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Small Business Tax Preferences: Legislative Proposals in the 108th Congress

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Summary

Some policy issues seem to be permanent fixtures on the congressional legislative agenda. One such issue is the taxation of small firms and its effects on their formation, performance, and growth. Some contend that the current tax burden on small firms serves as a drag on their growth and thus should be reduced. Others see no solid economic rationale for targeting tax relief at small business owners.

The federal tax code contains a number of provisions that bestow tax relief on small firms in a wide range of industries. Most of these provisions take the form of deductions, exclusions and exemptions, credits, deferrals, and preferential tax rates. Nonetheless, some policymakers want to do more to lessen the tax burden on small business owners. A variety of proposals to enhance existing small business tax preferences or create new ones have been introduced in the 108th Congress. This report describes those proposals. It will be updated as legislative activity warrants.

In the first session of the 108th Congress, one bill lowering the tax burden on many small business owners was enacted: the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA, P.L. 108-27). The act moved forward to 2003 the phased-in cuts in individual income tax rates established by the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16), and it temporarily enhanced the small business expensing allowance under section 179 of the Internal Revenue Code (IRC).

In addition, a number of proposals to expand certain existing small business tax preferences or to create new ones are being considered. In the wake of JGTRRA's enactment, at least four bills (H.R. 2638, H.R. 2896, S. 1885, and S. 1637) would either extend the changes in the expensing allowance made by JGTRRA or further enhance them. At least three bills (S. 106, S. 842, and S. 1885) would expand the partial exclusion of long-term capital gains on the sale or exchange of qualified small business stock under IRC section 1202. And five bills to modify the statutory provisions governing subchapter S corporations with the intent of increasing their access to financial capital have been introduced: H.R. 714, H.R. 1498, H.R. 1896, H.R. 2896, and S. 850.

At least three new small business tax preferences would be created by legislative proposals in the current Congress. A total of seven bills (H.R. 450, H.R. 3607, S. 53, S. 86, S. 414, S. 906, and S. 2163) would establish either a refundable or non-refundable tax credit for a portion of the cost to small employers of offering health benefits to employees. Under H.R. 1222 and S. 1371, taxpayers could claim a special amortization deduction for certain intangible assets acquired from qualified small firms. And S. 1885 would add a new section to the tax code to permit eligible small corporations to pay their federal income tax liabilities for a specific tax year in four equal installments spread out over a period not to exceed six years.

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Some policy issues seem to be permanent fixtures on the congressional legislative agenda. One such issue is the taxation of small firms and its effects on their formation, performance, and growth. Some argue that the current tax burden on small firms serves as a drag on their growth and should be reduced. Others can see no sound economic rationale for targeting tax relief at small business.

Underscoring the allure and economic importance of small entrepreneurial firms and the political influence of small business owners, the federal tax code contains a number of provisions that bestow tax relief on small firms in a wide range of industries. Nonetheless, some policymakers would like to do more to lessen the tax burden on small business owners. A variety of proposals to enhance existing small business tax preferences or create new ones have been introduced in the 108th Congress. This report describes these proposals. It will be updated to reflect new legislative activity.

Existing Small Business Tax Preferences

Firm size may play an important role in the performance of certain industries and markets, but it has little influence on the organization of the federal tax code. The code makes no explicit or formal distinction between the taxation of small firms and all other firms. For example, there are no separate sections in the code addressing the tax treatment of small and large firms. Instead, current tax law contains a number of provisions scattered throughout that confer preferential treatment on small firms but not on larger ones. Most of these provisions take the form of deductions, exclusions and exemptions, credits, deferrals, and preferential tax rates. Tax preferences such as these generally have the effect of reducing the tax burden on the returns to new and old investments by small firms relative to all other firms. A few tax code provisions benefit small firms by reducing the cost and administrative burden of complying with tax laws, or by offering tax relief in exchange for providing certain fringe benefits (e.g., pension plans) to employees.

Contrary to what one might expect, no uniform definition of a small firm underlies existing small business tax preferences. As a result, a striking inconsistency marks the criteria used to determine eligibility for current small business tax benefits. For example, some such benefits are available only to firms with annual gross receipts below a certain level, while other benefits can be had only by firms under a certain asset size. Employment size is seldom used as a criterion for determining eligibility for small business tax preferences. By contrast, the Small

Business Administration relies heavily on employment size to collect and publish data on the economic condition of small business.

Not all small business tax preferences are equal in scope and importance. Some apply only to small firms in specific industries such as life insurance, banking, and energy production and distribution, while others have the potential to affect most small firms. Those preferences with the broadest reach outside agriculture include the taxation of passthrough entities (including subchapter S corporations), graduated corporate income tax rates, the expensing allowance for certain depreciable business assets, the exemption of small corporations from the corporate alternative minimum tax, the amortization of business start-up costs, cash-basis accounting, the exclusion of gains on certain small business stock, and the tax credit for pension plan start-up costs of small firms.[1] These specific preferences form the core of this report.

Although it is unclear how much federal revenue is forgone because of small business tax preferences, recent estimates by the Joint Committee on Taxation and the Treasury Department indicate that the preferences may exceed $6.5 billion in FY2004.[2]

Legislative Proposals in the 108th Congress

In the 107th Congress, many proposals to enhance or expand small business tax benefits (broadly defined) were introduced. Of the legislation that was enacted, one measure offered immediate and direct benefits for many small business owners: the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16). Among other things, the act established a new 10% tax bracket and established a timetable for the gradual reduction in the 28% bracket to 25%, the 31% bracket to 28%, the 36% bracket to 33%, and the 39.6% bracket to 35%, between July 1, 2001 and July 1, 2006. These rate reductions increased the tax advantage of operating a small firm as a passthrough entity rather than as a subchapter C corporation and shrank the tax burden on owners of such entities.[3] There is some fresh evidence that

[1] For a description of existing small business tax preferences and the economic arguments that have been raised for and against them, see CRS Report RL32254, *Small Business Tax Benefits: Overview and Economic Analysis*, by Gary Guenther.

[2] For estimates of the revenue losses in FY2004 associated with selected small business tax preferences, see U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2004-2008*, JCS-8-03 (Washington: GPO, 2003), table 1; and Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2005* (Washington: GPO, 2004), table 18-1.

[3] In early 2001, President Bush proposed lowering the top individual tax rate from 39.6% to 33% between 2001 and 2006. The Treasury Department's Office of Tax Analysis estimated that 800,000 small business owners and entrepreneurs would benefit from this cut. It also estimated that these same individuals would receive 77% of the tax relief provided by this reduction. See Patti Mohr, "O'Neill Gives Small Businesses Reassuring Tax Cut Prognosis," *Tax Notes*, vol. 91, no. 7, May 14, 2001, pp. 1053-1055.

tax rate reductions can spur faster growth in small business output in the short run.[4] EGTRRA also created a 50% non-refundable tax credit for the first $1,000 in administrative and educational expenses incurred by certain small firms in setting up new qualified pension plans for employees.

Legislation reducing the tax burden on most small business owners has also been enacted during the 108th Congress: the Jobs and Growth Tax Relief and Reconciliation Act of 2003 (JGTRRA; P.L. 108-27). The act moved forward to 2003 the individual income tax rate cuts established by EGTRRA and scheduled to take effect in 2006. More specifically, it lowered the 27% rate to 25%, the 30% rate to 28%, the 35% rate to 33% and the 38.6% rate to 35%. These reductions will remain in effect through 2010. And JGTRRA sought to stimulate small business investment by increasing the maximum expensing allowance small firms may claim under section 179 of the Internal Revenue Code (IRC) from $25,000 to $100,000 in 2003 through 2005. The act also raised the phase-out threshold for the allowance from $200,000 to $400,000, indexed both the maximum expensing allowance and the phase-out threshold for increases in inflation in 2004 and 2005, and made purchases of off-the-shelf business software eligible for the allowance in the same period.[5]

In addition, numerous proposals to enhance existing small business tax preferences or create new ones are being considered in the current Congress. They vary in scope from something as seemingly minor as relaxing the eligibility requirements for S corporations to something as seemingly major as creating a new permanent tax credit for a portion of the costs to small firms of offering health insurance coverage to their uninsured employees for the first time. While there is bipartisan support for many of these proposals in both houses, considerable uncertainty surrounds their prospects for enactment in the second session of the 108th Congress. Some of this uncertainty stems from a widespread concern over the large and growing federal budget deficit. The tax cuts under EGTRRA and JGTRRA have made significant contributions to the deterioration in the federal budget since the late 1990s, and some Members of Congress are reluctant to enact additional tax cuts that might worsen the existing outlook for the budget. The proposals are described below under the existing small business tax preferences they would alter or the new preferences they would establish.

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[4] In an analysis of the impact of shifts in personal income tax rates on the growth of small firms using tax return data from just before and just after the Tax Reform Act of 1986 took effect, Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey S. Rosen found that when a sole proprietor's marginal tax rate rose by 10%, his business receipts went up 8.4%. This implied that a reduction in the marginal tax rate levied on a sole proprietor from 50% to 33% would lead to a 28% increase in his or her receipts. See Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey S. Rosen, *Personal Income Taxes and the Growth of Small Firms*, Working Paper 7980, National Bureau of Economic Research (Cambridge, MA: Oct. 2000).

[5] For more details on the expensing allowance, the changes made by JGTRRA, and their short-term economic effects, see CRS Report RL31852, *Small Business Expensing Allowance Under the Jobs and Growth Tax Relief Reconciliation Act of 2003: Changes and Likely Economic Effects*, by Gary Guenther.

Current Small Business Tax Preferences

Expensing Allowance Under IRC Section 179.

Under IRC section 179, business taxpayers buying qualified property may deduct (or expense) some or all of its cost (depending on the amount) in the year when it is placed into service, provided certain conditions are met. For the most part, qualified property consists of machinery and equipment, including motor vehicles. The alternative to expensing is to recover the acquisition cost of this property over longer periods through allowable depreciation deductions. Between 2003 and 2005, the maximum expensing allowance is $100,000 for firms operating outside empowerment zones. For firms that conduct all their business within such zones, the maximum allowance during that period is the lesser of $35,000 or the cost of qualified property. In 2006, assuming no change in current law, the maximum allowance for firms operating outside empowerment zones falls to $25,000, its level before the enactment of JGTRRA. The allowance begins to phase out, dollar for dollar, when the total cost of qualified property placed in service in a tax year from 2003 through 2005 reaches $400,000.

Before the enactment of JGTRRA, there was considerable interest in the 108th Congress in making the expensing allowance available under IRC section 179 more generous, either temporarily or permanently. This interest manifested itself in the numerous bills to liberalize the allowance introduced in the months leading up to the passage of JGTRRA.[6] Some of the bills were modeled after a proposal included in President Bush's budget request for FY2004 to raise the expensing allowance from $25,000 to $75,000 and the phase-out threshold from $200,000 to $325,000, index both amounts for inflation, and include off-the-shelf computer software in the depreciable assets eligible for expensing, as of January 1, 2003 and thereafter.

In the wake of JGTRRA's enactment, there is some interest in Congress in extending its expansion of the small business expensing allowance. Bills introduced by Representative Herger (H.R. 2638) and Senator Daschle (S. 1885) would permanently extend the changes in the allowance made by JGTRRA. In late October 2003, the House Ways and Means Committee passed a measure (H.R. 2896; H.Rept. 108-393) that included a provision extending the changes in the allowance under JGTRRA by another two years, meaning that the allowance would revert to its pre-JGTRRA status beginning in 2008 instead of 2006. And under a bill (S. 1637; S.Rept. 108-192) favorably reported by the Senate Finance Committee in November 2003, the expensing allowance would be enhanced by making the reduction in the allowance in the phase-out range equal to 50% of the amount above the phase-out threshold, instead of 100% under current law.

In the budget request for FY2005 that he submitted to Congress in early February 2004, President Bush is proposing to extend permanently the changes in the expensing allowance made under JGTRRA.

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[6] The bills are H.R. 2, H.R. 22, H.R. 179, H.R. 224, H.R. 1079, H.R. 1126, S. 2 (identical to H.R. 2), S. 106, S. 158 (identical to H.R. 179), S. 414, S. 513, and S. 842.

Partial Exclusion of Gains on Certain Small Business Stock.

Under IRC section 1202, taxpayers other than C corporations may exclude 50% of any gain from the sale or exchange of qualified small business stock that has been held for more than five years. The gain that may be excluded in a tax year is limited to the greater of 10 times the taxpayer's adjusted basis in the stock or $10 million, reduced by the amount of any gain previously excluded. Any remaining gain is taxed at a rate of 28%. This provision effectively lowers the capital gains tax rate on the sale or exchange of qualified small business stock held for longer than five years to 14%.

At least three bills (S. 106 introduced by Senator Snowe, S. 842 introduced by Senator Kerry, and S. 1885 introduced by Senator Daschle) would expand the partial exclusion of long-term capital gains on the sale or exchange of small business stock under IRC section 1202. S. 106 would increase the share of gains that can be excluded from 50% to 75% for firms not classified for tax purposes as "empowerment-zone businesses." It would also shrink the minimum holding period for small business stock to qualify for the exclusion from five years to three years, repeal the current requirement that 42% of any excluded gain be treated as an individual AMT preference item, relax existing restrictions on working capital held by qualified small firms, increase the cap on the gain eligible for the exclusion from $10 million to $20 million for married couples filing joint tax returns, and expand the range of business activities eligible for the exclusion to include biotechnology and fish farming.

Under S. 842 and S. 1885, eligible taxpayers would be able to exclude 75% of the capital gains on qualified small business stock, but the exclusion would rise to 100% for stock issued by "critical technology" corporations and specialized small business investment companies. A corporation would be considered a "critical technology corporation" if, during the minimum holding period for the exclusion, "substantially all" the firm's active business is focused on technologies related to national defense, homeland security, transportation, anti-terrorism, environmental improvement, or improved energy efficiency. S. 1885 would raise the exclusion to 100% for stock issued by eligible manufacturing corporations. In addition, both bills would reduce the minimum holding period for qualified small business stock from five to four years, allow corporations — as well as individual taxpayers — to claim the exclusion, and double the maximum asset size (from $50 million to $100 million) of corporations eligible to issue qualified small business stock and index that limit for inflation beginning in 2005.

Subchapter S Corporation Reform.

Subchapter S corporations are a type of passthrough entity that combines some of the defining characteristics of C corporations and partnerships. On the one hand, S corporations are closely held firms whose income is not taxed at the corporate level but is passed through to their shareholders who are required to include it in their income, which is subject to taxation at individual tax rates. On the other hand, S corporations are organized as small corporations, which entitles their shareholders to many of the rights held by shareholders of subchapter C corporations, including limited liability for a firm's debt and claims against it. To qualify as an S corporation, a firm must satisfy certain requirements, most notably that it have no more than 75 shareholders, issue only one class of stock, not have partnerships or C corporations as shareholders, and not be a financial institution using the reserve method of accounting for bad debts, an insurance company, a corporation benefitting from the Puerto Rico and possessions tax credit, or a Domestic International Sales Corporation.

At least five bills (H.R. 714, H.R. 1498, H.R. 1896, H.R. 2896 — as reported by the House Ways and Means Committee — and S. 850) would modify some of the provisions in the tax code governing S corporations.[7] A chief aim of these proposals is to increase their access to financial capital.

Among other things, H.R. 714 and its companion in the Senate, S. 850, would exclude certain investment income from the definition of passive income for S corporation banks, increase the maximum number of shareholders an S corporation may have from 75 to 150, allow trusts that are individual retirement accounts (IRAs) to become S corporation shareholders, treat the members of a family owing S corporation stock as a single shareholder, allow a bank director to own stock in an S corporation without the stock being considered a disqualifying second class of stock, and allow S corporations to issue qualified preferred stock.

H.R. 1498 would exempt S corporations that re-invest recognized built-in gains in their business from the built-in gains tax under IRC section 1374.

H.R. 1896 would treat members of a family owning S corporation stock as a single shareholder, allow S corporations to issue qualified preferred stock, permit financial institutions to own convertible debt issued by S corporations, and exclude certain investment income from the definition of passive income for banks organized as S corporations, among other things.

And H.R. 2896 would increase the maximum number of shareholders to 100, allow IRAs to be shareholders of banks organized as S corporations under certain conditions, treat the members of a family as a single S corporation shareholder, and exclude certain investment income from the definition of passive income for S corporation banks.

Graduated Corporate Income Tax Rates.

Under current federal tax law, corporations with less than $10 million in taxable income are subject to graduated income tax rates, which in some cases are much lower than the rates that apply to corporations with taxable income in excess of $10 million. Specifically, the corporate income tax rate is 15% on the first $50,000 of taxable income, 25% on the next $25,000, and 34% on selected amounts up to $10 million. The benefits of the first two rates are phased out by a 5% surcharge for corporations with taxable incomes between $100,000 and $335,000, and the benefits

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[7] For an explanation of the changes these bills would make in the tax code provisions governing S corporations, see U.S. Congress, Joint Committee on Taxation, *Background and Proposals Relating to S Corporations*, JCX-62-03 (Washington: June 18, 2003), pp. 23-28.

of the 34% rate are phased out by a 3% surcharge for corporations with taxable incomes between $15 million and $18.3 million. Corporations with taxable incomes between $10 million and $15 million and above $18.3 million pay a marginal rate of 35%.

H.R. 2896, as reported favorably by the Ways and Means Committee, would reduce corporate income tax rates for taxable incomes greater than $75,000. Specifically, under the bill, corporations with taxable incomes between $75,000 and $1 million would be taxed at a rate of 33% in 2004 through 2006 and 32% in 2007 and 2008. In 2009 through 2011, the 32% rate would apply to taxable incomes between $75,000 and $5 million. Corporations with taxable incomes in excess of $1 million would pay a marginal tax rate of 34% from 2004 through 2008; and from 2009 through 2011, the 34% rate would apply to corporate taxable incomes in excess of $5 million. The benefits of the rates below 34% would be phased out by a 5% surcharge for corporations with taxable incomes between $1 million and $1.42 million in 2004 through 2006 and between $1 million and $1.605 million in 2007 and 2008 (making the marginal tax rate in these ranges 39%); in 2009 through 2011, the surcharge would apply to taxable incomes between $5 million and $7.205 million. From 2004 through 2011, a marginal tax rate of 34% would apply to taxable incomes between the phase-out ranges and $10 million, and incomes above $10 million would be subject to a flat rate of 35%.

In 2012 and thereafter, H.R. 2896 would impose a marginal tax rate of 32% on corporate taxable incomes between $75,000 and $20 million. The benefits of the rates below 35% would be phased out by a 3% surcharge for corporate taxable incomes between $20 million and $40,341,667 (making the marginal tax rate in that range 38%). Taxable incomes above the phase-out range would be taxed at a flat rate of 35%.

New Small Business Tax Preferences

Tax Credit for Employee Health Insurance.

Current federal tax law offers no tax credit for employers that provide health insurance to employees. But at least seven bills would establish either a refundable or non-refundable tax credit for a portion of the cost to small employers of offering health benefits to employees: H.R. 450, H.R. 3607, S. 53, S. 86, S. 414, S. 906, and S. 2163. While they differ in such important details as the credit rate and eligibility criteria for firms and their employees, they share the important policy aim of expanding health insurance coverage by giving small employers who currently do not offer health insurance coverage to employees an incentive to do so.

For example, H.R. 450 would establish a refundable tax credit equal to 50% of employer health insurance contributions for firms with 10 or fewer employees; the credit rate drops to 25% for firms with 11 to 15 employees; and it reaches 0% for firms with 16 or more employees. The credit applies only to health insurance premium payments made on behalf of employees who work at least 400 hours and earn $40,000 or less in a calendar year. In addition, the employer must cover at least 75% of the cost of the insurance coverage. By contrast, S. 53 would create a non-refundable tax credit equal to 25% of the cost of individual health insurance coverage up to $750 per eligible employee and 35% of the cost of family coverage up to $2,450 per eligible employee. The credit may be claimed only by firms employing an average of 25 or fewer workers in either of the two preceding calendar years.

Special Amortization Deduction for Intangible Assets Acquired from Certain Small Firms.

Under IRC section 197, the value of intangible assets must be amortized over 15 years. Assets eligible for this treatment include goodwill, covenants not to compete, patents, copyrights, licenses, permits, and trademarks.

Two bills, H.R. 1222 and S. 1371, would modify this provision to permit taxpayers to claim a special amortization deduction for any intangible assets acquired from an eligible small firm. The bills would allow the owner of the acquiring firm to write off the first $5 million in intangible assets acquired from an eligible firm in the year of purchase, and the remainder (if any) would be amortized over 14 years, including the year of purchase. An eligible firm is defined as one with annual gross receipts of $5 million or less in each of the three previous tax years.

Delayed Payment of Federal Income Tax by Certain Small Firms.

In general, a business taxpayer's tax liability is to be paid by the due date for filing its tax returns. Under IRC section 6161, however, the Internal Revenue Service may extend the time of tax payment for up to six months if a taxpayer can demonstrate that earlier payment would lead to undue hardship. To receive an extension, a taxpayer must file Form 1127 on or before the original due date for payment of the tax. The application must be accompanied by evidence showing the undue hardship that would result if the extension were refused, a statement of the taxpayer's assets and liabilities, and a statement of the taxpayer's receipts and disbursements during the three months preceding the original due date for the payment of tax.

S. 1885 would add a new section to the tax code (section 6168) that would make it possible for eligible small firms to pay their federal income tax liabilities in four equal installments, and eligible small manufacturing firms to do so in six equal installments. To be eligible, a firm must use at least 80% of its assets in the pursuit of a trade or business outside of farming, insurance, financial services, mineral extraction, health care, law, engineering, architecture, accounting, actuarial science, the performing arts, consulting, and athletics; its gross receipts must not exceed $10 million in the current tax year; its gross receipts in the current tax year must be at least 10% greater than its average annual gross receipts in the previous two tax years; and it must use the accrual method of accounting. Eligible small manufacturing firms must meet the same criteria and be classified as a manufacturing enterprise under the North American Industrial Classification System. The due date for the first installment would be the earlier of a date selected by the taxpayer or two years after the due date for the tax under current law. Each additional installment would be paid no later than one year after the due date for the previous installment.