SUMMARY OF THE SMALL BUSINESS TAX REVISION BILL OF 1958 (H. R. 13382)

As it Passed the House of Representatives

PREPARED BY

THE STAFF OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

FOR THE USE OF

THE SENATE COMMITTEE ON FINANCE

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SECTION 1. SHORT TITLE

This section provides that the bill is to be known as the Small Business Tax Revision Act of 1958.

SECTION 2. LOSSES ON SMALL BUSINESS STOCK

Summary

Section 2 of the bill would add a new provision to the code permitting individuals to deduct losses on small-business stock from their ordinary income.

General statement

Under present law, unless an individual is a dealer, a loss on stock is treated as a capital loss, which, if it exceeds capital gains, is deductible from ordinary income only to the extent of $1,000 per year. The bill would permit an individual who owns stock in a small-business corporation to treat the loss from the sale or exchange or worthlessness of that stock as an ordinary loss, up to a maximum amount of $25,000 in any one year ($50,000 in the case of a husband and wife filing a joint return).

The report of the Committee on Ways and Means indicates that this provision is intended to encourage financing of small business by decreasing the risk in small-business investments.

The ordinary loss treatment provided by this provision is limited to individuals (not including partnerships, trusts, or estates) and is applicable only if the individual is the original holder of the stock. The stock to which this provision applies includes only common stock in a domestic corporation. Furthermore, the stock must be issued pursuant to a plan adopted by the corporation after June 30, 1958, and must be issued for money or other property (not including stock or securities).

Two additional requirements are imposed for the purpose of limiting the benefit of this new provision to small business: (1) a corporation may not issue more than $500,000 worth of ordinary loss stock, and (2) the total stock offering per corporation plus the equity capital of the corporation may not exceed $1 million. Thus, a corporation whose equity capital (assets, at their tax basis, less liabilities to others than shareholders) already equals or exceeds $1 million cannot issue any ordinary loss stock.

An additional restriction, for the purpose of limiting the benefits extended by the new provision to operating companies, provides that the corporation, in the 5 years before the taxpayer sustains the loss on his stock, must have derived more than one-half of its gross receipts from sources other than royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities.

Special basis rules are provided to prevent the conversion of an existing capital loss into an ordinary loss and to prevent subsequent

increases in stock basis (through contributions to capital or otherwise) from increasing the amount of ordinary loss on a disposition of the stock. Provision is also made extending the application of this provision to stock received in connection with certain recapitalizations and reorganizations involving a mere change in identity, form, or place of organization.

This provision is not expected to result in any immediate revenue loss.

Effective date

This section applies only to stock issued pursuant to a plan adopted by a corporation after June 30, 1958.

SECTION 3. THREE-YEAR NET OPERATING LOSS CARRYBACK

Summary

Section 3 of the bill extends the 2-year net operating loss carryback under present law to a 3-year carryback. As a result, taxpayers will have a 3-year carryback and a 5-year carryforward for losses.

General statement

Under present law a loss can be carried back and offset against income of the 2 years preceding the year of the loss and then if any loss still remains unabsorbed it may be carried forward and offset against income in the 5 years following the year of the loss. The bill extends the present carryback period from 2 years to 3 years. Thus, under the bill a loss is first carried back to the third year preceding the year of the loss. Then if any loss remains unabsorbed, it is carried to the second year preceding the year of the loss, and any loss then remaining is carried to the first year preceding the year of the loss. Any loss still remaining, as under present law, is carried forward to the 5 succeeding years after the year of the loss. This 3-year carryback is to be available with respect to losses arising in the calendar year 1958 or in the portion of a fiscal year falling in 1958.

The 3-year carryback combined with the year of the loss and the 5 succeeding years of the carryforward provide a 9-year span over which either corporate or unincorporated businesses may spread their losses.

The Committee on Ways and Means reported that for the most part, the addition of 1 year to the net operating loss carryback will not increase the loss offsets available to most corporations at the present time, since those which cannot entirely offset a loss in the 2 prior years usually can do so against income in the 5 succeeding years. It further reported that the 3-year carryback is advantageous because it provides for a refund shortly after the loss is incurred, instead of requiring the business to wait and obtain the benefit by paying lower taxes in subsequent years. It believes that this current refund, rather than subsequently reduced taxes, is particularly appropriate at the present time as a means of placing funds in the hands of business in a period when many of them are incurring losses. Consequently, it believes that the additional 1-year carryback will be especially advantageous to small business.

It is estimated that this provision may result in a revenue loss in the first full year of operation of perhaps as much as $50 million, representing for the most part an acceleration from future years to

the current year of the impact of the deduction to a taxpayer for net operating losses.

Effective date

The above amendments made by this section of the bill will apply to net operating losses for taxable years ending after December 31, 1957.

SECTION 4. ADDITIONAL FIRST-YEAR DEPRECIATION ALLOWANCE FOR SMALL BUSINESS

Summary

Section 4 of the bill would add a new section to the code providing a special 20 percent depreciation deduction with respect to the purchase of a limited amount of depreciable tangible personal property having a useful life of 6 years or more.

General statement

Section 4 of the bill would add a new section to the code, which would permit any individual or corporation who buys depreciable property to take an additional first-year depreciation deduction of 20 percent of the cost of items purchased in that year. For each individual or corporation the maximum special deduction is $2,000 a year, or $4,000 for an individual filing a joint return; that is, 20 percent of items (or part of an item) costing not more than $10,000 ($20,000 in the case of a joint return). Where there are several entities under common control the maximum relates to the purchases of all of them; thus, if a single individual conducts a proprietorship and controls 2 corporations the 3 business entities together could deduct not more than 20 percent of $10,000. The 20 percent deduction is in addition to ordinary depreciation computed on the remaining 80 percent of cost.

For example, if a single individual buys $10,000 worth of new equipment in 1958 he may elect to deduct $2,000 as a special depreciation deduction for 1958. If the items are new he may elect to use the declining-balance method with respect to the remaining $8,000, so that if the useful life is 20 years he can deduct in the first year, in addition to the special $2,000, 10 percent of the remaining $8,000, or $800, a total of $2,800 instead of $1,000 allowable under present law. In the second and following years the remaining $7,200 will be written off in the usual way.

The special deduction is available only for tangible personal property having a useful life at the time of its acquisition of 6 years or more. Thus, it will not apply to buildings and similar items which are not personal property, nor to intangible items such as patents and copyrights; nor will it apply to short-lived assets. It will apply to purchases of used, as well as new items.

To prevent abuses, the special-depreciation deduction will apply only to property purchased in an arm's-length transaction. It will not apply to property received as a gift or from a decedent. In the case of trade-ins it will apply only to any money paid in addition to the traded-in property. It will not apply to property acquired in a nontaxable exchange such as a reorganization, nor to property bought from a member of the taxpayer's family, including his spouse, ancestors, and lineal descendents, or from another related entity as defined in section 267, nor from a person who controls, is controlled

by, or is under common control with the taxpayer. Thus it will not apply, for example, if one member of an affiliated group of corporations purchases property from another member or if an individual who controls a corporation purchases property from that corporation. The special deduction is not available to trusts, although it is available to estates.

The report of the Committee on Ways and Means indicates that this provision, permitting a writeoff of one-fifth of the total cost of certain assets in the year of their acquisition, in addition to regular depreciation on the balance, will make it possible to use depreciation reserves for expansion and will also make less critical the determination of the useful lives of assets and the estimation of salvage value. The benefits of this provision are concentrated largely in the area of small business by limiting the cost of property, with respect to which this 20 percent writeoff can be taken, to $10,000 ($20,000 in the case of a joint return).

It is estimated that the revenue loss will be $175 million in the first full year of operation.

Effective date

This section will apply with respect to taxable years ending after June 30, 1958, but only as to property purchased after December 31, 1957.

SECTION 5. INCREASE OF MINIMUM ACCUMULATED EARNINGS CREDIT FROM $60,000 TO $100,000

Summary

Section 5 of the bill increases from $60,000 to $100,000 the minimum accumulated earnings credit representing amounts which a corporate business can accumulate over a period of years without the possibility of the imposition of any accumulated earnings tax (formerly called the sec. 102 tax).

General statement

In addition to the regular corporate income tax, present law imposes an accumulated earnings tax (formerly called the sec. 102 tax) of 27½ to 38½ percent on improperly accumulated corporate earnings. In computing the income base on which this tax is imposed, there is excluded an amount equal to the earnings and profits of the taxable year which are retained for the reasonable needs of the business. This is known as the accumulated earnings credit. Present law provides, however, that in any case there is to be a minimum credit of $60,000 of earnings which may be accumulated before any income is subject to this tax. This is a cumulative credit, however, rather than an annual credit. The bill will increase this $60,000 minimum accumulated earnings credit to $100,000. This increase in the minimum credit is not intended as an indication that accumulated earnings in excess of $100,000 are necessarily subject to this special tax.

The Committee on Ways and Means reported that the accumulated earnings tax has presented an especially serious problem for small business, because the absence of specific plans frequently makes it difficult for small business to establish the reasonable needs of the business for accumulated earnings. This problem led to the establishment of this $60,000 minimum credit in the 1954 Code. By raising this amount to $100,000, the report indicates, the bill makes allowances

for rising costs since this figure was first established, and also provides a slightly wider margin of accumulation with respect to which business can be free of worry concerning the accumulated earnings tax.

It is estimated that the revenue effect of this change will be negligible.

Effective date

This change is made effective with respect to taxable years beginning after December 31, 1957.

SECTION 6. INSTALLMENT PAYMENTS OF ESTATE TAX ATTRIBUTABLE TO INVESTMENTS IN CLOSELY HELD BUSINESS ENTERPRISE

Summary

Section 6 of the bill provides that where the estate of a decedent consists largely of an interest in a closely held business, the estate is to have up to 10 years for payment of the Federal estate tax attributable to the value of such interest.

General statement

This section of the bill would add a new provision to the code permitting the executor of an estate, one of the principal assets of which is an interest in a closely held business, to elect to pay the Federal estate tax in 10 or less equal annual installments rather than in one lump-sum payment 15 months after the death of the decedent. The value of the closely held business must exceed either 35 percent of the gross estate or 50 percent of the taxable estate. The estate tax which may be paid in installments is limited to the portion of the estate tax attributable to the value represented by the closely held business. The installment payments are subject to interest at the rate of 4 percent (the rate applicable in the case of extensions of time due to hardship).

The Committee on Ways and Means report indicates that this provision is intended to make it possible to keep together a business enterprise where the death of one of the larger owners of the business results in the imposition of a relatively heavy estate tax. Since small businesses are generally closely held, it was believed that this provision would be helpful in preventing corporate mergers by spreading out the period over which the estate tax may be paid.

A closely held business is defined as: (1) any interest as a proprietor in a trade or business; (2) an interest as a partner in a partnership engaged in a trade or business if the decedent owned 20 percent or more of the capital interest in the partnership or if the partnership had 10 or less partners; and (3) ownership of any stock in a corporation engaged in a trade or business if the decedent owned 20 percent or more in value of the voting stock or if the corporation had 10 or less shareholders. In addition, it is provided that where there are two or more closely held businesses, if more than 50 percent of the total value of each business is included in the value of the decedent's gross estate, such businesses shall be treated as an interest in a single closely held business. By treating these interests as a single interest, the estate may be able to qualify under the new installment provision notwithstanding the fact that the estate could not qualify under it with respect to any interest in a closely held business considered separately.

Under the bill, the installment payments are accelerated under certain circumstances. Where there is a withdrawal from the business of money or other property equal to 50 percent or more of the value of the trade or business, the extension of time shall cease to apply. The extension shall also cease to apply if 50 percent or more of a qualifying interest in a closely held business is distributed, sold, exchanged, or otherwise disposed of. The bill also provides that after the fourth year of the estate, any accumulated income of the estate must be applied against the balance of the unpaid estate tax.

It is estimated that this provision will result in a revenue loss of about $35 million in the first full year of operation.

Effective date

This provision applies to estates of decedents where the date for filing the Federal estate return (including extensions) is after the date of enactment of this bill. It also applies in the case of a deficiency assessed after the date of enactment of this bill if the deficiency is not due to negligence, intentional disregard of rules and regulations, or to fraud, and if the deficiency arose in the case of a decedent dying after August 16, 1954, where the date for filing the estate tax return (including extensions) expired before the date of enactment of this bill.

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