Congress shortened the cost recovery of certain leasehold and restaurant improvements from 39 to 15 years for the remainder of 2004 and 2005. The Tax Relief and Health Care Act of 2006 extended this provision to property placed in service after December 31, 2005 through December 31, 2007. The proposal extends the present-law rules for qualified leasehold and restaurant improvements to March 31, 2008. The proposal generally applies to property placed in service after December 31, 2007. *The proposal is estimated to cost $345 million over five years and $847 million over ten years.*

Fifteen-Year Straight-Line Cost Recovery for Qualified New Restaurant Buildings. Section 168(e)(3)(E)(v) currently provides a 15-year recovery period for qualified restaurant property placed in service before January 1, 2008. For purposes of the provision, qualified restaurant property means any improvement to a building if such improvement is placed in service more than three years after the date such building was first placed in service and more the 50 percent of the building's square footage is devoted to the preparation of, and seating for on-premises consumption of, prepared meals. The proposal extends the 15-year recovery period for qualified restaurant improvements to new restaurant buildings. The proposal generally applies to property placed in service after the date of enactment. Repeal of the three-year rule for restaurant property is effective for property placed in service after the date of enactment. The proposal expires on March 31, 2008. *The proposal is estimated to cost $379 million over five years and $847 million over ten years.*

Fifteen-Year Straight-Line Cost Recovery for Qualified Retail Improvement Property. The proposal extends the 15-year recovery period for qualified leasehold improvements to improvements made by retailers who own their buildings. For purposes of the provision, qualified retail improvement property does not include any improvement for which expenditure is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building. For purposes of this proposal, retail establishments that qualify for the 15-year recovery period include those with a physical store front open to the general public in order to sell tangible personal property and/or services. The proposal applies to property placed in service after the date of enactment. The proposal expires on March 31, 2008. *The proposal is estimated to cost $467 million over five years and $1.012 billion over ten years.*

Expand Eligibility for Cash Method of Accounting. Currently, cash method of accounting may not be used by any C corporation, by any partnership that has a C corporation as a partner, or by any tax shelter. Exceptions are made for farming businesses and qualified personal service corporations. An exception is provided for C corporations and partnerships that have a C corporation as a partner is the average annual gross receipts in the three previous tax years do not exceed $5 million. In addition, companies that keep inventory must generally use the accrual method of accounting unless they have less than $1 million in gross receipts. Under cash method, income is recorded when it is received in the form of cash or its equivalent. Expenses generally are recorded when they are paid. Under accrual method, income and expenses typically are recorded when the transactions giving rise to them are completed, regardless of when cash is received or paid. The proposal permanently increases the threshold for the exception from $5 million to $10 million and indexes the threshold for inflation. This allowance would apply irrespective of whether inventories are maintained. The proposal is applicable to taxable years beginning after the date of enactment. *The proposal is estimated to cost $547 million over five years and $931 million over ten years.*

The Work Opportunity Tax Credit ("WOTC"). WOTC allows employers credits against wages 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 proposal extends WOTC for five years (for qualified individuals who begin work for an employer after December 31, 2007 and before January 1, 2013). The proposal expands the qualified veterans' targeted group to include an individual who is certified as entitled to compensation for a service-connected disability incurred after September 10, 2001. In the case of individuals certified as entitled to compensation for a service-connected disability incurred after September 10, 2001, the proposal expands the definition of qualified first-year wages from $6,000 to $12,000. The proposal expands the definition of high risk youths to include otherwise qualifying individuals age 18 but not yet age 40 on the hiring date. The proposal also changes the name of the category to the "designated community residents" targeted group. 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 January 1, 2013. The other provisions are effective for individuals who begin work for an employer after the date of enactment in taxable years ending after such date. *The proposal is estimated to cost $1.788 billion over five years and $3.624 billion over ten years.*

Treatment of Professional Employer Organizations as Employers. The proposal creates a voluntary certification program for PEOs (CPEOs) that meet standards of solvency and responsibility and that maintain ongoing certification by the IRS. CPEOs would have to accept sole liability for the collection of Federal employment taxes with respect to workers ("worksite employees") performing services for PEO clients. Small or medium-sized business that contract with CPEOs would be assured they would not be liable for those taxes already paid to the PEO. The proposal does not affect the determination of whether or not an employer-employee relationship exists for any purpose other than liability for payroll tax deposits. The proposal is effective with respect to wages paid for services performed on or after January 1 of the first calendar year beginning more than 12 months after the date of enactment of the proposal. The Secretary is directed to establish the certification program for professional employer organizations not later than six months before the proposal becomes effective. *The proposal is to cost $8 million over five years and $32 million over ten years.*

II. Subchapter S Provisions

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 has (1) accumulated earnings and profits at the close of the taxable year and (2) gross receipts more than 25 percent of which are passive investment income. In addition, an S corporation election is terminated whenever the S corporation has accumulated earnings and profits at the close of each of three consecutive taxable years and has gross receipts for each of those years more than 25 percent of which are passive investment income. The proposal eliminates gains from sales or exchanges of stock or securities as an item of passive investment income. The proposal applies to taxable years beginning after the date of enactment. *The proposal is estimated to cost $111 million over five years and $312 million over ten years.*

Treatment of Bank Director Shares. An S corporation may have no more than 100 shareholders and may have only one outstanding class of stock. An S corporation has one class of stock if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds. National and state banking laws require that a director of a bank own stock. In some cases, a bank enters into an agreement under which the bank (or holding company) 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. The proposal clarifies that qualifying director shares are not treated as a second class of stock for purposes of subchapter S. The proposal applies to taxable years beginning after December 31, 2006. *The proposal is estimated to cost $66 million over five years and $178 million over ten years.*

Treatment of Banks Changing from Reserve Method of Accounting. A financial institution which uses the reserve method of accounting for bad debts may not elect to be an S corporation. If a financial institution changes from the reserve method of accounting, there is taken into account for the taxable year of the change adjustments to taxable income necessary to prevent amounts from being duplicated or omitted by reason of change. These adjustments are subject two levels of taxation. The proposal allows a bank which changes from the reserve method of accounting for bad debts to elect to take into account all adjustments the year before it changes to an S corporation. Adjustments taken into account the year before the corporation changes to an S corporation are only subject to corporate-level taxation. The proposal applies to taxable years beginning after December 31, 2006. *The proposal is estimated to cost $60 million over five years and $173 million over ten years.*

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 exchange for its stock. The proposal 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. The proposal applies to taxable years beginning after December 31, 2006. *The proposal is estimated to cost $15 million over five years and $40 million over ten years.*

Elimination of Earnings and Profits Attributable to Pre-1983 Years. The proposal provides in the case of any corporation which was not an S corporation for its first taxable year beginning after December 31, 1996, the accumulated earnings and profits of the corporation as of the beginning of the first taxable year beginning after the date of the enactment of this proposal is 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. The proposal applies to taxable years beginning after the date of enactment. *The proposal is estimated to cost $11 million over five years and $21 million over ten years*.

Expansion of Qualifying Beneficiaries of an Electing Small Business Trust ("ESBT"). Under current law, an ESBT may be a shareholder of an S corporation. A nonresident alien may not be a shareholder of an S corporation, but may be a shareholder of a Limited Liability Corporation (LLC). The proposal provides some parity between S corporations and LLCs by allowing nonresident aliens to become a qualified beneficiary of an electing small business trust that owns S corporation stock. Current law treatment of nonresident aliens as non-qualified shareholders of an S corporation does not change. The proposal is effective on the date of enactment. *The proposal is estimated to cost $10 million over five years and $33 million over ten years.*

Offsets

Sale-In/Lease-Out (SILO) – Foreign. The provision disallows future losses on foreign tax exempt use property for leases entered into on or before March 12, 2004. A provision in the American Jobs Creation Act applied to leases entered into after March 12, 2004. In a foreign SILO transaction, a foreign government or other foreign entity that doesn't pay U.S. tax "sells" property, such as a subway or sewer, to a U.S. taxable investor and then "leases" the property back for use. The effect is to transfer depreciation deductions from the tax-exempt entity, which cannot use the deductions, to a taxable entity that can, with little economic risk. The proposal is effective for taxable years beginning after December 31, 2006. *The proposal is estimated to raise $4.273 billion over five years and $4.088 billion over ten years*.

Corporate Inversions. This proposal revises the corporate inversion effective date of section 7874 of the American Jobs Creation Act (AJCA) from the AJCA date of March 4, 2003 to March 20, 2002. Section 7874 was enacted to stop U.S. corporations and partnerships from using inversion transactions to escape U.S. tax on their earnings. Section 7874 applies to two types of inversion transactions that occurred after March 4, 2003. In the first type of transaction, a U.S. corporation becomes a subsidiary of a foreign-incorporated entity and the former shareholders of the U.S. corporation own 80 percent or more of the foreign-incorporated entity (an "80-percent inversion'). These foreign-incorporated entities are treated as U.S. corporations for all U.S. income tax purposes. In the second type of transaction, former shareholders of the U.S. corporation own 60 percent or more, but less than 80 percent, of the foreign-incorporated entity. In these transactions, the foreign-incorporated entity is treated as foreign, but any applicable corporate-level "toll-charge" taxes are not offset by tax attributes such as net operating losses or foreign tax credits. Section 7874 also applies inversion transactions involving certain partnerships. An exception applies for transactions that were substantially completed prior to March 4, 2003. Under this provision section 7874 would apply to treat foreign corporations as U.S. corporations if they completed an 80-percent inversion after March 20, 2002 but on or before March 4, 2003, subject to the same exception for substantially completed transactions that is contained in present law. The proposal is effective for tax years beginning after December 31, 2006. *It is estimated to raise $449 million over five years and $1.153 billion over ten years.*

Deny Deduction for Punitive Damages. This provision eliminates the deduction for punitive damages, including torts, that are paid or incurred by the taxpayer as a result of a judgment or in settlement of a claim. Payments made by insurance companies for punitive damages are included in the gross income of the insured person and the insurer is required to report the amount paid to both the insured person and the IRS. The proposal is effective for punitive damages that are paid or incurred on or after the date of enactment. *The proposal is estimated to raise $130 million over five years and $299 million over ten years.*

Denial of Deduction for Certain Fines, Penalties, and Other Amounts. This provision clarifies that amounts paid or incurred in connection with civil settlements to or at the direction of a government for the violation of any law or the potential violation of law are not deductible for Federal income tax purposes. Amounts for restitution or remediation are deductible. Government agencies are required to notify the IRS of settlements. The provision would be effective for amounts paid or incurred on or after the date of enactment unless paid under a binding order or agreement entered before that date. *The proposal is estimated to raise $172 million over five years and $244 million over ten years.*

Impose Mark to Market on Individuals Who Expatriate. This provision applies to certain U.S. citizens who relinquish their U.S. citizenship and certain long-term residents who terminate their U.S. residency. The proposal generally taxes these individuals on the net unrealized gain in their property as if such property were sold for fair market value. Any net gain on the deemed sale is recognized to the extent it exceeds $600,000 ($1.2 million in the case of married individuals filing a joint return, both of whom relinquish citizenship or terminate residency), and it is taken into account at the time of expatriation without regard to other tax code provisions. Any loss from the deemed sale generally is taken into account to the extent otherwise provided in the tax code. In addition, the exclusion from income for the value of property acquired by gift or inheritance does not apply to the value of any property received from a covered expatriate. This provision is generally effective for U.S. citizens who relinquish citizenship or long-term residents who terminate their residency on or after the date of enactment. *The proposal is estimated to raise $220 million over five years and $417 million over ten years.*

Deferred Compensation. The annual deferral on behalf of an individual to nonqualified deferred compensation arrangements of an employer is limited to the lesser of $1 million or the average taxable compensation for the previous five years. Failure to comply will result in ordinary income tax and the penalties applicable to other failures to comply with deferral rules. The provision applies to taxable years beginning after December 31, 2006; however, earlier years will be taken into account for purposes of computing the five-year average. *The proposal is estimated to raise $307 million over five years and $806 million over ten years.*

Increase in Certain Criminal Penalties. The provision increases the criminal penalties for tax evasion and failure to file. It also institutes an "aggravated" failure to file penalty that is a felony when there is a failure to file for at least three years. It applies to actions and failures to act after the date of enactment. *The proposal is estimated to raise $1 million over five years and $5 million over ten years.*

Doubling of Certain Penalties, Fines, and Interest on Underpayments Related to Certain Offshore Financial Arrangements. The proposal doubles the amounts of civil penalties, interest, and fines related to taxpayers' underpayments of U.S. income tax liability through the direct or indirect use of certain offshore financial arrangements. The proposal applies to taxpayers who did not voluntarily disclose such arrangements through the IRS Offshore Voluntary Compliance Initiative, or who do not otherwise disclose. The provision applies to open tax years on or after the date of enactment. *The proposal is estimated to raise $5 million over five years and $10 million over ten years.*

Increase in Penalty for Bad Checks and Money Orders. For bad checks or money orders paid to the IRS of less than $1,250, the penalty is raised to the lesser of $25 or the amount of the check or money order. This is an increase from the current threshold of less than $750 and $15. For amounts of $1,250 or more, the penalty remains at 2 percent of the check amount. It is effective to checks or money orders received on or after the date of enactment. *The proposal is estimated to raise $10 million over five years and $20 million over ten years.*

Modify the Tax Treatment of Contingent Payment Convertible Debt Instruments. The provision creates a consistent "apples to apples" approach to value contingent convertible debt for purposes of computing original issue discount (OID). A "comparable rate" for a *contingent convertible* debt instrument would be based on a *non-contingent, convertible* debt instrument (instead of a non-convertible debt instrument, as the IRS now applies the law). It is effective for debt instruments issued on or after the date of enactment. *The proposal is estimated to raise $222 million over five years and $448 million over ten years.*

Extension of IRS User Fees. The proposal extends the statutory authorization of the IRS to impose user fees for two additional years, through 9/30/16. The authorization was extended through 2014 in the American Jobs Creation Act. The provision is effective for requests after 9/30/14. *It is estimated to raise $60 million over ten years.*

Amend Collection Due Process Procedures for Employment Tax Liabilities.
Levy is the IRS's administrative authority to seize a taxpayer's property to pay the taxpayer's tax liability. The IRS is required to notify taxpayers that they have a right to a fair and impartial collection due process ("CDP") hearing before levy may be made on any property or right to property. Under the proposal, levies issued to collect Federal employment taxes are excepted from the pre-levy CDP hearing requirement. Taxpayers have full rights after the CDP hearing. This provision applies to levies issued on or after 120 days after the date of enactment. *The proposal is estimated to raise $156 million over five years and $271 million over ten years.*

Whistleblower Reforms. The Code currently authorizes the IRS to pay reward money for information received from whistleblowers. The reward amount varies based on the type of information and the amount of proceeds actually collected. The proposal expands whistleblower reforms enacted in H.R. 6408, the Tax Relief and Health Care Act of 2006, by requiring the establishment of a Whistleblower Office that is responsible for monitoring information received from informants and determining amounts to be awarded. It applies to deficiencies exceeding $20,000 and, in the case of individuals, incomes exceeding $200,000. This provision applies to information provided on or after the date of enactment. *The proposal raises $77 million over five years and $402 million over ten years.*

Modify Definition of Covered Employee. The proposal modifies the definition of a covered employee to include (1) any individual who was the Chief Executive Officer of the company at any time during the taxable year; (2) the four officers with the highest compensation for the year; and (3) any individual who was previously a covered employee with respect to the company (or a beneficiary of such person). The provision is effective for taxable years beginning after 12/31/06. *It is estimated to raise $20 million over five years and $105 million over ten years.*