

FINANCIAL

THE MEMORIAL DAY SURPRISE

by Mark E. Battersby



Just as the Memorial Day holiday was about to begin, as lawmakers prepared to flee Washington, DC for vacation, agreement was reached to continue funding the war in Iraq. That funding bill also raised the minimum wage. Not a big deal, many pressure cleaning contractors and business owners would say, because half the states already require minimum wages in excess of the federal level. However, there are all those tax breaks—over \$5 billion worth—tacked onto the bill to consider.

The Small Business and Work Opportunity Tax Act of 2007, part of the much larger and more controversial, H.R. 1591, U.S. Troops Readiness, Veterans' Health and Iraq Accountability Act of 2007, targets nearly \$5 billion in tax incentives for small business. The bill also includes tax incentives to help taxpayers recovering from Hurricane Katrina, as well as an important package of S corporation reforms.

Unlike tax bills in the past, the so-called "revenue raisers," that mean more taxes for certain taxpayers are unusually limited. The small business tax incentives, on the other hand, were designed to help businesses absorb the cost of a higher minimum wage that will rise to \$7.25 an hour from \$5.15 in three steps over two years.

The Work Opportunity Tax Credit (WOTC)

Those who employ large numbers of workers have long been aware of the Work Opportunity Tax Credit. The WOTC was created, in 1996, to provide pressure cleaners/employers with a unique tax incentive to hire individuals from among groups that have a particularly high unemployment rate or other special employment needs.

Many employers in rural areas may now be able to take advantage of the WOTC. The new law expands the high-risk youth target groups to include individuals from rural renewal counties. These are counties outside of metropolitan areas that experienced population losses in the 1990s.

Combined with the Welfare-to-Work tax incentives for 2007, the WOTC enlists state employment security agencies to find and certify individuals who are members of a targeted group. Set to expire for employees hired after December 31, 2007, the WOTC was extended through August 31, 2011.

Small Business Expensing

In lieu of depreciation deductions, a contractor, supplier, or equipment dealer with sufficiently small investments in equipment or other business property can choose to deduct (or "expense") such cost under Tax Code Section 179. The new law extends and expands the Section 179, enhanced first-year expensing provisions through 2010. It provides for an immediate 2007 increase in the expensing limit from \$112,000 to \$125,000, while the new law retroactively raises the investment limitation from \$450,000 to \$500,000 for tax years beginning in 2007 through 2010.

The investment limitation for property placed in service in tax years beginning in 2007 was formerly \$450,000 as indexed for inflation. The new law retroactively raises the investment limitation to \$500,000 for tax years beginning in 2007 through 2010. The \$500,000 amount is indexed for inflation in tax years beginning after 2007 and before 2011.

If Congress had not acted, the dollar limitation would have plummeted to \$25,000 and the investment limitation to \$200,000 after 2009. Because the deduction is completely phased out under the new levels for qualifying purchases above \$625,000, the deduction continues to be confined generally to relatively small pressure cleaning businesses.

Naturally, no first-year expensing allowance is allowed if the contractor or dealer did not have taxable income in the year in which the property is placed in service. However, the amount

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of the deduction disallowed for this reason may be carried forward to a non-loss year. And, do not forget, off-the-shelf computer software placed in service in taxable years beginning before 2010 is treated as property qualifying for Section 179 write-offs.

Go Zone Businesses

The 2007 Small Business Tax Act extends and expands some of the tax incentives in the Gulf Opportunity Zone Act of 2005 and Katrina Emergency Tax Relief Act of 2005. These include extension of special expensing for qualified property, an enhanced low-income housing credit, and flexible tax-exempt bond financing rules.

Family Business Tax Simplification

Although relatively rare among pressure cleaning businesses, married couples jointly operating an unincorporated business usually attributed all of their operation's income to one spouse. Married couples who, in the past, attributed all of their pressure cleaning business's income to one spouse need to carefully consider the new provisions, particularly as it relates to Social Security. The new law aims to ensure that when a married couple jointly own and participate in a small business, they both get credit for paying Social Security and Medicare taxes.

Under the new law, a married couple who jointly operate an unincorporated pressure cleaning business and who file a joint return can elect not to be treated as a partnership for federal tax purposes. This treatment is available for tax years beginning after December 31, 2006.

The S Corporation Business Entity

Several modifications to the S corporation rules will help small businesses retain the benefits of being an S corporation. In fact, the new S corporation provisions were designed specifically to make it easier for small businesses to retain their status as an S corporation, a status often inadvertently jeopardized thanks to the complexity of the rules in this area.

Two of the new rules—"electing small business trust" (ESBT) interest and "earnings and profits" (E&P) reduction—encourage the use of the S corporation business entity by effectively reducing the taxes owed by S corporation shareholders.

Among the S corporation reforms are those involving passive investment income. The passive investment income test has long been a trap for many S corporations that have converted from regular or 'C' corporation status. An S corporation is not subject to corporate level income tax on its income, usually passing through income (and losses) to its shareholders—except when it comes to passive investment income.

The passive investment income test has long been a trap for S corporations that have converted from C corporations. The new tax law eliminates some of that worry by switching treatments and no longer characterizing capital gain from the sale of stock or securities as passive investment income.

Ordinarily, a pressure cleaning business operating as an S corporation has to pay corporate level tax at the highest rate on its excess net passive income if the corporation has accumulated earnings and profits from its C corporation years and has gross receipts that are more than 25 percent passive investment income. Worse yet, if more than 25 percent of the S corporation's gross receipts are passive investment income for three consecutive years, it loses its S corporation status.

Gross receipts from more regular income streams (those derived from royalties, rents, dividends, interest and annuities), remain subject to the passive investment income limitations.

A qualified Subchapter S corporation (QSub) is a wholly-owned subsidiary that an S corporation has chosen to treat as a "QSub." These entities are frequently employed by pressure cleaning operations in joint ventures, expansion as well as for liability protection when spinning off a new venture. Unfortunately,

once the QSub is no longer wholly-owned by the S corporation, it ceases to qualify as a QSub and is treated as a new corporation that acquired all of its assets from the parent S corporation in exchange for stock.

The new law favorably alters the treatment of a sale of qualified Subchapter S subsidiary (QSUB) stock that terminates the QSub election. Under the new rules, the sale will be treated as a sale of an undivided interest in the assets of the QSub.

This provision eliminates the danger of an avalanche of gain being recognized—and taxed—on the sale of only a partial, but substantial (more than 20 percent) interest in the subsidiary. Now, for example, if an S corporation sells 25 percent of its QSub stock, it would recognize only 25 percent of the gain. Obviously, this would save the pressure cleaning business operating as an S corporation substantial tax on the deemed sale.

Paybacks

As with most recent tax legislation, not all of the provisions contained in the new tax law are pro-taxpayer. Some were inserted to offset the cost of pro-taxpayer provisions, pursuant to Congressional rules. One of the most significant offsets extends the reach of the so-called "kiddie tax" by raising the age limit to include (1) all children under age 19 (previously under age 18) and (2) students under the age of 24. Both changes are effective for tax years beginning after May 25, 2007, which means the change should not be noticed by the average, calendar year taxpayer.

While Congress recently handed a major victory to low-income workers by passing the first increase in the federal minimum wage in a decade, small businesses have not been ignored. Many of the \$4.84 billion in business-related tax cuts designed to ease the pain of the increased minimum wage included in that bill are retroactive to January 1, 2007. Will you—and your pressure cleaning business—plan now to take advantage of these tax breaks? *cr*