DESCRIPTION OF THE CHAIRMAN'S MARK
OF THE
"SMALL BUSINESS AND WORK OPPORTUNITY ACT OF 2007"

Scheduled for Markup
by the
SENATE COMMITTEE ON FINANCE
on January 17, 2007

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Senate Committee on Finance has scheduled a markup on January 17, 2007, of the "Small Business and Work Opportunity Act of 2007." This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's Mark.

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the Chairman's Mark of the "Small Business and Work Opportunity Act of 2007"* (JCX-3-07) January 12, 2007.

I. SMALL BUSINESS PROPOSALS

A. Extension of Increased Expensing for Small Business

Present Law

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct (or "expense") such costs under section 179. Present law provides that the maximum amount a taxpayer may expense, for taxable years beginning in 2003 through 2009, is $100,000 of the cost of qualifying property placed in service for the taxable year.[2] In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. Off-the-shelf computer software placed in service in taxable years beginning before 2010 is treated as qualifying property. The $100,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $400,000. The $100,000 and $400,000 amounts are indexed for inflation for taxable years beginning after 2003 and before 2010. For taxable years beginning in 2007, the inflation-adjusted amounts are $112,000 and $450,000, respectively.[3]

The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179. An expensing election is made under rules prescribed by the Secretary.[4]

For taxable years beginning in 2010 and thereafter (or before 2003), the following rules apply. A taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. The $25,000 and $200,000 amounts are not indexed. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business (not including off-

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[2] Additional section 179 incentives are provided with respect to qualified property meeting applicable requirements that is used by a business in an empowerment zone (sec. 1397A), a renewal community (sec. 1400J), or the Gulf Opportunity Zone (sec. 1400N(e)).

[3] Rev. Proc. 2006-53, sec. 2.19, 2006-48 I.R.B. 996 (Nov. 27, 2006).

[4] Sec. 179(c)(1). Under Treas. Reg. sec. 1.179-5, applicable to property placed in service in taxable years beginning after 2002 and before 2008, a taxpayer is permitted to make or revoke an election under section 179 without the consent of the Commissioner on an amended Federal tax return for that taxable year. This amended return must be filed within the time prescribed by law for filing an amended return for the taxable year. T.D. 9209, July 12, 2005.

the-shelf computer software). An expensing election may be revoked only with consent of the Commissioner.[5]

Description of Proposal

The proposal extends for one year the increased amount that a taxpayer may deduct and the other section 179 rules applicable in taxable years beginning before 2010. Thus, under the provision, these present-law rules continue in effect for taxable years beginning after 2009 and before 2011.

Effective Date

The provision is effective for taxable years beginning after December 31, 2009.

[5] Sec. 179(c)(2).

B. Fifteen-Year Straight-Line Cost Recovery for Qualified Leasehold Improvements, Qualified Restaurant Improvements and New Restaurant Buildings

Present Law

In general

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system ("MACRS"), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.[6] The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years. Nonresidential real property is subject to the mid-month placed-in-service convention. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month.

Depreciation of leasehold improvements

Generally, depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease. This rule applies regardless of whether the lessor or the lessee places the leasehold improvements in service. If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement generally is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service. However, exceptions exist for certain qualified leasehold improvements and certain qualified restaurant property.

Qualified leasehold improvement property

Section 168(e)(3)(E)(iv) provides a statutory 15-year recovery period for qualified leasehold improvement property placed in service before January 1, 2008. Qualified leasehold improvement property is recovered using the straight-line method. Leasehold improvements placed in service in 2008 and later will be subject to the general rules described above.

Qualified leasehold improvement property is any improvement to an interior portion of a building that is nonresidential real property, provided certain requirements are met. The improvement must be made under or pursuant to a lease either by the lessee (or sublessee), or by the lessor, of that portion of the building to be occupied exclusively by the lessee (or sublessee). The improvement must be placed in service more than three years after the date the building was first placed in service. Qualified leasehold improvement property does not include any

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[6] Sec. 168.

improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building. However, if a lessor makes an improvement that qualifies as qualified leasehold improvement property, such improvement does not qualify as qualified leasehold improvement property to any subsequent owner of such improvement. An exception to the rule applies in the case of death and certain transfers of property that qualify for non-recognition treatment.

Qualified restaurant property

Section 168(e)(3)(E)(v) provides a statutory 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 than 50 percent of the building's square footage is devoted to the preparation of, and seating for on-premises consumption of, prepared meals. Qualified restaurant property is recovered using the straight-line method.

Description of Proposal

The present-law provisions for restaurant improvements are extended for three months (through March 31, 2008). In addition, the three-year rule for restaurant property is repealed. Thus, newly constructed restaurant buildings and restaurant improvements within the first three years also qualify for the 15-year recovery period.

Effective Date

The proposal generally applies to property placed in service after December 31, 2007. Repeal of the three-year rule for restaurant property is effective for property placed in service after the date of enactment, the original use of which begins with the taxpayer after the date of enactment.

C. Fifteen-Year Straight-line Cost Recovery for Qualified Retail Improvement Property

Present Law

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system ("MACRS"), which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.[7] The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years. Nonresidential real property is subject to the mid-month placed-in-service convention. Under the mid-month convention, the depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month.

Generally, depreciation allowances for improvements made on retail property are determined under MACRS. If a retail property improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement generally is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service. A special provision provides a 15-year recovery period for qualified leasehold improvement property.[8]

Description of Proposal

The provision provides a statutory 15-year recovery period for qualified retail improvement property placed in service before March 31, 2008. For purposes of the provision, qualified retail improvement property means any improvement to an interior portion of a building which is nonresidential real property if such portion is open to the general public[9] and is used in the retail trade or business of selling tangible personal property to the general public, and such improvement is placed in service more than three years after the date the building was first placed in service. Qualified retail improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building.

For the purposes of this proposal, retail establishments that qualify for the 15-year recovery period include those primarily engaged in the sale of goods. Examples of these retail establishments include, but are not limited to, grocery stores, clothing stores, hardware stores and

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[7] Sec. 168.

[8] Sec. 168(e)(3)(E)(iv).

[9] Improvements to portions of a building not open to the general public (e.g., stock room in back of retail space) do not qualify under the proposal.

convenience stores. However, establishments primarily engaged in providing services, such as professional services, financial services, personal services, health services, and entertainment, do not qualify. It is generally intended that businesses defined as a store retailer under the current North American Industry Classification System (industry sub-sectors 441 through 453) qualify for the proposal, while those in other industry classes do not qualify under the proposal.

Effective Date

The proposal applies to property placed in service after the date of enactment.

D. Expand Eligibility for Cash Method of Accounting

Present Law

Section 446(c) of the Code generally allows a taxpayer to select the method of accounting it will use to compute its taxable income provided that such method clearly reflects the income of the taxpayer. A taxpayer is entitled to adopt any one of the permissible methods for each separate trade or business, subject to certain restrictions. Permissible methods include the cash receipts and disbursements method ("cash method"), an accrual method, or any other method (including a hybrid method) permitted under regulations prescribed by the Secretary of the Treasury.

Section 448 generally provides that the cash method of accounting may not be used by any C corporation,[10] 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. Additionally, an exception is provided for C corporations and partnerships that have a C corporation as a partner if the average annual gross receipts of the taxpayer is $5 million or less for all prior taxable years (including the prior taxable years of any predecessor of the entity). For this purpose, average annual gross receipts is calculated for each tax year by averaging the annual gross receipts for the three-year period ending in such year. The test must be met for all prior tax years beginning after December 31, 1985 in order for a taxpayer to be eligible for the exception.

Section 471 provides that, regardless of a taxpayer's overall method of accounting, the Secretary may require taxpayers to maintain inventories on the accrual method if necessary to clearly reflect income. This requirement is generally applied to taxpayers for whom the production, purchase, or sale of merchandise is an income-producing factor.[11] However, an exception is provided for taxpayers whose average annual gross receipts does not exceed $1 million.[12] Such taxpayers account for inventory as materials and supplies that are not incidental pursuant to Regulations section 1.162-3.[13]

When a taxpayer changes its 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 the change.[14] Positive adjustments (i.e., additions to

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[10] For this purpose, a tax-exempt trust with unrelated business income is treated as a C corporation with respect to the portion of its activities that constitute an unrelated trade or business. Treas. Reg. sec. 1.448-1T(a)(3).

[11] Treas. Reg. sec. 1.471-1.

[12] Rev. Proc. 2001-10, 2001-02 I.R.B. 272 (January 8, 2001).

[13] Under Treas. Reg. sec. 1.162-3, a deduction is permitted for the cost of materials and supplies only in the amount that they are actually consumed and used in operations during the tax year.

[14] Sec. 481.

taxable income), if initiated by the taxpayer and made with the consent of the Secretary, are generally spread over four taxable years beginning in the year of change.[15] Negative adjustments (i.e., reductions to taxable income) are generally taken into account entirely in the year of change.[16]

Description of Proposal

Under the proposal, eligibility to use the cash method under the annual gross receipts exception is expanded to all non-farm taxpayers other than tax shelters regardless of the presence of inventories, and the threshold for the exception is increased from $5 million to $10 million.

The provision also resets the December 31, 1985 testing start date. Under the provision, the gross receipts test must be met for all tax years ending on or after the date of enactment. Thus, a taxpayer who did not meet the $5 million gross receipts test in one or more years ending prior to the date of enactment but meets the new $10 million test for all tax years ending on or after the date of enactment is eligible to use the cash method under the provision.

The $10 million threshold is indexed for tax years beginning in calendar years after 2008. The indexed amount applies in each year for the purposes of testing the average annual gross receipts, calculated based on the prior three tax years. Once a taxpayer has either met or not met the gross receipts test with respect to a particular tax year, that result cannot subsequently be changed by the effect of the indexing. Thus, a tax year that ends on or after the date of enactment for which the gross receipts test is not met causes the taxpayer to be ineligible to use the cash method under the gross receipts test exception in all tax years subsequent to the year in which the test is not met, regardless of whether the threshold is subsequently increased by indexing above the amount of average annual gross receipts for the year in which the test was not met.

Accounting method changes under the provision are deemed to be initiated by the taxpayer and made with the consent of the Secretary. Thus, the adjustments under section 481 are spread over four years (in the case of a positive change) or taken into account entirely in one year (in the case of a negative change).

Taxpayers who are eligible to use the cash method under the proposal also are exempt from maintaining inventories on the accrual method. Thus, the $1 million gross receipts threshold of Rev. Proc. 2001-10 is effectively increased to $10 million for taxpayers qualifying for the provision.

Effective Date

The proposal is applicable to taxable years beginning after the date of enactment.

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[15] Rev. Proc. 2002-19, 2002-1 C.B. 696.

[16] Ibid.

E. Work Opportunity Tax Credit

Present Law

In general

The work opportunity tax credit is available on an elective basis for employers hiring individuals from one or more of nine targeted groups. The amount of the credit available to an employer is determined by the amount of qualified wages paid by the employer. Generally, qualified wages consist of wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual begins work for the employer (two years in the case of an individual in the long-term family assistance recipient category).

Targeted groups eligible for the credit

Generally an employer is eligible for the credit only for qualified wages paid to members of a targeted group.

(1) Families receiving TANF

An eligible recipient is an individual certified by a designated local employment agency (e.g., a State employment agency) as being a member of a family eligible to receive benefits under the Temporary Assistance for Needy Families Program ("TANF") for a period of at least nine months part of which is during the 18-month period ending on the hiring date. For these purposes, members of the family are defined to include only those individuals taken into account for purposes of determining eligibility for the TANF.

(2) Qualified veteran

A qualified veteran is a veteran who is certified by the designated local agency as a member of a family certified as receiving assistance under a food stamp program under the Food Stamp Act of 1977 for a period of at least three months part of which is during the 12-month period ending on the hiring date. For these purposes, members of a family are defined to include only those individuals taken into account for purposes of determining eligibility for a food stamp program under the Food Stamp Act of 1977.

For these purposes, a veteran is an individual who has served on active duty (other than for training) in the Armed Forces for more than 180 days or who has been discharged or released from active duty in the Armed Forces for a service-connected disability. However, any individual who has served for a period of more than 90 days during which the individual was on active duty (other than for training) is not a qualified veteran if any of this active duty occurred during the 60-day period ending on the date the individual was hired by the employer. This latter rule is intended to prevent employers who hire current members of the armed services (or those departed from service within the last 60 days) from receiving the credit.

(3) Qualified ex-felon

A qualified ex-felon is an individual certified as: (1) having been convicted of a felony under any State or Federal law, and (2) having a hiring date within one year of release from prison or date of conviction.

(4) High risk youth

A high-risk youth is an individual certified as being at least age 18 but not yet age 25 on the hiring date and as having a principal place of abode within an empowerment zone, enterprise community, or renewal community (as defined under Subchapter U of Subtitle A, Chapter 1 of the Internal Revenue Code). Qualified wages do not include wages paid or incurred for services performed after the individual moves outside an empowerment zone, enterprise community, or renewal community.

(5) Vocational rehabilitation referral

A vocational rehabilitation referral is an individual who is certified by a designated local agency as an individual who has a physical or mental disability that constitutes a substantial handicap to employment and who has been referred to the employer while receiving, or after completing: (a) vocational rehabilitation services under an individualized, written plan for employment under a State plan approved under the Rehabilitation Act of 1973; or (b) under a rehabilitation plan for veterans carried out under Chapter 31 of Title 38, U.S. Code. Certification will be provided by the designated local employment agency upon assurances from the vocational rehabilitation agency that the employee has met the above conditions.

(6) Qualified summer youth employee

A qualified summer youth employee is an individual: (1) who performs services during any 90-day period between May 1 and September 15, (2) who is certified by the designated local agency as being 16 or 17 years of age on the hiring date, (3) who has not been an employee of that employer before, and (4) who is certified by the designated local agency as having a principal place of abode within an empowerment zone, enterprise community, or renewal community (as defined under Subchapter U of Subtitle A, Chapter 1 of the Internal Revenue Code). As with high risk youths, no credit is available on wages paid or incurred for service performed after the qualified summer youth moves outside of an empowerment zone, enterprise community, or renewal community. If, after the end of the 90-day period, the employer continues to employ a youth who was certified during the 90-day period as a member of another targeted group, the limit on qualified first year wages will take into account wages paid to the youth while a qualified summer youth employee.

(7) Qualified food stamp recipient

A qualified food stamp recipient is an individual aged 18 but not yet 40 certified by a designated local employment agency as being a member of a family receiving assistance under a food stamp program under the Food Stamp Act of 1977 for a period of at least six months ending on the hiring date. In the case of families that cease to be eligible for food stamps under section 6(o) of the Food Stamp Act of 1977, the six-month requirement is replaced with a requirement that the family has been receiving food stamps for at least three of the five months ending on the date of hire. For these purposes, members of the family are defined to include only those individuals taken into account for purposes of determining eligibility for a food stamp program under the Food Stamp Act of 1977.

(8) Qualified SSI recipient

A qualified SSI recipient is an individual designated by a local agency as receiving supplemental security income ("SSI") benefits under Title XVI of the Social Security Act for any month ending within the 60-day period ending on the hiring date.

(9) Long-term family assistance recipients

A qualified long-term family assistance recipient is an individual certified by a designated local agency as being: (1) a member of a family that have received family assistance for at least 18 consecutive months ending on the hiring date; (2) a member of a family that have received such family assistance for a total of at least 18 months (whether or not consecutive) after August 5, 1997 (the date of enactment of the welfare-to-work tax credit)[17] if the individual is hired within two years after the date that the 18-month total is reached; or (3) a member of a family who are no longer eligible for family assistance because of either Federal or State time limits, if the individual is hired within two years after the Federal or State time limits made the family ineligible for family assistance.

Qualified wages

Generally, qualified wages are defined as cash wages paid by the employer to a member of a targeted group. The employer's deduction for wages is reduced by the amount of the credit.

For purposes of the credit, generally wages are defined by reference to the FUTA definition of wages contained in sec. 3306(b) (without regard to the dollar limitation therein contained). Special rules apply in the case of certain agricultural labor and certain railroad labor.

Calculation of the credit

The credit available to an employer for qualified wages paid to members of all targeted groups except for long-term family assistance recipients equals 40 percent (25 percent for employment of 400 hours or less) of qualified first-year wages. Generally, qualified first-year wages are qualified wages (not in excess of $6,000) attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee is $2,400 (40 percent of the first $6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is $1,200 (40 percent of the first $3,000 of qualified first-year wages). Except for long-term family assistance recipients, no credit is allowed for second-year wages.

[17] The welfare-to-work tax credit was consolidated into the work opportunity tax credit in the Tax Relief and Health Care Act of 2006 (Pub. L. 109-432).

In the case of long-term family assistance recipients, the credit equals 40 percent (25 percent for employment of 400 hours or less) of $10,000 for qualified first-year wages and 50 percent of the first $10,000 of qualified second-year wages. Generally, qualified second-year wages are qualified wages (not in excess of $10,000) attributable to service rendered by a member of the long-term family assistance category during the one-year period beginning on the day after the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee is $9,000 (40 percent of the first $10,000 of qualified first-year wages plus 50 percent of the first $10,000 of qualified second-year wages).

Certification rules

An individual is not treated as a member of a targeted group unless: (1) on or before the day on which an individual begins work for an employer, the employer has received a certification from a designated local agency that such individual is a member of a targeted group; or (2) on or before the day an individual is offered employment with the employer, a pre-screening notice is completed by the employer with respect to such individual, and not later than the 28th day after the individual begins work for the employer, the employer submits such notice, signed by the employer and the individual under penalties of perjury, to the designated local agency as part of a written request for certification. For these purposes, a pre-screening notice is a document (in such form as the Secretary may prescribe) which contains information provided by the individual on the basis of which the employer believes that the individual is a member of a targeted group.

Minimum employment period

No credit is allowed for qualified wages paid to employees who work less than 120 hours in the first year of employment.

Other rules

The work opportunity tax credit is not allowed for wages paid to a relative or dependent of the taxpayer. No credit is allowed for wages paid to an individual who is a more than fifty-percent owner of the entity. Similarly, wages paid to replacement workers during a strike or lockout are not eligible for the work opportunity tax credit. Wages paid to any employee during any period for which the employer received on-the-job training program payments with respect to that employee are not eligible for the work opportunity tax credit. The work opportunity tax credit generally is not allowed for wages paid to individuals who had previously been employed by the employer. In addition, many other technical rules apply.

Expiration

The work opportunity tax credit is not available for individuals who begin work for an employer after December 31, 2007.

Explanation of Provision

Extension

The provision extends the work opportunity tax credit for five years (for qualified individuals who begin work for an employer after December 31, 2007 and before January 1, 2013).

Qualified veterans targeted group

The provision 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. Being entitled to such compensation means having a disability rating of 10-percent or higher for service connected injuries.

Qualified first-year wages

The provision expands the definition of qualified first-year wages from $6,000 to $12,000 in the case of individuals certified as being entitled to compensation for a service-connected disability incurred after September 10, 2001 (i.e. having a disability rating of 10-percent or higher).

High risk youth targeted group

The provision expands the definition of high risk youths to include otherwise qualifying individuals age 18 but not yet age 40 on the hiring date. The provision also changes the name of the category to the "designated community residents" targeted group.

Vocational rehabilitation referral targeted group

The provision expands the definition of vocational rehabilitation referral to include any individual who is certified by a designated local agency as an individual who has a physical or mental disability that constitutes a substantial handicap to employment and who has been referred to the employer while receiving, or after completing, an individual work plan developed and implemented by an employment network pursuant to subsection (g) of section 1148 of the Social Security Act.

Effective Date

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.

F. Subchapter S Provisions

1. Capital gain not treated as passive investment income

Present Law

Overview

In general, an S corporation is not subject to corporate-level income tax on its items of income and loss. Instead, an S corporation passes through its items of income and loss to its shareholders. The shareholders take into account separately their shares of these items on their individual income tax returns. To prevent double taxation of these items when the stock is later disposed of, each shareholder's basis in the stock of the S corporation is increased by the amount included in income (including tax-exempt income) and is decreased by the amount of any losses (including nondeductible losses) taken into account. A shareholder's loss may be deducted only to the extent of his or her basis in the stock or debt of the S corporation. To the extent a loss is not allowed due to this limitation, the loss generally is carried forward with respect to the shareholder.

Passive investment income

An S corporation is subject to corporate-level tax, at the highest corporate tax rate, on its excess 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.

Excess net passive income is the net passive income for a taxable year multiplied by a fraction, the numerator of which is the amount of passive investment income in excess of 25 percent of gross receipts and the denominator of which is the passive investment income for the year. Net passive income is defined as passive investment income reduced by the allowable deductions that are directly connected with the production of that income. Passive investment income generally means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (to the extent of gains). Passive investment income generally does not include interest on accounts receivable, gross receipts that are derived directly from the active and regular conduct of a lending or finance business, gross receipts from certain liquidations, gain or loss from any section 1256 contract (or related property) of an options or commodities dealer, or certain interest and dividend income of banks and depository institution holding companies.

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.

Description of Proposal

The provision eliminates gains from sales or exchanges of stock or securities as an item of passive investment income.

Effective Date

The provision applies to taxable years beginning after the date of enactment.

2. Treatment of bank director shares

Present Law

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. Differences in voting rights are disregarded.[18]

National banking law requires that a director of a national bank own stock in the bank and that a bank have at least five directors.[19] A number of States have similar requirements for State-chartered banks. In some cases, a bank director enters into an agreement under which the bank (or a 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.[20]

Description of Proposal

Under the provision, restricted bank director stock is not taken into account as outstanding stock in applying the provisions of subchapter S.[21] Thus, the stock is not treated as a second class of stock; a director is not treated as a shareholder of the S corporation by reason of the stock; the stock is disregarded in allocating items of income, loss, etc. among the shareholders; and the stock is not treated as outstanding for purposes of determining whether an S corporation holds 100 percent of the stock of a qualified subchapter S subsidiary.

Restricted bank director stock is stock in a bank (as defined in sec. 581), or a depository institution holding company (within the meaning of sec. 3(w)(1) of the Federal Deposit

[18] Sec. 1361(c)(4). Treasury regulations provide that buy-sell and redemption agreements are disregarded in determining whether a corporation's outstanding shares confer identical distribution and liquidation rights unless (1) a principal purpose of the agreement is to circumvent the one class of stock requirement and (2) the agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of, or below, the fair market value of the stock. Treas. Reg. sec. 1.1361-1(l).

[19] 12 U.S.C. secs. 71-72.

[20] See Private Letter Ruling 200217048 (January 24, 2002) describing such an agreement and holding that it creates a second class of stock. Nonetheless, the ruling concluded that the election to be an S corporation was inadvertently invalid and that an amended agreement did not create a second class of stock so that the corporation's election was validated.

[21] No inference is intended as to the proper tax treatment under present law.

Insurance Act), registered with the Federal Reserve System, if the stock is required to be held by an individual under applicable Federal or State law in order to permit the individual to serve as a director of the bank or holding company and which is subject to an agreement with the bank or holding company (or corporation in control of the bank or company) pursuant to which the holder is required to sell the stock back upon ceasing to be a director at the same price the individual acquired the stock.

A distribution (other than a payment in exchange for the stock) with respect to the restricted stock is includible in the gross income of the director and is deductible by the S corporation for the taxable year that includes the last day of the director's taxable year in which the distribution is included in income.

Effective Date

The provision applies to taxable years beginning after December 31, 2006. The provision also provides that restricted bank director stock is not treated as a second class of stock for taxable years beginning after December 31, 1996.

3. Treatment of banks changing from reserve method of accounting

Present Law

A financial institution which uses the reserve method of accounting for bad debts may not elect to be an S corporation.[22] 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 the change.[23]

Positive adjustments (i.e., additions to taxable income) are generally spread over four taxable years beginning in the year of change.[24] Negative adjustments (i.e., reductions to taxable income) are generally taken into account entirely in the year of change.[25]

In the case of a financial institution that changes from the reserve method and elects to be an S corporation for the year of change, the adjustments are both included in the income of the shareholders and are taken into account in computing the tax on built-in gain under section 1374. If the change in accounting method is made for the last taxable year prior to becoming an S corporation, any adjustments for that year are taken into account in computing the corporation's taxable income, but not taken into account by the shareholders.

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[22] Sec. 1361(b)(2)(A).

[23] Sec. 481.

[24] Rev. Proc. 2002-19, 2002-1 C.B. 696.

[25] Id.

Description of Proposal

The provision allows a bank which changes from the reserve method of accounting for bad debts for its first taxable year for which it is an S corporation to elect to take into account all adjustments under section 481 by reason of the change in the last taxable year it was a C corporation.

Effective Date

The provision applies to taxable years beginning after December 31, 2006.

4. Treatment of disposition of an interest in a qualified subchapter S subsidiary

Present Law

Under present law, an S corporation that owns all the stock of a corporation may elect to treat the subsidiary corporation as a qualified subchapter S subsidiary ("QSub"). A qualified subchapter S subsidiary is disregarded as a separate entity for Federal tax purposes and its items of income, deduction, loss, and credit are treated as items of the S corporation.

If the subsidiary corporation ceases to be a QSub (e.g., fails to meet the wholly-owned requirement) the subsidiary is treated as a new corporation acquiring all its assets (and assuming all of its liabilities) immediately before such cessation from the parent S corporation in exchange for its stock. Under Treasury regulations,[26] the tax treatment of the termination of the QSub election is determined under general principals of tax law, including the step transaction doctrine. The regulations set forth an example[27] in which an S corporation sells 21 percent of the stock of a QSub to an unrelated party. In the example, the deemed transfer of all the assets to the QSub is treated as a taxable sale because the S corporation was not in control of the QSub immediately after the transfer by reason of the sale, and thus the transfer did not qualify for nonrecognition treatment under section 351.

Description of Proposal

The provision 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 in a transaction to which section 351 applies.

Thus, in the above example, the S corporation will be treated as selling a 21 percent-interest in all the assets of the QSub to the unrelated party, followed by a transfer of all the assets to a new corporation in a transaction to which section 351 applies. Thus, the S corporation will recognize 21 percent of the gain or loss in the assets of the QSub.

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[26] Treas. Reg. sec. 1.1361-5(b).

[27] Example 1 of Treas. Reg. sec. 1.1361-5(b)(3).

Effective Date

The provision applies to taxable years beginning after December 31. 2006.

5. Elimination of earnings and profits attributable to pre-1983 years

Present Law

The Small Business Jobs Protection Act of 1996 provided that if a corporation was 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 that year were 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.

Description of Proposal

The provision 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 provision 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.

Effective Date

The provision applies to taxable years beginning after the date of enactment.

6. Expansion of qualifying beneficiaries of an electing small business trust

Present Law

Under present law, an electing small business trust ("ESBT") may be a shareholder of an S corporation. Generally, the eligible beneficiaries of an ESBT include individuals, estates, and certain charitable organizations eligible to hold S corporation stock directly. A nonresident alien individual may not be a potential current beneficiary of an ESBT.

The portion of an ESBT which consists of the stock of an S corporation is treated as a separate trust and is generally taxed on its share of the S corporation's income at the highest rate of tax imposed on individual taxpayers (currently 35 percent). This income (whether or not distributed by the ESBT) is not taxed to the beneficiaries of the ESBT.

Description of Proposal

The provision allows a nonresident alien individual to be a potential current beneficiary of an ESBT.

Effective Date

The provision is effective on the date of enactment.

G. Treatment of Professional Employer Organizations as Employers

Present Law

In general

Employment taxes generally consist of the taxes under the Federal Insurance Contributions Act ("FICA"), the taxes under the Railroad Retirement Tax Act ("RRTA"), the tax under the Federal Unemployment Tax Act ("FUTA"), and income taxes required to be withheld by employers from wages paid to employees ("income tax withholding").[28]

FICA tax consists of two parts: (1) old age, survivor, and disability insurance ("OASDI"), which correlates to the Social Security program that provides monthly benefits after retirement, disability, or death; and (2) Medicare hospital insurance ("HI"). The OASDI tax rate is 6.2 percent on both the employee and employer (for a total rate of 12.4 percent). The OASDI tax rate applies to wages up to the OASDI wage base for the calendar year ($97,500 for 2007). The HI tax rate is 1.45 percent on both the employee and the employer (for a total rate of 2.9 percent). Unlike the OASDI tax, the HI tax is not limited to a specific amount of wages, but applies to all wages.

RRTA taxes consist of tier 1 taxes and tier 2 taxes. Tier 1 taxes parallel the OASDI and HI taxes applicable to employers and employees. Tier 2 taxes consist of employer and employee taxes on railroad compensation up to the tier 2 wage base for the calendar year. For 2007, the tier 2 employer rate is 12.1 percent, the employee rate is 3.9 percent, and the tier 2 wage base is $72,600.

Under FUTA, employers must pay a tax of 6.2 percent of wages up to the FUTA wage base of $7,000. An employer may take a credit against its FUTA tax liability for its contributions to a State unemployment fund and, in certain cases, an additional credit for contributions that would have been required if the employer had been subject to a higher contribution rate under State law. For purposes of the credit, contributions means payments required by State law to be made by an employer into an unemployment fund, to the extent the payments are made by the employer without being deducted or deductible from employees' remuneration.

Employers are required to withhold income taxes from wages paid to employees. Withholding rates vary depending on the amount of wages paid, the length of the payroll period, and the number of withholding allowances claimed by the employee.

Wages paid to employees, and FICA, RRTA, and income taxes withheld from the wages, are required to be reported on employment tax returns and on Forms W-2.[29]

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[28] Secs. 3101-3128 (FICA), 3201-3241 (RRTA), 3301-3311 (FUTA), and 3401-3404 (income tax withholding). Sections 3501-3510 provide additional rules.

[29] Secs. 6011 and 6051.

Employment taxes generally apply to all remuneration paid by an employer to an employee. However, various exclusions apply to certain types of remuneration or certain types of services, which may depend on the type of employer for whom an employee performs services.[30] For example, remuneration (subject to a dollar limit) paid to an employee by a tax-exempt organization is excluded from wages for FICA purposes, and services performed in the employ of certain tax-exempt organizations are excluded from employment for FUTA purposes.[31] In addition, various definitions and special rules apply to certain types of employers.[32]

As discussed above, certain employment taxes apply only on amounts up to a specified wage base. If an employee works for multiple employers during a year, separate wage bases generally apply to each employer. However, a single OASDI, RRTA tier 1 or tier 2, or FUTA wage base applies in certain cases in which an employer (a "successor" employer) takes over the business of another employer (the "predecessor" employer) and employs the employees of the predecessor employer.

Responsibility for employment tax compliance

Employment tax responsibility generally rests with the person who is the employer of an employee under a common-law test that has been incorporated into Treasury regulations.[33] Under the regulations, an employer-employee relationship generally exists if the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer, not only as to what is to be done, but also as to how it is to be done. It is not necessary that the employer actually control the manner in which the services are performed, rather it is sufficient that the employer have a right to control. Whether the requisite control exists is determined on the basis of all the relevant facts and circumstances. The test of whether an employer-employee relationship exists often arises in determining whether a worker is an employee or an independent contractor. However, the same test applies in determining whether a worker is an employee of one person or another.[34]

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[30] See, e.g., secs. 3121(a) and (b), 3231(e), 3306(b) and (c), and 3401(a).

[31] Secs. 3121(a)(16) and 3306(c)(8).

[32] See, e.g., secs. 3121, 3122, 3125, 3126, 3127, 3231, 3306, 3308, 3309, 3401(a), 3404, 3506, and 3510.

[33] Treas. Reg. secs. 31.3121(d)-1(c)(1), 31.3306(i)-1(a), and 31.3401(c)-1.

[34] Issues relating to the classification of workers as employees or independent contractors are discussed in Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001, at Vol. II, Part XV.A, at 539-550.

In some cases, a person other than the common-law employer (a "third party") may be liable for employment taxes. For example, if wages are paid to an employee by a third party and the third party, rather than the employer, has control of the payment of the wages, the third party is the statutory employer responsible for complying with applicable employment tax requirements.[35] In addition, an employer may designate a reporting agent to be responsible for FICA tax and income tax withholding compliance,[36] including filing employment tax returns and issuing Forms W-2 to employees.[37] In that case, the reporting agent and the employer are jointly and severally liable for compliance.[38]

Professional employer organizations

A professional employer organization (sometimes called an employee leasing company) provides employees to perform services in the businesses of the professional employer organization's customers, generally small and medium-sized businesses. In many cases, before the professional employer organization arrangement is entered into, the employees already work in the customer's business as employees of the customer. The terms of a typical professional employer organization arrangement provide that the professional employer organization is the employer of the employees and is responsible for paying the employees and for the related employment tax compliance. The customer typically pays the professional employer organization a fee based on payroll costs plus an additional amount.[39]

In some cases, the employees provided to work in the customer's business are legally the employees of the customer, and the customer is legally responsible for employment tax

[35] Sec. 3401(d)(1) (for purposes of income tax withholding, if the employer does not have control of the payment of wages, the person having control of the payment of such wages is treated as the employer); *Otte v. United States*, 419 U.S. 43 (1974) (the person who has the control of the payment of wages is treated as the employer for purposes of withholding the employee's share of FICA from wages); *In re Armadillo Corporation*, 561 F.2d 1382 (10th Cir. 1977), and *In re The Laub Baking Company v. United States*, 642 F.2d 196 (6th Cir. 1981) (the person who has control of the payment of wages is the employer for purposes of the employer's share of FICA and FUTA). The mere fact that wages are paid by a person other than the employer does not necessarily mean that the payor has control of the payment of the wages. Rather, control depends on the facts and circumstances. See, e.g., *Consolidated Flooring Services v. United States*, 38 Fed. Cl. 450 (1997), and *Winstead v. United States*, 109 F. 2d 989 (4th Cir. 1997).

[36] The designated reporting agent rules do not apply for purposes of FUTA compliance.

[37] Sec. 3504. Form 2678 is used to designate a reporting agent.

[38] For administrative convenience, an employer may also use a payroll service to handle payroll and employment tax filings on its behalf, but the employer, not the payroll service, continues to be responsible for employment tax compliance.

[39] A professional employer organization may also provide employees with employee benefit coverage, such as under a pension plan or a health plan, even if the customer does not maintain such a plan. In such a case, the fee paid by the customer also covers employee benefit costs.

compliance. Nonetheless, customers generally rely on the professional employer organization for employment tax compliance (without designating the professional employer organization as a reporting agent) and treat the employees as employees of the professional employer organization.

Income tax credits based on wages for employment tax purposes

The Code provides various income tax credits to employers under which the amount of the credit is determined by reference to the amount of wages for employment tax purposes.[40] For example, the amount of an employer's work opportunity credit is based on a portion of FUTA wages paid by the employer to employees who are members of certain targeted groups.[41] In addition, the credit for employer FICA tax paid on tips is based on the employer share of FICA tax paid by the employer with respect to certain tips treated as wages for FICA purposes.[42]

Reporting by large food and beverage establishments

Certain reporting requirements relating to tips apply to large food or beverage establishments.[43] In the case of such an establishment, an employer is generally required to report the following information to the IRS each calendar year: (1) the gross receipts of the establishment from the provision of food and beverages (other than certain receipts); (2) the aggregate amount of charge receipts (other than certain receipts); (3) the aggregate amount of charged tips on the charge receipts; (4) the sum of the aggregate amount of tips reported to the employer by employees and certain amounts required to be reported by the employer on employees' Form W-2s; and (5) with respect to each employee, the amount of tips allocated to the employee based on the receipts of the establishment. The employer must also provide employees with written statements showing certain information each calendar year, including the amount of tips allocated to the employee for the year.

User fees

User fees apply to requests to the IRS for ruling letters, opinion letters, determination letters, and similar requests.[44] The user fees that apply are determined by the IRS and are generally required to be determined after taking into account the average time and difficulty involved in a request.

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[40] See, e.g., secs. 41 (credit for research expenses), 45A (Indian employment credit), 45B (credit for employer FICA tax paid on tips), 45C (credit for clinical drug testing expenses), 51 (work opportunity credit), 51A (welfare-to-work credit), 1396 (empowerment zone employment credit), 1400(d) (DC Zone employment credit), and 1400H (renewal community employment credit).

[41] Sec. 51(c)(1).

[42] Sec. 45B(b)(1).

[43] Sec. 6053(c).

[44] Sec. 7528.

Description of Proposal

Treatment of certified professional employer organization as employer for employment tax purposes

Under the proposal, if certain requirements are met, for purposes of employment taxes and other obligations under the employment tax rules, a certified professional employer organization is treated as the employer of any work site employee performing services for any customer of the certified professional employer organization, but only with respect to remuneration remitted to the work site employee by the certified professional employer organization. In addition, no other person is treated as the employer for employment tax purposes with respect to remuneration remitted by the certified professional employer organization to a work site employee.

Under the proposal, exclusions, definitions, and special rules that are based on the type of employer and that would apply if the certified professional employer organization were not treated as the employer under the proposal continue to apply. Thus, for example, if services performed in the employ of a customer that is a tax-exempt organization would be excluded from employment for FUTA purposes, the fact that a certified professional employer organization is treated as the employer for employment tax purposes does not affect the application of the exclusion.

The provision provides rules under which, on entering into a service contract with a customer with respect to a work site employee, a certified professional employer organization is treated as a successor employer and the customer is treated as the predecessor employer. Similarly, on termination of a service contract with respect to a worksite employee, the customer is treated as a successor employer and the certified professional employer organization is treated as a predecessor employer. Thus, wages paid by the customer and the certified professional employer organization to a work site employee during a calendar year are subject to a single OASDI, RRTA tier 1 or tier 2, or FUTA wage base.

The proposal does not apply in the case of a customer who is related to the certified professional employer organization.[45] In addition, an individual with net earnings from self-employment derived from a customer's trade or business (i.e., a self-employed individual), including a customer who is a sole proprietor or a partner of a customer that is a partnership, is not a work site employee for employment tax purposes with respect to remuneration paid by a certified professional employer organization.

As discussed more fully below, a work site employee is an individual who performs services (1) for a customer pursuant to a contract between the customer and the certified professional employer organization that meets certain requirements and (2) at a work site that

[45] Whether a customer and a certified professional employer organization are related is determined under the rules of section 267(b) (relating to transactions between related taxpayers) or 707(b) (relating to transactions between a partner and partnership). However, rules based on more than 50 percent ownership are applied by substituting 10 percent for 50 percent.

meets certain requirements. Thus, if the contract or work site fails to meet these requirements, the individual is not a work site employee. The proposal applies also in the case of an individual (other than a self-employed individual) who is not a work site employee, but who performs services under a contract that meets the specified requirements. In this case, solely for purposes of a certified professional employer organization's liability for employment taxes and other obligations under the employment tax rules, a certified professional employer organization is treated as the employer of the individual, but only with respect to remuneration remitted to the individual by the certified professional employer organization. Exclusions, definitions, and special rules that are based on the type of employer and that would apply if the certified professional employer organization were not treated as the employer under the proposal continue to apply.

A certified professional employer organization is eligible for the FUTA credit with respect to contributions made to a State unemployment fund with respect to a work site employee by the certified professional employer organization or a customer. An additional FUTA credit may be claimed by a certified professional employer organization if, under State law, a certified professional employer organization is permitted to collect and remit contributions with respect to a work site employee to the State unemployment fund.

Except to the extent necessary for purposes of the proposal treating a certified professional employer organization as the employer for employment tax purposes, nothing in the proposal is to be construed to affect the determination of who is an employee or employer for purposes of the Code.

<u>Certified professional employer organization</u>

A certified professional employer organization is a person who has been certified by the Secretary, for purposes of being treated as the employer for employment tax purposes under the proposal, as meeting certain requirements. These requirements are met if the person--

- demonstrates that the person (and any owner, officer, and such other persons as may be specified in regulations) meets requirements established by the Secretary with respect to tax status, background, experience, business location, and annual financial audits;
- computes its taxable income using an accrual method of accounting unless the Secretary approves another method;
- agrees to satisfy the bond and independent financial review requirements (described below) on an ongoing basis;
- agrees to satisfy any reporting obligations imposed by the Secretary;
- agrees to verify on such periodic basis as prescribed by the Secretary that it continues to meet the requirements for certification; and
- agrees to notify the Secretary in writing within such time as prescribed by the Secretary of any change that materially affects whether it continues to meet the requirements for certification.

Under the bond requirement, a certified professional employer organization must post a bond for the payment of employment taxes in a minimum amount and in a form acceptable to the Secretary. The minimum amount is determined for the period April 1 of any calendar year through March 31 of the following calendar year and is the greater of (1) five percent of the employment taxes for which the certified professional employer organization is liable under the proposal during the preceding calendar year (but not to exceed $1,000,000), or (2) $50,000.

Under the independent financial review requirements, a certified professional employer organization must: (1) have, as of the most recent review date (i.e., six months after the completion of the certified professional employer organization's fiscal year), caused to be prepared and provided to the Secretary an opinion of an independent certified public accountant that the certified professional employer organization's financial statements are presented fairly in accordance with generally accepted accounting principles; and (2) provide to the Secretary, not later than the last day of the second month beginning after the end of each calendar quarter, from an independent certified public accountant an assertion regarding Federal employment tax payments and an examination level attestation on the assertion. The assertion must state that the certified professional employer organization has withheld and made deposits of all required FICA, RRTA, and withheld income taxes for the calendar quarter, and the attestation must state that the assertion is fairly stated in all material respects. If a certified professional employer organization fails to file the required assertion and attestation with respect to any calendar quarter, the independent financial review requirements are treated as not satisfied for the period beginning on the due date for the attestation.

For purposes of the bond and independent financial review requirements, all professional employer organizations that are members of a controlled group of corporations or under common control are treated as a single organization.[46] The Secretary may suspend or revoke the certification of a person's certified professional employer organization status if the Secretary determines that the person does not satisfy the representations or other requirements for certification or fails to satisfy the applicable accounting, reporting, payment, or deposit requirements.

Work site employee

A work site employee is an individual who: (1) performs services for a customer of a certified professional employer organization pursuant to a contract between the customer and the certified professional employer organization that meets certain requirements (described below); and (2) performs services at a work site meeting certain requirements (described below).[47]

The contract between the customer and the certified professional employer organization must be in writing and, with respect to an individual performing services for the customer, must provide that the certified professional employer organization will--

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[46] Whether entities are members of a controlled group of corporations or under common control is determined under the rules of section 414(b) and (c).

[47] As discussed above, a self-employed individual is not a work site employee.

- assume responsibility for payment of wages to the individual, without regard to the receipt or adequacy of payment from the customer;
- assume responsibility for reporting, withholding, and paying any employment taxes with respect to the individual's wages, without regard to the receipt or adequacy of payment from the customer;
- assume responsibility for any employee benefits that the contract may require the certified professional employer organization to provide, without regard to the receipt or adequacy of payment from the customer;
- assume responsibility for hiring, firing, and recruiting workers in addition to the customer's responsibility for hiring, firing and recruiting workers;
- maintain employee records relating to the individual; and
- agree to be treated as a certified professional employer organization for employment tax purposes with respect to such individual.

For purposes of whether an individual is a work site employee, the work site where the individual performs services meets the applicable requirements if at least 85 percent of the individuals performing services for the customer at the work site are subject to one or more contracts with the certified professional employer organization that meet the above requirements.[48]

Regulations

The Secretary of Treasury ("Secretary") is directed to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the proposal. The Secretary is also directed to develop reporting and recordkeeping rules, regulations, and procedures to ensure compliance with the proposal with respect to entities applying for and receiving certification as certified professional employer organizations. These are to be designed in a manner to streamline, to the extent possible, the application of the requirements of the proposal, the exchange of information between a certified professional employer organization and its customers, and the reporting and recordkeeping obligations of a certified professional employer organization.

Other rules

Income tax credits based on wages for employment tax purposes

Under the proposal, for purposes of various income tax credits[49] under which the amount of the credit is determined by reference to the amount of employment tax wages or employment taxes: (1) the credit with respect to a worksite employee performing services for a customer applies to the customer (not to the certified professional employer organization); (2) the

[48] For this purpose, excluded employees under section 414(q)(5), such as employees who are under age 21 or have not completed six months of service, are not taken into account.

customer (and not the certified professional employer organization) is to take into account wages and employment taxes paid by the certified professional employer organization with respect to the worksite employee and for which the certified professional employer organization receives payment from the customer; and (3) the certified professional employer organization is required to furnish the customer with any information necessary for the customer to claim the credit.[50]

Reporting by large food and beverage establishments

Under the proposal, if a certified professional employer organization is treated for employment tax purposes as the employer of a work site employee, the customer for whom the work site employee performs services is the employer for purposes of the reporting required with respect to a large food or beverage establishment. The certified professional employer organization is required to furnish the customer with any information necessary to complete the required reporting.

User fees

Under the proposal, the user fee charged under the program for certifying a professional employer organization may not exceed $500.

No inference as to effect of proposal

Nothing contained in the proposal or the amendments made by the proposal is to be construed to create any inference with respect to the determination of who is an employee or employer (1) for Federal tax purposes (other than the purposes set forth in the proposal), or (2) for purposes of any other provision of law.

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[49] Secs. 41 (credit for research expenses), 45A (Indian employment credit), 45B (credit for employer FICA tax paid on tips), 45C (credit for clinical drug testing expenses), 51 (work opportunity credit), 51A (welfare-to-work credit), 1396 (empowerment zone employment credit), 1400(d) (DC Zone employment credit), 1400H (renewal community employment credit), and any other provision as provided by the Secretary.

[50] Present law provides a deduction from taxable income (or, in the case of an individual, adjusted gross income) that is equal to a portion of the taxpayer's qualified production activities income (sec. 199). The deduction for a taxable year is limited to 50 percent of the wages deducted in arriving at qualified production activities income. To be taken into account, wages must be paid by the taxpayer to its employees and reported on Form W-2. For this purpose, wages means wages subject to income tax withholding, as well as elective deferrals and certain other amounts. Under regulations dealing with wages paid by an entity other than the common-law employer, a taxpayer may take into account wages paid by another entity and reported by the other entity on Form W-2 (with the other entity listed as the employer on the Form W-2), provided that the wages were paid to employees of the taxpayer for employment by the taxpayer. Treas. Reg. sec. 1.199-2(a)(2). The proposal does not affect the application of these rules.

Effective Date

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.