TAX LETTER

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Small Business and Work Opportunity Tax Act of 2007, Part II

This letter continues to introduce certain tax incentives provided for by the new law regarding Employment and S Corporations.

(B) The Work Opportunity Tax Credit

The work opportunity tax credit (WOTC) allows employers to take certain tax credits for hiring individuals from one or more targeted groups. These tax credits were scheduled to expire at the end of 2007. The new law extends them to September 31, 2011 with additional features, and the first year wage eligible for credit generally is $6,000.

Special Veteran Group - Expanding the qualified veteran group to include individual who is certified as entitled to compensation for a service-connected disability and who is hired by the employer within one year of being discharged or released from active duty , or has been unemployed for six months or more during the one-year period preceding the date of hire. For these individuals, the amount of first-year wages eligible for the credit is increased from $6,000 to $12,000.

High Risk Youth Group - This group refers to qualified individuals between the age 18 and 25. They must be certified and referred by appropriate youth authorities of various Counties as qualified high risk youths.

Rural Renewal Counties - Rural renewal counties are Counties outside any Metropolitan Area. They must have had a net population loss during a 5-year period either 1990 – 1994 or 1995 – 1999. The age of these qualified individuals from these Counties must be from 18 to 40 on the date of hire.

Vocational Rehabilitation Referral – Modifying the definition of vocational rehabilitation referral to include certain work plans developed and implemented by an employment network under Section 1148(g) of the Social Security Act which specially allows Social Security to issue a “Ticket-to-Work” to certain Social Security Disability Recipients.

(C) S Corporation Provisions

Treatment of disposition of an interest in qualified Subchapter S subsidiary ("QSub" - Under pre-Act law, an S corporation could be required to recognize 100 percent of the gain if it sold more than 20 percent of the stock of the QSub. Therefore, S Corporation was in effect, required to recognize gain on assets without making any disposition of

those assets. Effective January 1, 2007 the new law rectifies this situation by providing that the S corporation is only required to recognize gain proportionate to the percentage of stock sold.

Deducting interest expense of an electing small business trust ("ESBT") incurred to acquire S corporation stock - The new law eliminates a distinction between an individual purchaser of S corporation stock and a trust purchaser, and makes the ESBT more attractive. Under prior law, the only permissible deductions against income of an ESBT were its administrative expenses, i.e. costs incurred in the management and preservation of the trust's assets. Interest incurred to acquire stock from an S Corp. was not deductible. The new law permits an electing ESBT to deduct the interest incurred to purchase S stock, effective January 1, 2007 and thereafter.

Capital gain not treated as passive investment income – *If the total passive income of an S Corporation were 25 percent or more of its total gross income and* it was previously a C corporation and has undistributed dividends, the S corporation is taxed at the highest corporate rate – 35%. Further, if the S corporation earns too much passive investment income for three consecutive years, then the S election would be terminated altogether. Passive investment income generally means gross receipts from royalties, rents, dividends, interest, annuities, and the gain from sale or exchanges of stock or securities. The new law, effective 5/25/07, eliminates gains from sales or exchange of stock or securities from the definition of "passive investment income" for S Corporation purposes. Thus, allowing S Corporations to acquire and trade securities without penalty of paying at the highest corporate rate.

Treatment of banks changing from reserve method of accounting – *Before the new law,* banks that use the reserve method for bad debts are not eligible to make an S election. If a bank makes an S election, the bank is automatically changing to the direct charge-off method for bad debts. This change in accounting results in a recapture of the bad debt reserve over 4 years, and is treated as built-in gain. Under the built-in gain rules, tax must be paid both at the corporate and shareholder level in the year of recognition. In contrast, a C corporation would pay tax on the recapture at the corporate level but the shareholders would not have to pay tax until the C Corporation paid dividends. Effective January 1, 2007, the new law allows banks to take the recapture of the bad debt reserves into account in the last C corporation year, rather than the first S corporation year, thereby eliminating the imposition of a second layer of tax.

Next month we will continue to introduce other provisions of the New Law.