OVERVIEW OF PRESENT LAW AND SELECTED PROPOSALS REGARDING THE FEDERAL INCOME TAXATION OF SMALL BUSINESS AND AGRICULTURE

Scheduled for a Public Hearing

Before the

SENATE COMMITTEE ON FINANCE

on March 28, 2001

Prepared by the Staff

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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on March 28, 2001, on issuing relating to the Federal income taxation of small business and agriculture. This document,[1] prepared by the staff of the Joint Committee on Taxation, describes selected Federal income tax provisions that affect these activities, as well as proposals in the Senate that would affect small business and agriculture.

[1] This document may be cited as follows: Joint Committee on Taxation, *Overview of Present Law and Selected Proposals Regarding the Federal Income Taxation of Small Business and Agriculture* (JCX-19-01), March 27, 2001.

I. OVERVIEW

A. Federal Income Tax Rates -- Summary of Certain Provisions Affecting Small Business

U.S. individuals (citizens and residents) are taxed at graduated statutory rates ranging from 15 percent (for taxable income of married joint filers or surviving spouses up to $45,200) to 39.6 percent (for taxable income of married joint filers or surviving spouses over $297,350) for 2001. The intermediate rates are 28 percent, 31 percent, and 36 percent. The maximum tax rate on net long-term capital gains generally is 20 percent.[2]

Corporations are taxed at statutory rates ranging from 15 percent (for taxable income up to $50,000) to 35 percent (for taxable income over $10,000,000). The intermediate rates are 25 percent and 34 percent. The benefit of graduated rates below 34 percent is phased out for corporations with taxable income between $100,000 and $335,000. Thus, a corporation with taxable income between $335,000 and $10,000,000 is effectively subject to a flat rate of 34 percent. The maximum tax rate for corporate net long-term capital gains is 35 percent.

In addition, present law imposes a minimum tax on individuals and corporations to the extent their minimum tax liability exceeds their regular tax liability.[3] This alternative minimum tax ("AMT") is imposed on corporations at the rate of 20 percent on the alternative minimum taxable income ("AMTI") in excess of a $40,000 phased-out exemption amount and on individuals at a rate of 26 percent for the first $175,000 of AMTI in excess of a phased-out exemption amount and 28 percent in excess of such amount.[4] AMTI is the taxpayer's regular taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items. In general, the AMT applies a lower tax rate to a broader tax base. Specifically, the regular tax base is increased for AMT purposes by adding back certain items treated as tax preferences, and disallowing certain deductions and credits.

B. Definition of "Small Business"

The Code does not contain a uniform definition of a "small business." Rather, there are numerous definitions throughout the Code that are applied in specific contexts. Moreover, there

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[2] Net gain from the sale of collectibles is taxed at a 28 percent rate, while certain gain from the sale or exchange of certain depreciable real estate (i.e., "unrecaptured section 1250 property") is taxed at a 25 percent rate.

[3] A corporation with average gross receipts of less that $7.5 million for the prior three taxable years is exempt from the corporate minimum tax. The $7.5 million threshold is reduced to $5 million for the corporation's first 3-taxable year period.

[4] The exemption amount is $45,000 in the case of married individuals filing a joint return. The exemption amount is completely phased out for married individuals filing a joint return with AMTI in excess of $330,000 and for a corporation with AMTI in excess of $310,000.

is no single criterion used to determine whether a business is "small." Examples of the different criteria used in the Code include a business's gross assets,[5] gross receipts,[6] number of shareholders[7], or a combination of factors.[8]

The range of definitions also is significant. For example, a small producer for purposes of certain excise taxes is defined as having gross receipts in the previous year of less than $500,000.[9] In contrast, the definition of a "small business" for purposes of the 50-percent exclusion for gain from the sale of stock in certain small business stock is one that at the time of the issuance of the stock had aggregate gross assets of not more than $50 million.[10] One commonly-used measure is whether the entity's average annual gross receipts for the three-taxable year period ending with the prior year exceeds $5 million.[11]

C. Choice of Entity

1. In general

Owners of a business may conduct their activities as "sole proprietorships," which do not involve legal entities separate from the owner. However, for a variety of business or other reasons, a separate entity may be used to conduct the business. One common reason to use a separate entity is the limited liability protection provided by State law to qualifying entities (but not sole proprietorships). The choice of entity affects the tax treatment of the entity as well as of the investors. As described in detail below, some entities ("C corporations") involve tax at the entity and the owner level; other entities ("pass-through entities") involve a single level of tax at the owner level.

2. Corporations

A corporation is a business entity organized under a Federal or State statute, or under a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as

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[5] Section 1202(d)(1).

[6] Section 474(c).

[7] Section 1361(b)(1)(A).

[8] Section 44(b) defines an "eligible small business" as any person if either (a) the gross receipts for the preceding year did not exceed $1 million or (b) the business did not employ more than 30 full-time employees during the preceding year.

[9] Sections 5081(b)(1) and 5801(b)(1).

[10] Section 1202(d)(1).

[11] Sections 448(c), 474(c), and 172(b)(1)(F)(iii).

incorporated or as a corporation.[12] Subchapter C of the Code taxes a corporation as an entity separate from its shareholders. Thus, a C corporation's income generally is taxed when earned at the corporate level, and is taxed again when distributed as dividends[13] to individual shareholders. Corporate deductions and credits reduce only corporate income and are not passed through to individual shareholders.

Corporate income that is not distributed to shareholders is subject to current tax at the corporate level only. To the extent that income retained at the corporate level is reflected in an increased share value, the shareholder may be taxed at favorable capital gains rates upon sale or exchange (including certain redemptions) of the stock or upon liquidation of the corporation.[14] Because of the preferential tax treatment of capital gains, certain investors may prefer not to receive dividends from a C corporation, but instead may prefer retention of earnings at the corporate level so that the value attributable to those earnings may be realized as capital gains on the sale or disposition of stock. (Any appreciation in the stock that has not been realized at the time of death is exempt from capital gains tax, due to the step-up of basis to fair market value at death). In addition, foreign investors may be exempt from tax on certain capital gains, but are subject to withholding tax on dividends.

An "accumulated earnings tax" can be imposed on certain earnings in excess of $250,000 ($150,000 for certain service corporations in certain fields) accumulated beyond the reasonable needs of the business (secs. 531-537). A "personal holding company tax" is imposed on certain undistributed personal holding company income, generally where the corporation meets certain closely held stock requirements and more than 60 percent of the adjusted ordinary gross income (as defined) consists of certain passive-type income such as dividends, interest, and similar items (secs. 541-547).

Amounts paid as reasonable compensation to shareholders who are also employees are deductible by the corporation, and thus are taxed only as ordinary income compensation at the individual level. On the other hand, amounts paid as dividends to shareholders generally are not deductible by the corporation and are taxed as ordinary income to the shareholders. Thus, there is an incentive to pay compensation or other deductible amounts (e.g., rents or royalties) to shareholders who also provide services or property to the corporation sufficient to reduce or eliminate corporate-level tax. To the extent a C corporation is able to establish that amounts paid to shareholder-employees do not exceed reasonable compensation for services provided, the

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[12] Treas. Reg. sec. 301.7701-2(b)(1).

[13] Distributions with respect to stock that exceed corporate earnings and profits are not taxed as dividend income to shareholders but are treated as a tax-free return of capital that reduces the shareholder’s basis in the stock. Distributions in excess of corporate earnings and profits that exceed a shareholder’s basis in the stock are treated as amounts received in exchange for the stock and in general are taxed to the shareholder at capital gains rates.

[14] If an individual shareholder retains stock until death, the appreciation can pass to the heirs free of income tax (sec. 1014).

deduction is permitted. Otherwise, the portion in excess of the amount determined to be reasonable compensation is not deductible to the corporation and is treated as a dividend to the shareholder.

In general, interest is deductible by a C corporation but dividends are not. Subject to non-tax business considerations, this creates a tax incentive favoring debt over equity in the capital structure. A common issue in the closely held corporate context is whether instruments denominated as debt and issued to persons who are also equity owners (or to other persons) should be respected as debt or should be recharacterized as additional equity. This determination requires an examination of the economic substance of the instrument.

A C corporation may be the entity of choice if a corporation anticipates "going public," since publicly traded partnerships are generally taxed as corporations, and S corporations (discussed below) are not permitted to have more than 75 shareholders and thus are not suitable public offering vehicles.

3. Partnerships

In general

Partnerships generally are treated for Federal income tax purposes as pass-through entities, not subject to tax at the entity level (sec. 701). Items of income (including tax-exempt income), loss, deduction and credit of the partnership are taken into account in computing the tax of the partners (regardless of whether the income is distributed to the partners). Each partner takes into income his "distributive share" of the partnership's taxable income and the separately allocable items of income, deduction, and credit (sec. 702(a)). A partner's deduction for partnership losses is limited to the amount of the partner's adjusted basis in his partnership interest (sec. 704(d)).[15] To the extent a loss is not allowed due to a limitation, it generally is carried forward to the next year. A partner's basis in his partnership interest generally equals the sum of his capital contribution to the partnership, his distributive share of partnership income, and his share of partnership liabilities, less his distributive share of losses allowed as a deduction and any partnership distributions (sec. 705).

Partnerships provide partners a significant amount of flexibility to vary their respective shares of partnership income. Unlike some other types of pass-through entities, such as an S corporation (discussed below), partnerships generally permit a significant amount of flexibility in allocating specific tax consequences to particular partners; for example, depreciation deductions can be allocated disproportionately to one partner while taxable income (but not current cash flow) can be allocated disproportionately to another partner. The Code permits such allocations only to the extent they have "substantial economic effect". In general, an allocation is permitted

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[15] In addition, "passive loss" and “at-risk” limitations limit the extent to which certain types of limited partner income can be offset by partnership deductions. These limitations do not apply to corporate partners (except certain closely held corporations) and may not be important to individual partners who have partner level "passive income" from other investments.

to the extent the partner to whom the allocation is made receives the economic benefit or bears the economic burden of such allocation and the allocation substantially impacts the dollar amounts to be received by the partners from the partnership independent of tax consequences.

Limited liability companies

In recent years, another form of entity--the limited liability company ("LLC")--has emerged that provides corporate treatment for local law purposes and partnership treatment for Federal income tax purpose.[16] LLCs are entities organized under State law. They are neither partnership nor corporations under applicable State law, but they generally provide limited liability to their owners. An LLC generally affords local law and income tax treatment similar to that of a partnership. Under regulations promulgated in 1996, any domestic non-publicly traded unincorporated entity with two or more members generally may elect to be treated as either a partnership or a corporation; while any single-member unincorporated entity may be disregarded for Federal income tax purposes (i.e., treated as not separate from its owner).[17] These regulations, known as the "check-the-box" regulations, were a response, in part, to the growth of LLCs. The regulations permit an LLC simply to elect to be treated as a partnership.

4. S corporations

In many instances, owners of business enterprises may wish to incorporate for nontax reasons (e.g., to obtain limited liability or easier access to capital markets), but would prefer not to have C corporation tax treatment. Noncorporate tax treatment may be preferred because: (i) owners may not wish business earnings to be subject to two layers of tax (once when earned and again when distributed); (ii) the average or marginal tax rates for the individual shareholders may be lower than that of the corporation; (iii) owners may wish to use losses generated by the business to offset income from other sources; and (iv) the owners may not wish tax to be imposed under the corporate tax base (which may include items not applicable to individuals).

Subchapter S of the Code allows certain qualified corporations to elect essentially to be relieved from corporate-level taxation and to pass the corporate items of taxable income and loss through to the shareholders of the corporation. Thus, a corporation that elects subchapter S status (an "S corporation") and its shareholders are generally treated more like a partnership and its partners than a C corporation and its shareholders, respectively. In order to make an election to be treated as an S corporation, a corporation must meet certain requirements primarily regarding its capital structure and the identity of its shareholders. These requirements are discussed in detail below.

To be eligible to elect S corporation status, a corporation may not have more than 75 shareholders and may not have more than one class of stock. Only individuals (other than nonresident aliens), certain tax-exempt organizations, and certain trusts and estates are permitted

[16] The first LLC statute was enacted in Wyoming in 1977. All States (and the District of Columbia) now have an LLC statute.

[17] Treas. Reg. sec. 301.7701-3.

shareholders. A corporation may elect S corporation status only with the consent of all its shareholders, and may terminate its election with the consent of shareholders holding more than 50 percent of the stock (sec. 1362). Although there are limitations on the types of shareholders and stock structure an S corporation may have, there is no limit on the asset size of such a corporation (as there is no limit on the size of a C corporation or partnership).

S corporations generally are treated for Federal income tax purposes as pass-through entities, not subject to tax at the corporate level (secs. 1363 and 1366). Items of income (including tax-exempt income), loss, deduction and credit of the corporation are taken into account in computing the tax of the shareholders (regardless of whether the income is distributed to the shareholders). A shareholder's deduction for corporate losses is limited to the sum of amount of the shareholder's adjusted basis in his stock and in the indebtedness of the corporation to such shareholder. To the extent a loss is not allowed due to this limitation, the loss generally is carried forward to the next year. The shareholder's basis in the S corporation stock and debt is reduced by his share of losses allowed as a deduction and, in the case of stock, by distributions; whereas the shareholder's basis in the S corporation stock is increased by his share of the corporation's income (sec. 1367).

There are two principal exceptions to the general pass-through treatment of S corporations. Both are applicable only if the corporation was previously a C corporation and are generally intended to prevent avoidance of otherwise applicable C corporation tax consequences. First, an S corporation is subject to tax on excess net passive investment income (but not in excess of its taxable income, subject to certain adjustments), if (for less than three consecutive years[18]) the corporation has subchapter C earnings and profits, and has gross receipts more than 25 percent of which are passive investment income for the year (sec. 1375). Second, for the first 10 years after a corporation that was previously a regular C corporation elects to be an S corporation, certain net "built-in" capital gains of the corporation attributable to the period in which it was a C corporation are subject to tax at the corporate level (sec. 1374).

In general, a shareholder is not subject to tax on distributions unless the distributions exceed the shareholder's basis in the stock of the corporation or the corporation was formerly a C corporation and has remaining earnings and profits (sec. 1368). To the extent of such earnings and profits, corporate distributions are treated like dividends of C corporations and generally are subject to tax as ordinary income in the hands of the shareholders.

Notwithstanding that they both provide for pass-through treatment, there are significant differences between S corporations and partnerships. For example, corporate liabilities are not included in a shareholder's basis for his interest in an S corporation. Thus, unlike a limited partner who can take deductions supported by certain partnership indebtedness, S corporation shareholders who wish to obtain similar types of deductions are required to individually borrow and contribute or re-lend such amounts to the S corporation. Also, S corporations generally may

[18] If the S corporation continues to have C corporation earnings and profits and has gross receipts more than 25 percent of which are passive investment income in each year for three consecutive years, the S corporation election is automatically terminated.

have only one class of stock, and thus do not offer the same flexibility as partnerships to allocate income or losses to different investors.

II. DATA ON SMALL BUSINESS AND AGRICULTURE

Figure 1 and Table 1 show data from the Internal Revenue Service's Statistics of Income ("SOI") regarding the number of tax returns filed by different forms of business organizations from 1978 to 1998.[19] In these data, farms are measured solely by reference to those taxpayers who report income (or loss) on Schedule F of Form 1040. Other taxpayers engaged in agricultural enterprises may use a separate entity. When this occurs, the data reported below report that entity among the totals of C corporations, S corporations, or partnerships.

Throughout the period 1978 to 1998, nonfarm sole proprietorships made up the vast majority of businesses. In 1998, they constituted 66.4 percent of all business entities; over the 20 years, they were never lower than 58 percent of the total.

[19] These data are based upon returns filed by individuals and entities. The numbers reported for nonfarm sole proprietorships and for farm returns are based upon the number of taxpayers who file a business return as a sole proprietor (Schedule C to Form 1040) and who file a farm income return (Schedule F to Form 1040). One taxpayer may report more than one business organized as a sole proprietorship; the data reported here count only one sole proprietorship. On the other hand, the data for C corporations, S corporations, and partnerships count the number of tax returns and information returns filed by C corporations, S corporations, and partnerships. One taxpayer may own more than one corporation. When this occurs, unlike the case in sole proprietorships, the data reported here count each corporation as a separate entity. Thus, the data are not perfectly comparable across entity classification.

Figure 1.--Number of Different Types of Business Returns, 1978-1998

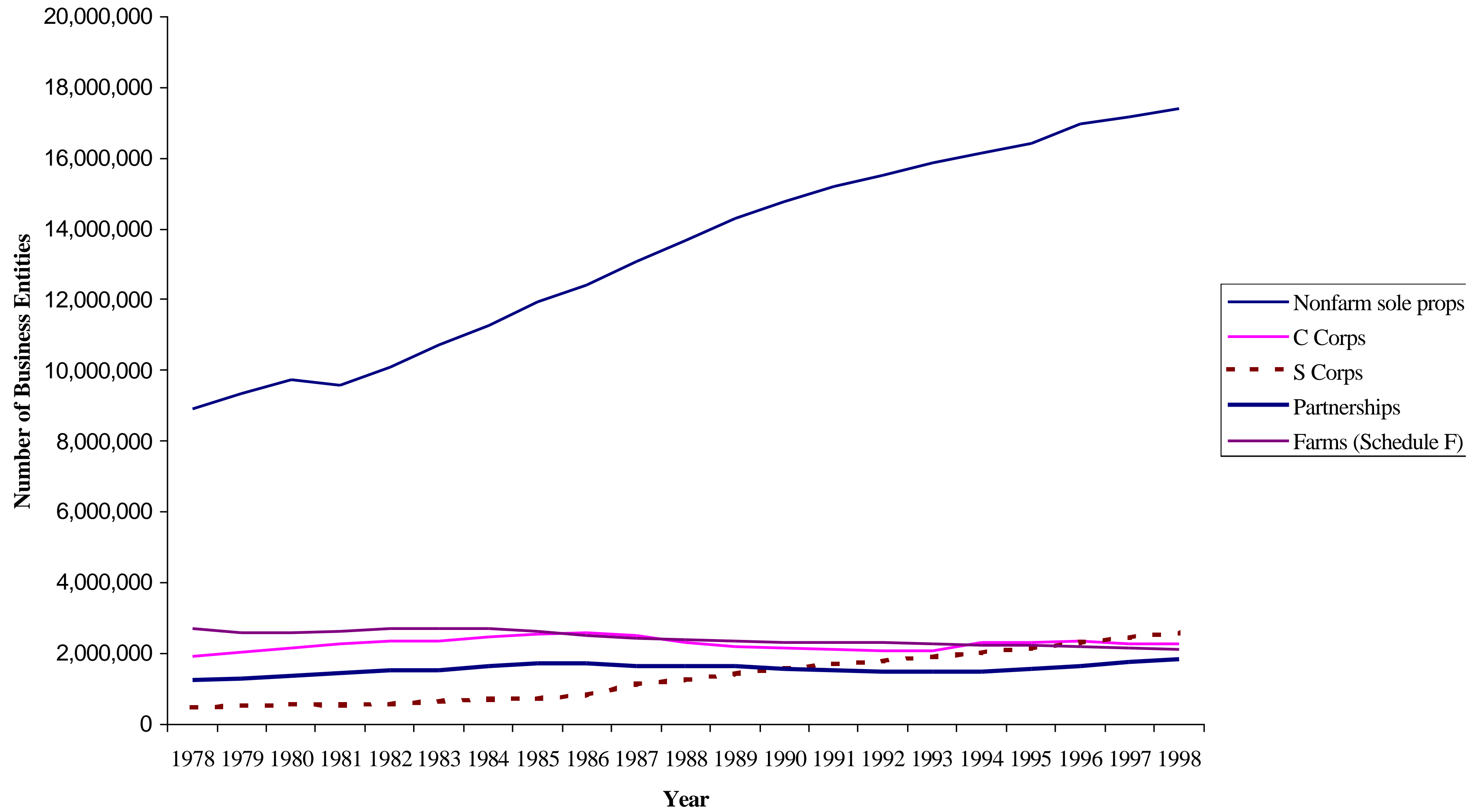


Table 1.-- Number of Different Types of Business Returns Relative to All Business Returns, 1978-1998

Year	Sole Proprietorships	C Corporations	S Corporations	Partnerships	Farms	Total
1978	8,908,289	1,898,100	478,679	1,234,157	2,704,794	15,224,019
1979	9,343,603	2,041,887	545,389	1,299,593	2,605,684	15,805,674
1980	9,730,019	2,165,149	545,389	1,379,654	2,608,430	16,428,641
1981	9,584,790	2,270,931	541,489	1,460,502	2,641,254	16,498,966
1982	10,105,515	2,361,714	564,219	1,514,212	2,689,237	17,234,897
1983	10,703,921	2,350,804	648,267	1,541,539	2,710,044	17,954,575
1984	11,262,390	2,469,404	701,339	1,643,581	2,694,420	18,771,134
1985	11,928,573	2,552,470	724,749	1,713,603	2,620,861	19,540,256
1986	12,393,700	2,602,301	826,214	1,702,952	2,524,331	20,049,498
1987	13,091,132	2,484,228	1,127,905	1,648,035	2,420,186	20,771,486
1988	13,679,302	2,305,598	1,257,191	1,654,245	2,367,527	21,263,863
1989	14,297,558	2,204,896	1,422,967	1,635,164	2,359,718	21,920,303
1990	14,782,738	2,141,558	1,575,092	1,553,529	2,321,153	22,374,070
1991	15,180,722	2,105,200	1,696,927	1,515,345	2,290,908	22,789,102
1992	15,495,419	2,083,652	1,785,371	1,484,752	2,288,218	23,137,412
1993	15,848,119	2,063,124	1,901,505	1,467,567	2,272,407	23,552,722
1994	16,153,871	2,318,614	2,023,754	1,493,963	2,242,324	24,232,526
1995	16,423,872	2,321,048	2,153,119	1,580,900	2,219,244	24,698,183
1996	16,955,023	2,326,954	2,304,416	1,654,256	2,188,025	25,428,674
1997	17,176,486	2,257,829	2,452,254	1,758,627	2,160,954	25,806,150
1998	17,398,440	2,260,757	2,588,081	1,855,348	2,091,845	26,194,471

Source: Internal Revenue Service, Statistics of Income, published and unpublished data

Table 2 reports the rate of growth in the number of different types of business entities. The growth rate of all entities was greater for the period 1978 to 1988 than for the period 1988 to 1998. The number of farm returns generally declined through the 20-year period. While the relative share of nonfarm sole proprietorships increased after 1986, the growth rate in their numbers did not rise from that of earlier periods and has in fact slowed in the 1990s. The increase in the relative share of nonfarm sole proprietorships is an artifact of the decline in the absolute number of partnerships and C corporations following the Tax Reform Act of 1986. The number of each of those forms has declined in each year from 1987 through 1993. At the same time, the number of S corporations increased threefold between 1986 and 1998. The growth in the number of S corporations was most dramatic immediately following 1986; in the past few years, growth rates have returned to the range of pre-1986 growth rates. The number of S corporations also grew rapidly following the Subchapter S Revision Act of 1982.[20]

Table 2.--Average Annual Rate of Growth in Business Entities (percent)

Business	1978-1988	1988-1998	1978-1998
Nonfarm sole proprietorship	4.4	2.4	3.4
C corporation	4.1	-4.4	0.9
S corporation	10.1	7.5	8.8
Partnerships	3.0	1.2	2.1
Farms (Schedule F)	-1.3	-1.2	-1.3
Total	3.7	1.5	2.8

Source: Joint Committee on Taxation staff calculations

[20] For details on the changes in S corporation law over the 1980's, see Part II.C. of Joint Committee on Taxation, *Present Law and Proposals Relating to Subchapter S Corporations and Home Office Deductions* (JCS-16-95), May 24, 1995. For a description of the changes made in S corporation law part of the Small Business Job Protection Act of 1996 see, Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress* (JCS-12-96), December 18, 1996.

As a consequence of the changing rates of growth of different forms of business entities, the distribution of different types of business has changed since 1978, with sole proprietorships and S corporations growing in relative shares of business entities and farms and C corporations declining in relative shares. Figures 2, 3, and 4, below, display the percentage distribution of different types of business returns for 1978, 1988, and 1998.

Figure 2.–Percentage Distribution of Different Types of Buisness Returns, 1978

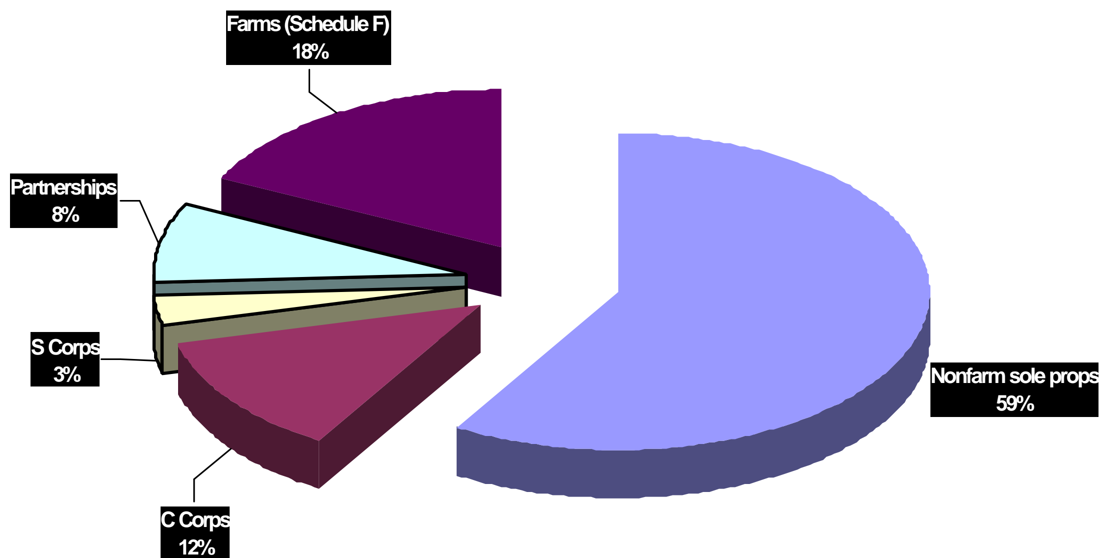


Figure 3.--Percentage Distribution of Different Types of Business Returns, 1988

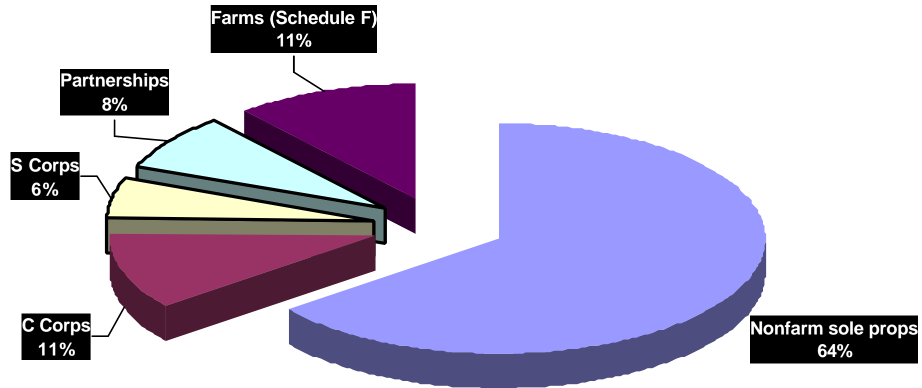
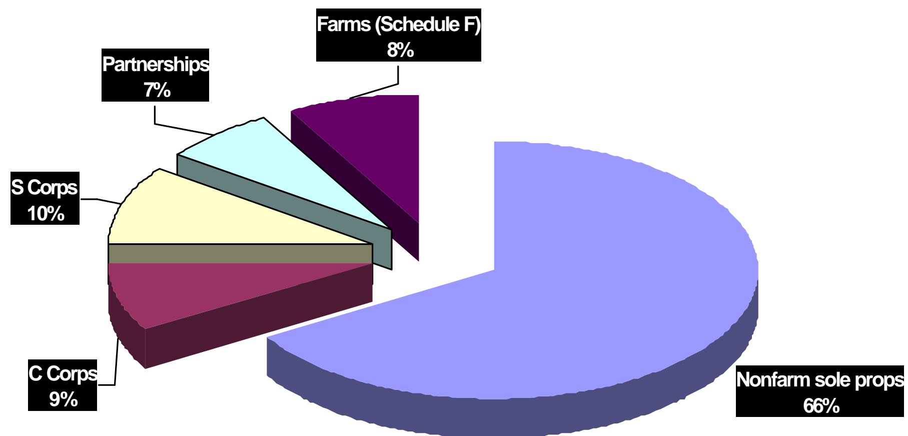


Figure 4.–Percentage Distribution of Different Types of Business Returns, 1998



The use of the limited liability company ("LLC") as an entity is a development of the past several years. Most LLCs filed the partnership reporting form for Federal reporting purposes and their numbers, assets, and gross receipts are counted among the partnership data reported in Tables 1 and 2 and Figures 1-4 above. Table 3 and Figure 5, below, decompose the number of partnerships for the period 1990 through 1998 into general partnerships, limited partnerships, and LLCs.[21] Figure 5 documents the rapid growth of LLCs relative to other partnership forms over the past several years.

Table 3.--Number of Partnership Returns by Type, 1990-1998

	Type of Partnership		
Year	**General Partnerships** (thousands)	**Limited Partnerships** (thousands)	**Limited Liability Companies** (thousands)
1990…………………	1,267	285	n.a.
1991…………………	1,245	271	n.a.
1992…………………	1,214	271	n.a.
1993…………………	1,176	275	17
1994…………………	1,163	283	48
1995…………………	1,167	295	119
1996…………………	1,116	311	221
1997…………………	1,069	329	349
1998…………………	945	343	470

n.a. - not available.
Source: Alan Zempel, "Partnership Returns, 1998," *SOI Bulletin*, 20, Fall 2000.

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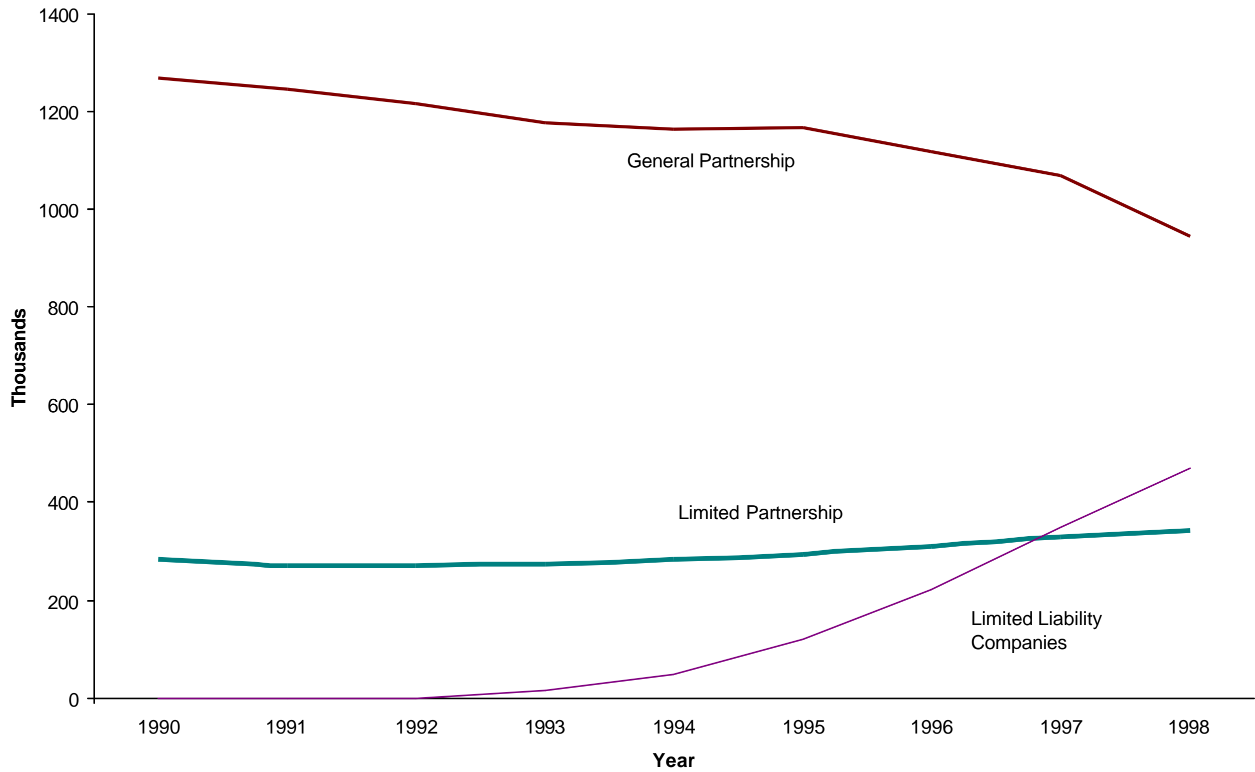
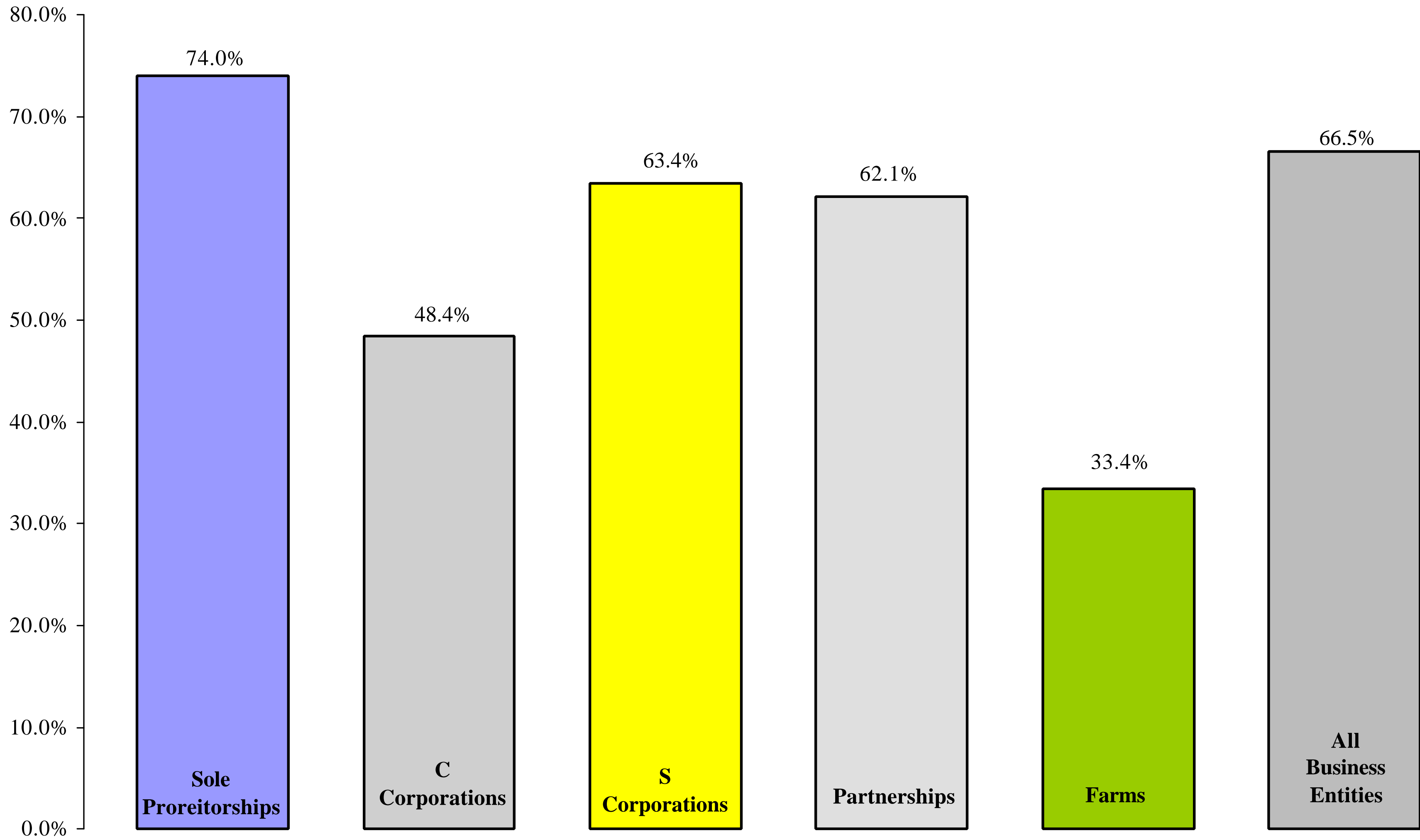
[21] The data in Table 3 may not sum to the total number of partnerships reported in Table 1 because of rounding. Also, for 1998, the IRS has excluded from this decomposition those businesses that checked either the "limited liability partnership" box or the "other" box on Form 1065, Schedule B, line 1. See, Alan Zempel, "Partnership Returns, 1998," *SOI Bulletin*, 20, Fall 2000.

Figure 5.--Partnership Returns by Type of Partnership, 1990-1998



It is important to recognize that in any given year a substantial number of business enterprises report a loss. Figure 6, below, reports for 1997 the percentage of businesses by type of entity that reported net income.

Figure 6.--Percentage of Businesses with Net Income, 1997



Source: IRS Statistics of Income data Appendix Table A-1.

While one may often associate small businesses with organization in the form of a sole proprietorship, a partnership, or an S corporation, there is not an ironclad correspondence between the size of the business and the form of organization. While many small businesses are arranged as a sole proprietorship, a partnership, or an S corporation, not all businesses organized in those forms are small and not all businesses organized as C corporations are large. One can use SOI data on assets and gross receipts to measure the size of businesses in order to sort out how small businesses are arrayed across the different forms of organization.

Tables 4 through 7 display 1998 SOI data on C corporations, S corporations, partnerships, and nonfarm sole proprietorships. For the first three forms of organization, the tables classify all taxpayers using that form of organization both by the size of assets and gross receipts. For sole proprietorships (Table 7), there is no tax data on assets, so the table uses only gross receipts as a classifier. When businesses are classified by asset size, one can see that there are a significant number of C corporations of small size. More than 900,000 corporations have assets under $50,000, approximately 40 percent of the total number of C corporations. For both S corporations and partnerships, approximately one half have assets under $50,000.

The concentration of assets differs among the three forms. C corporations have the largest disparity in asset holding. Firms with over $100 million in assets, which represent three-quarters of one percent of all C corporations, hold 96 percent of the assets in C corporations. By comparison, a nearly similar share of partnership returns (those with assets over $50 million) holds just under 68 percent of the assets in partnerships and a similar share of S corporation returns (those with assets over $10 million) hold 45 percent of S corporations assets.

When businesses are classified by gross receipts, a picture emerges that is similar to that seen in the asset data. There are a substantial number of quite small C corporations (more than 400,000 corporations with gross receipts less than $25,000, nearly 18 percent of the number of C corporations). But across the other forms of organization there are higher percentages of businesses with small amounts of gross receipts. For nonfarm sole proprietorships, two thirds have gross receipts under $25,000, while for partnerships there are 36 percent, and for S corporations there are 21 percent.

As with assets, the dispersion of gross receipts across the classifrications is more skewed for C corporations and partnerships than for S corporations. C corporations with over $50 million in gross receipts, which represent approximately three quarters of one percent of all C corporations, collect over 80 percent of gross receipts of all C corporations. For partnerships, approximately the one percent of partnership returns with gross receipts in excess of $10 million report nearly 70 percent of all partnership gross receipts. On the other hand, the two percent of S corporation returns reporting gross receipts in excess of $10 million account for 55 percent of all S corporation gross receipts. For nonfarm sole proprietorships, the 1.5 percent of returns reporting gross receipts in excess of $500,000 account for one third of all nonfarm sole proprietorship gross receipts.

Table 4.--Distribution of C Corporations, 1998

Firms classified by assets less than	Number of returns	Total assets (millions)	Cumulative percent: Returns	Cumulative percent: Total Assets
$0	0	0	0.00%	0.00%
$25,000	665,363	4,786	29.43%	0.01%
$50,000	247,999	9,082	40.40%	0.04%
$100,000	279,177	20,083	52.75%	0.09%
$250,000	380,371	62,174	69.57%	0.27%
$500,000	244,581	86,657	80.39%	0.51%
$1,000,000	174,352	122,695	88.10%	0.85%
$10,000,000	215,263	587,502	97.63%	2.49%
$50,000,000	29,379	647,379	98.92%	4.29%
$100,000,000	7,396	526,262	99.25%	5.76%
Over $100,000,000	16,882	33,825,312	100.00%	100.00%
Total	2,260,797	35,891,796		

Firms classified by assets less than	Number of returns	Gross receipts (millions)	Cumulative percent: Returns	Cumulative percent: Gross receipts
$0	94,123	0	4.16%	0.00%
$2,500	90,382	79	8.16%	0.00%
$5,000	40,559	148	9.96%	0.00%
$10,000	60,124	447	12.61%	0.00%
$25,000	121,346	2,057	17.98%	0.02%
$50,000	142,881	5,282	24.30%	0.06%
$100,000	208,289	15,415	33.52%	0.16%
$250,000	373,163	61,955	50.02%	0.60%
$500,000	326,090	117,626	64.45%	1.42%
$1,000,000	287,600	204,290	77.17%	2.86%
$10,000,000	443,074	1,255,010	96.77%	11.65%
$50,000,000	55,768	1,127,372	99.23%	19.56%
Over $50,000,000	17,355	11,474,079	100.00%	100.00%
Total	2,260,757	14,263,763		

Source: JCT calculation from Statistics of Income data.

Table 5.--Distribution of S Corporations, 1998

Firms classified by assets less than	All returns			
			Cumulative percent	
	Number of returns	Total assets (millions)	Returns	Total Assets
$0	0	0	0.00%	0.00%
$25,000	1,001,604	7,367	38.70%	0.51%
$50,000	299,276	10,895	50.26%	1.25%
$100,000	320,240	23,006	62.64%	2.84%
$250,000	396,195	64,242	77.95%	7.25%
$500,000	218,852	77,157	86.40%	12.55%
$1,000,000	148,379	104,176	92.14%	19.71%
$10,000,000	184,549	507,382	99.27%	54.57%
$50,000,000	16,551	314,283	99.91%	76.16%
$100,000,000	1,456	100,563	99.96%	83.07%
Over $100,000,000	981	246,412	100.00%	100.00%
Total	2,588,084	1,455,484		

Firms classified by assets less than	All returns			
			Cumulative percent	
	Number of returns	Gross receipts (millions)	Returns	Gross receipts
$0	145,434	0	5.62%	0.00%
$2,500	105,342	103	9.69%	0.00%
$5,000	53,762	197	11.77%	0.01%
$10,000	75,309	550	14.68%	0.03%
$25,000	164,823	2,832	21.05%	0.12%
$50,000	193,838	7,278	28.53%	0.35%
$100,000	296,237	21,753	39.98%	1.04%
$250,000	516,610	84,918	59.94%	3.74%
$500,000	347,309	122,019	73.36%	7.61%
$1,000,000	288,333	201,470	84.50%	14.02%
$10,000,000	349,083	966,513	97.99%	44.73%
$50,000,000	45,033	915,396	99.73%	73.81%
Over $50,000,000	6,968	824,250	100.00%	100.00%
Total	2,588,081	3,147,278		

Source: JCT calculation from Statistics of Income data.

Table 6.--Distribution of Partnerships, 1998

Firms classified by assets less than	All returns			
			Cumulative percent	
	Number of returns	Total assets (millions)	Returns	Total Assets
$0	581,788	0	31.36%	0.00%
$25,000	212,577	1,857	42.81%	0.04%
$50,000	92,560	3,374	47.80%	0.10%
$100,000	122,319	9,007	54.40%	0.28%
$250,000	210,660	34,307	65.75%	0.94%
$500,000	162,055	59,030	74.49%	2.08%
$1,000,000	162,868	115,883	83.26%	4.32%
$10,000,000	266,082	769,048	97.60%	19.20%
$50,000,000	34,319	691,157	99.45%	32.57%
$100,000,000	4,723	328,395	99.71%	38.93%
Over $100,000,000	5,399	3,156,571	100.00%	100.00%
Total	1,855,348	5,168,628		

Firms classified by assets less than	All returns			
			Cumulative percent	
	Number of returns	Gross receipts (millions)	Returns	Gross receipts
$0	169,561	0	9.14%	0.00%
$2,500	169,840	128	18.29%	0.01%
$5,000	62,614	237	21.67%	0.02%
$10,000	95,524	708	26.82%	0.05%
$25,000	184,234	3,095	36.75%	0.21%
$50,000	200,121	7,322	47.53%	0.58%
$100,000	223,534	16,176	59.58%	1.40%
$250,000	293,988	47,672	75.43%	3.82%
$500,000	171,998	60,423	84.70%	6.88%
$1,000,000	121,315	85,362	91.24%	11.21%
$10,000,000	142,390	381,165	98.91%	30.53%
$50,000,000	15,884	329,091	99.77%	47.21%
Over $50,000,000	4,345	1,041,400	100.00%	100.00%
Total	1,855,348	1,972,782		

Source: JCT calculation from Statistics of Income data.

Table 7.--Distribution of Nonfarm Sole Proprietorships, 1998

	All returns			
			Cumulative percent	
Firms classified by assets less than	Number of returns	Gross receipts (millions)	Returns	Gross receipts
$0	481,950	0	2.77%	0.00%
$2,500	3,796,610	4,422	24.59%	0.48%
$5,000	2,052,015	7,525	36.39%	1.30%
$10,000	2,404,495	17,639	50.21%	3.22%
$25,000	3,035,564	49,644	67.65%	8.64%
$50,000	2,111,469	75,435	79.79%	16.86%
$100,000	1,584,188	112,558	88.89%	29.12%
$250,000	1,227,428	189,890	95.95%	49.82%
$500,000	451,608	154,345	98.55%	66.64%
$1,000,000	175,063	118,354	99.55%	79.54%
$10,000,000	76,807	145,831	99.99%	95.43%
$50,000,000	1,141	20,747	100.00%	97.70%
Over $50,000,000	101	21,139	100.00%	100.00%
Total	17,398,440	917,529		

Source: JCT calculation from Statistics of Income data.

An alternative way of characterizing business size is by the number of employees. The Small Business Administration ("SBA") utilizes Department of Labor employment data to classify business entities by size. The SBA defines a firm as a small business if it employs fewer than 500 employees. Tables 8 and 9 below present data compiled by the SBA from surveys in 1996 by the Bureau of the Census. The SBA estimates that in 1996 there were approximately 5.5 million firms in the United States employing 102 million persons.[22] The SBA estimates that more than 99 percent of the firms in the United States are small business and that these small businesses employ 52 percent of the individuals employed in the private sector. Thus, oppositely, a relatively small number of businesses (the large businesses) employ a large percentage of the private sector workforce. This finding is consistent with the data reported in Tables 4 through 7 that show that a large percentage of assets are held (gross receipts are received) by a relatively small number of businesses characterized by a high level of gross assets (gross receipts).

The majority of small business and the majority of small business employment are in the retail trade and service sectors. In 1996, these two sectors accounted for 59.8 percent of the small businesses in the United States and 58.0 percent of the small business employment. Table 8 below presents the percentage distribution of small business firms and the percentage

[22] U.S. Small Business Administration, *The State of Small Business: A Report of the President*, 1998, Table A.5.

distribution of small business employment across various sectors of the United States's economy for 1996.

Table 8. --Percentage Distribution of Small Business Firms and Employment by Sector, 1996

	Percent of all small business firms	Percent of all small business employees
Agriculture services, forestry and fishing………………	2.0	1.1
Mining………………………………………....	0.4	0.4
Construction…………………………………...	11.9	8.8
Manufacturing………………………………....	6.0	13.4
Transportation, communication and public utilities……………………………………	4.0	4.1
Wholesale trade……………………………….	7.6	8.3
Retail trade…………………………………....	20.1	20.7
Finance, insurance, and real estate…………….	8.2	5.8
Services……………………………………..	39.7	37.3
Other…………………………………………..	0.5	0.1

Source: U.S. Small Business Administration, *The State of Small Business: A Report of the President*, 1998, Table A. 5.

Table 9 reports within each sector the percentage distribution of firms and employment distributed by firm size. These data show the majority of employment is provided by small businesses in the agriculture; construction, communication, and public utility; wholesale trade; retail trade; and service sectors. Large firms provide the majority of employment in the mining, manufacturing; transportation, communication, and public utility sectors. In every sector except agriculture and construction firms, employing 100 or more employees provide a majority of the employment.

The data in Tables 8 and 9 are not comparable to the tax return data reported previously. These data are drawn from employment reports for the week of March 12, 1996. They do not include any farming enterprises. They do not include any enterprise that routinely has no employees. Hence, the majority of nonfarm sole proprietorships are not included. Similarly, partnerships with no employees would not be included. Table 9 does, however, report a significant number of firms with no employees. These data may arise from firms for which employment is seasonal, firms that are in the process of starting business operations, or firms that are in the process of ceasing business operations.

Table 9.--Percentage Distribution of Number of Firms and Employment by Size of Firm and Industry, 1996

Industry	Total	Percentage Distribution by Firm Size				
		Employing 0	Employing 1-19	Employing 20-99	Employing 100-499	Employing 500 or more
Agriculture Services, Forestry, and Fishing						
Firms	111,513	22.4%	95.3%	4.2%	0.3%	0.1%
Employees	664,356	0.0%	56.4%	23.9%	8.1%	11.7%
Mining						
Firms	21,102	11.4%	84.5%	11.0%	2.6%	1.8%
Employees	574,328	0.0%	12.7%	15.0%	13.6%	58.7%
Construction						
Firms	651,915	16.4%	92.3%	6.9%	0.7%	0.1%
Employees	5,207,460	0.0%	43.5%	31.6%	14.4%	10.5%
Manufacturing						
Firms	332,565	8.7%	73.4%	20.2%	5.0%	1.5%
Employees	18,558,485	0.0%	7.3%	15.0%	16.2%	61.5%
Transportation, Communication, and Public Utilities						
Firms	217,710	14.3%	87.9%	9.6%	1.8%	0.8%
Employees	6,057,265	0.0%	13.4%	13.2%	10.5%	64.0%
Wholesale Trade						
Firms	416,958	10.4%	85.9%	11.3%	2.0%	0.8%
Employees	6,664,886	0.0%	24.6%	25.7%	15.7%	43.1%
Retail trade						
Firms	1,103,549	12.5%	88.0%	10.5%	1.2%	0.3%
Employees	21,487,341	0.0%	20.6%	20.3%	10.3%	48.8%
Finance, Insurance, and Real Estate						
Firms	453,319	12.8%	90.8%	7.3%	1.5%	0.7%
Employee	7,185,291	0.0%	21.4%	17.2%	16.9%	57.3%
Service						
Firms	2,175,597	12.3%	90.8%	7.3%	1.5%	0.4%
Employee	35,747,905	0.0%	21.4%	17.2%	16.9%	44.5%
Other						
Firms	29,013	57.0%	99.3%	0.7%	0.0%	0.0%
Employee	39,980	0.0%	85.0%	15.0%	0.0%	0.0%

Source: U.S. Small Business Administration, *The State of Small Business: A Report of the President, 1998*, Table A-5.

III. SELECTED PROVISIONS THAT AFFECT SMALL BUSINESS AND AGRICULTURE

The previous discussion on the tax rate structure and choice of entity highlights two fundamental aspects of the tax laws that affect businesses (regardless of size) in all sectors of the economy. Small businesses and farmers are particularly sensitive to these considerations. The tax laws also include provisions that are more specifically targeted to small business and farmers. In some instances, the provisions are designed to provide additional economic incentives; in other cases, they are designed to alleviate some of the complicated aspects of business taxation. The discussion below focuses on selected areas of the tax laws where special rules are provided for small business and agriculture.

A. Expensing Depreciable Business Assets

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through allowances for depreciation or amortization. Tangible property generally is depreciated under a modified Accelerated Cost Recovery System, which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property (sec. 168).

To relieve some taxpayers of the requirement to calculate depreciation, section 179 permits taxpayers with a sufficiently small amount of annual investment to elect to expense and deduct up to $24,000 (in 2001) of the cost of qualifying property placed in service for the taxable year. 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. The $24,000 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. In addition, the amount eligible to be expensed for a taxable year may not exceed the taxable income of the taxpayer for the 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). In the case of a partnership (or S corporation), the $24,000, $200,000, and taxable income limitations are applied at the partnership (or corporate) and partner (or shareholder) levels.

B. Accounting Methods

1. In general

A taxpayer must compute its taxable income under a method of accounting on the basis of which the taxpayer regularly keeps its books so long as, in the opinion of the Secretary of the Treasury, such method clearly reflects the taxpayer's income (sec. 446). Among the permissible methods of accounting are the cash receipts and disbursement method ("cash method"), an accrual method, any other method permitted or required under the Code, or any hybrid method allowed under regulations. A taxpayer may change its method of accounting with the consent of the Secretary.

Special statutory rules allow farmers and small businesses to use accounting methods that are unavailable to larger taxpayers. Many of these rules are designed to alleviate the tax accounting burdens of small businesses, while other rules are designed to provide a tax incentive. Some of these special rules are described below.

2. Cash and accrual methods

Under the cash method of accounting, income is recognized and deductions are allowed when the taxpayer receives or remits cash or cash equivalents. The cash method is administratively easy and provides the taxpayer flexibility in the timing of income. It is the method generally used by most individual taxpayers.

Under an accrual method of accounting, income generally is recognized in the year in which all the events have occurred that establish the taxpayer's right to receive the income and the amount of the income can be determined with reasonable accuracy. A deduction is allowed for an expense in the year in which (i) all events have occurred that establish the liability of the taxpayer for the expense, (ii) the amount of the liability can be determined with reasonable accuracy, and (iii) economic performance has occurred with respect to the item of expense. Accrual methods of accounting generally result in a more accurate measure of economic income than does the cash method and conform to generally accepted accounting principles. The accrual method is used by most businesses for financial accounting purposes.

In general, a taxpayer must use an accrual method of accounting for Federal income tax purposes when the production, purchase, or sale of merchandise is an income-producing factor in the taxpayer's business. However, the IRS has provided that, as a matter of administrative convenience, a qualifying taxpayer with average annual gross receipts of $1 million or less will be permitted to use the cash method of accounting and will not be required to use an accrual method of accounting for purchases and sales of merchandise.[23]

Additionally, a taxpayer must use an accrual method of accounting for Federal income tax purposes if the taxpayer's average annual gross receipts for all prior taxable years exceed $5 million (sec. 448). Individuals, partnerships (other than partnerships having a C corporation as a partner), farming businesses, S corporations, and "qualified personal service corporations" are exempt from the required use of an accrual method.

Special rules are provided for corporations engaged in farming. A corporation (or a partnership with a corporate partner) engaged in the trade or business of farming must use an accrual method of accounting for such activities unless such corporation (or partnership), for each prior taxable year beginning after December 31, 1975, did not have gross receipts exceeding $1 million. A family corporation (or a partnership with a family corporation as a partner) must use an accrual method of accounting for its farming business unless, for each prior taxable year beginning after December 31, 1985, such corporation did not have gross receipts

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[23] Rev. Proc. 2001-10, 2001-2 I.R.B. 272, modifying Rev. Proc. 2000-22, 2000-20, I.R.B. 1008.

exceeding $25 million. A family corporation is defined as a corporation in which at least 50 percent of the stock of the corporation is held by one family (or in some limited cases, two or three families.)

3. Uniform capitalization of inventory costs

A taxpayer that sells goods in the active conduct of its trade or business generally must maintain inventory records in order to determine the cost of goods it sold during the taxable period. The cost of goods sold generally is determined by adding the taxpayer's inventory at the beginning of the period to purchases made during the period and subtracting from that sum the taxpayer's inventory at the end of the period.

In general, the uniform cost capitalization rules (sec. 263A) require taxpayers that are engaged in the production of real or tangible personal property or in the purchase and holding of property for resale to capitalize or include in inventory the direct costs of the property and the indirect costs that are allocable to the property. Direct costs generally are the costs directly associated with the production of a good; i.e., the materials and labor applied in the production of the cost. Indirect costs are costs associated with functions removed from the direct production of the good; e.g., overhead and administrative costs. In determining whether indirect costs are allocable to production or resale activities, taxpayers are allowed to use various methods so long as the method employed reasonably allocates indirect costs to production and resale activities.

However, the uniform capitalization rules do not apply to property acquired by a taxpayer during the taxable year for resale if the average annual gross receipts of the taxpayer for each of the preceding three taxable years did not exceed $10,000,000. Similarly, the uniform capitalization rules do not apply to taxpayers in certain farming businesses (unless the taxpayer is required to use an accrual method of accounting under sec. 447 or 448(a)(3)).[24]

The special rules discussed above highlight congressional and administrative efforts to alleviate the burdens of complying with the tax code for small business and agriculture. The following discussion summarizes legislative proposals that would affect small business and agriculture.

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[24] Sec. 263A(d).

IV. SUMMARY OF SELECTED PROPOSALS RELATING TO SMALL BUSINESS

A. Taxpayer Relief Act of 2000

The conference report to H.R. 5542, the Taxpayer Relief Act of 2000, which was incorporated by reference in the conference agreement for H.R. 2614, the Certified Development Company Program Improvements Act of 2000, included the following proposals that would affect the tax treatment of small businesses:

1. Increase in expensing of depreciable business assets

Present law provides that, in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $24,000 (for taxable years beginning in 2001)[25] of the cost of qualifying property placed in service for the taxable year (sec. 179). 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. The $20,000 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 proposal would increase the maximum dollar amount that may be deducted under section 179 from $24,000 to $35,000.

2. Increase deduction for business meals

Ordinary and necessary business expenses, as well as expenses incurred for the production of income, are generally deductible, subject to a number of restrictions and limitations (secs. 162 and 212). No deduction generally is allowed for personal, living, or family expenses (sec. 262). Meal and entertainment expenses incurred for business reasons or for the production of income are deductible if certain legal and substantiation requirements are met. Generally, the amount allowable as a deduction for business meal and entertainment expenses is limited to 50 percent of the otherwise deductible amount (sec. 274(n)). Exceptions to this 50-percent rule are provided for food and beverages provided to crew members of certain vessels and off-shore oil or gas platforms or drilling rigs, as well as to individuals subject to the hours of service limitations of the Department of Transportation.

An expense for food or beverages is not deductible unless the taxpayer establishes that the item was directly related to the "active conduct" of the taxpayer's trade or business or, in the case of an item directly preceding or following a substantial and bona fide business discussion, that the item was "associated with" the active conduct of the taxpayer's trade or business (sec. 274(a)(1)(A)). Accordingly, a business meal expense generally is not deductible unless there is a substantial and bona fide business discussion during, directly preceding, or directly following the meal. Also, the taxpayer or an employee of the taxpayer must be present at the meal (sec. 274(k)(1)(B)).

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[25] The amount is increased to $25,000 for taxable years beginning in 2003 and thereafter.

The proposal would increase the business meals deduction from the present-law 50 percent to 70 percent.

3. Increased deduction for business meals while operating under Department of Transportation hours of service limitation

The Taxpayer Relief Act of 1997 increased to 80 percent the deductible percentage of the cost of food and beverages consumed while away from home by an individual during, or incident to, a period of duty subject to the hours of service limitations of the Department of Transportation. Individuals subject to the hours of service limitations of the Department of Transportation include:

(1) certain air transportation employees such as pilots, crew, dispatchers, mechanics, and control tower operators pursuant to Federal Aviation Administration regulations,

(2) interstate truck operators and interstate bus drivers pursuant to Department of Transportation regulations,

(3) certain railroad employees such as engineers, conductors, train crews, dispatchers and control operations personnel pursuant to Federal Railroad Administration regulations, and

(4) certain merchant mariners pursuant to Coast Guard regulations.

The increase in the deductible percentage is phased in according to the following schedule:

Taxable years beginning in:	**Deductible percentage:**
1998, 1999	55 percent
2000, 2001	60 percent
2002, 2003	65 percent
2004, 2005	70 percent
2006, 2007	75 percent
2008 and thereafter	80 percent

The proposal would accelerate the increase in the deduction for business meals while operating under Department of Transportation hours of service limitations so that it becomes 80 percent sooner.

4. Repeal special occupational taxes on producers and marketers of alcoholic beverages

Under present law, special occupational taxes are imposed on producers and others engaged in the marketing of distilled spirits, wine, and beer. These excise taxes are imposed as part of a broader Federal tax and regulatory engine governing the production and marketing of alcoholic beverages. The special occupational taxes are payable annually, on July 1 of each year.

The present tax rates are as follows:

Producers:	
Distilled spirits and wines (sec. 5081)	$1,000 per year, per premise
Brewers (sec. 5091)	$1,000 per year, per premise
Wholesale dealers (sec. 5111):	
Liquors, wines, or beer	$500 per year per location
Retail dealers (sec. 5121):	
Liquors, wines, or beer	$250 per year per location
Nonbeverage use of distilled spirits (sec. 5131)	$500 per year
Industrial use of distilled spirits (sec. 5276)	$250 per year

The proposal would repeal the special occupational taxes on producers and marketers of alcoholic beverages.

5. Clarification of cash accounting rules for small businesses

The proposal would provide that a taxpayer is not required to use an accrual method of accounting if the average annual gross receipts[26] of the taxpayer (or any predecessor) do not exceed $2.5 million for all prior taxable years beginning after October 31, 1999 (including the prior taxable years of any predecessor).[27] Thus, even if the production, purchase, or sale of merchandise is an income-producing factor in the taxpayer's business, the taxpayer is not required to use an accrual method of accounting with regard to such purchases and sales if the average annual gross receipts of the taxpayer do not exceed $2.5 million.

The proposal would also provide that a taxpayer meeting the average annual gross receipts test is not required to account for inventories under section 471. If a taxpayer elects not to account for inventory under section 471, the taxpayer would be required to treat such inventory in the same manner as a material or supply that is not incidental. Thus, a taxpayer that elects to treat inventory as a material or supply would include in expense the charges for materials and supplies only in the amount that they are actually consumed and used in operation during the taxable year for which the return is made. If a taxpayer elects this treatment, direct

[26] Average annual gross receipts would be determined by averaging the gross receipts of the three taxable year period ending with such prior taxable year.

[27] Similar proposals have been introduced in the 107th Congress, but permitting the use of the cash method of accounting if the average annual gross receipts of the taxpayer does not exceed $5 million. See, S. 189 introduced by Senator Bond for himself and Senator Enzi, and S. 336 introduced by Senator Bond.

and indirect labor costs, production costs, and other costs that would normally be required to be capitalized under either section 471 or section 263A would not be required to be capitalized.

B. Proposals Relating to S Corporations

The following is a description of selected proposals introduced in the 106th Congress[28] that would affect the tax treatment of S corporations and their shareholders.

1. Shareholder and corporate eligibility

(a) Number of eligible shareholders

Under present law, a small business corporation may elect to be treated as an S corporation. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which does not have (1) more than 75-shareholders; (2) as a shareholder, a person (other than certain trusts, estates, charities, or ESOPs) who is not an individual; (3) a nonresident alien as a shareholder; and (4) more than one class of stock. For purposes of the 75-shareholder limitation, a husband and wife are treated as one shareholder. An "ineligible corporation" means any corporation which is a member of an affiliated group, certain financial institutions which use the reserve method of accounting for bad debts, certain insurance companies, a section 936 corporation, or a DISC or former DISC.

S. 1415 would provide that all family members owning stock could elect to be treated as one shareholder. A family would be defined as the lineal descendants of a common ancestor (and their spouses and former spouses). The common ancestor could not be more than six generations removed from the youngest generation of shareholder at the time the S election is made (or the effective date of the provision, if later). The election would be made available to only one family per corporation.

S. 875 would provide that the maximum number of eligible shareholders would be increased from 75 to 150.

(b) Individual Retirement Arrangements ("IRAs") allowed as shareholders

S. 875 would permit IRAs to be shareholders in small business corporations. In addition, an IRA could sell stock to the individual beneficiary pursuant to an election by the corporation to be an S corporation.

(c) Nonresident aliens allowed as shareholders

S. 1415 would permit a nonresident alien to be a shareholder in a small business corporation. Any effectively connected U.S. income allocable to the nonresident alien would be

[28] S. 1415 was introduced by Senator Hatch, and S. 875 was introduced by Senator Allard and others.

subject to a withholding tax in a manner similar to the treatment of such income allocable to nonresident aliens that are partners in U.S. partnerships under present law.

(d) Family partnerships allowed as shareholders

S. 875 would provide that partnerships all of whose members are of one family could hold stock in an S corporation.

(e) Requirement that an S corporation have one class of stock

Under present law, a small business corporation eligible to be an S corporation may not have more than one class of stock. Certain debt ("straight debt") is not treated as a second class of stock so long as such debt is an unconditional promise to pay on demand or on a specified date a sum certain in money if: (1) the interest rate (and interest payment dates) are not contingent on profits, the borrower's discretion, or similar factors; (2) there is no convertibility (directly or indirectly) into stock, and (3) the creditor is an individual (other than a nonresident alien), an estate, certain qualified trusts or person engaged in the lending business.

Under both S. 875 and S. 1415, a small business corporation would be permitted to issue certain preferred stock. In general, such preferred stock would be stock that is not convertible and does not participate in corporate growth to any significant extent. Only eligible S corporation shareholders would be allowed to own preferred stock. Payments made on the preferred stock would be treated as interest.

Under S. 1415, the definition of "straight debt" would be expanded to include debt that is convertible into the stock of the corporation under terms that are substantially the same as the terms that could have been obtained from an unrelated person.

Under S. 875, shares held by reason of being a bank director and which are subject to an agreement pursuant to which the holder is required to dispose of the shares upon termination of the holder’s status as a director at the same price the individual acquired such shares would be eligible stock of an S corporation. Distributions would be treated like interest payments.

2. Elections and terminations

(a) Election to be an S corporation

Under present law, a corporation may elect to be an S corporation only if all the shareholders consent to such election.

S. 875 would provide that an election could be made if shareholders holding 90 percent or more of the stock consent. The portion of the corporation represented by shares that did not consent would continue to be taxed as a C corporation.

(b) Termination of election and additions to tax due to passive investment income

Under present law, an S corporation is subject to corporate-level tax, at the highest marginal corporate tax rate, on its net passive income if the corporation has (1) subchapter C earnings and profits at the close of the taxable year and (2) gross receipts more than 25 percent of which are passive investment income. In addition, an S corporation election is terminated whenever the corporation has subchapter C earnings and profits at the close of three consecutive taxable years and has gross receipts for each of such years more than 25 percent of which are passive investment income. For these purposes, "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).

S. 1415 would repeal capital gain as a category of passive income. S. 1415 also would eliminate the rule that terminates an S corporation election whenever the corporation has excessive passive income for three consecutive years. Rather, the tax on excess passive income would apply.

S. 875 would provide that, in the case of a bank, passive income does not include interest or dividends on assets required to be held by the bank.[29]

3. Computation of taxable income

(a) Treatment of charitable contributions of certain property

Under present law, taxpayers generally are allowed to deduct the fair market value of property contributed to a charitable organization. In the case of business property contributed to a charity and used in the tax-exempt function of the charity, donors must reduce the amount of the deduction by the amount of gain that would not have been long-term capital gain had the property been sold by the donor (sec. 170(e)(1)(A)). However, the amount of the reduction is capped in the case of a corporation (other than an S corporation) that contributes (1) certain inventory used by the donee solely for the care of the ill, needy, or infants (sec. 170(e)(3)(B)) or (2) certain scientific property used for research (sec. 170(e)(4)). In such cases, the amount of the reduction is limited to the sum of (1) one-half of the amount of gain that would not have been long-term capital gain had the property been sold and (2) the amount (if any) by which the charitable contribution (determined by taking into account the amount described in (1)) exceeds twice the basis of the property.

If an S corporation contributes appreciated property to a charity, the shareholders of the corporation must reduce their basis in their S corporation stock by the amount of the contribution that flows through to them.

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[29] This proposal is in response to competing concerns of the passive investment income limitations and bank regulations regarding adequate capital requirements. Bank regulators want to ensure that banks have sufficient liquidity for safety and soundness reasons. Report by the General Accounting Office, Banking Taxation, *Implications of Proposed Revisions Governing S-Corporations on Community Banks (GAO/GGD-00-159),* at Appendix V, (June 23, 2000).

S. 1415 would provide that S corporations would be treated the same as C corporations with respect to charitable contributions of (1) certain inventory used by the donee solely for the care of the ill, needy, or infants and (2) certain scientific property used for research.

S. 1415 also would allow an increase in the basis of S corporation stock for the excess of the deduction for charitable contribution over the basis of the property contributed by the corporation.

(b) Treatment of certain fringe benefits

Under present law, for fringe benefit purposes, an individual that owns two percent or more of the stock of the S corporation at any time during the year is treated the same as a partner in a partnership. Self-employed individuals may deduct up to 60 percent (70 percent in taxable years beginning in 2002; 100 percent thereafter) of the amount paid during the year for medical insurance that covers the individual and his or her spouse and dependents. An individual that owns two percent or more of an S corporation at any time during the year is treated as a self-employed individual.

Under S. 875 and S. 1415, for fringe benefit purposes, an S corporation would be treated as a C corporation rather than as a partnership. However, two-percent shareholders would be treated as self-employed individuals for purposes of the deduction for medical insurance (i.e., their deductions for medical insurance would be limited to the applicable percent of their cost).

(c) Treatment of losses on liquidation of S corporation

Under present law, if an S corporation is liquidated, gain or loss on the property distributed in liquidation is measured at the corporate level (by comparing the fair market value of the property to its adjusted basis in the hands of the corporation) and flowed through to the shareholders. The character of such gain or loss also is determined at the corporate level and may flow through to shareholders as ordinary gain or loss. The gain increases the shareholders' adjusted bases in their stock. The shareholders then have gain or loss with respect to the property received (measured by comparing the fair market value of the property to the shareholders' adjusted bases in their stock). Such gain or loss generally is capital gain or loss.

Under S. 1415, loss recognized by a shareholder in complete liquidation of an S corporation would be treated as ordinary loss to the extent the shareholder's adjusted basis in the S corporation stock is attributable to ordinary income that was recognized as a result of the liquidation. In addition, years for which the corporation is an S corporation would be disregarded in determining the number of years an item may be carried over by a C corporation. A passive loss deduction on the disposition of an activity would be allowed to an S corporation after the election.

(d) Interest on certain tax-exempt obligations

Under present law, a financial institution which is a C corporation or, for its first three years after an election, is an S corporation is subject to a 20 percent reduction on the interest that is allocable to certain tax-exempt obligations issued after 1982 and before August 8, 1986.

S. 875 would alter the application of this rule in the case of financial institutions that are S corporations.

(e) Bad debt charge off

Under present law, a C corporation electing to be an S corporation is subject to tax on its net built-in-gain for the first 10 years after the election to the extent net gains are recognized.

S. 875 would require the Treasury Department to modify its regulations with respect to bad debt deductions to treat the deductions as a built-in-loss during the period the built-in-gains are recognized from changing its accounting method for recognizing bad debts.

4. Transition rule for elections after termination

Under present law, a small business corporation that terminates its subchapter S election (whether by revocation or otherwise) may not make another election to be an S corporation for five taxable years unless the Secretary of the Treasury consents to such election.

Under S. 1415, for purposes of the 5-year rule, any termination of subchapter S status in effect immediately before the date of enactment of the bill would not be taken into account. Thus, any corporation that had terminated its S corporation election within the 5-year period before the date of enactment may re-elect subchapter S status without the consent of the Secretary of the Treasury.

5. Information returns for qualified subchapter S subsidiaries

Under present law, a wholly owned subsidiary of an S corporation may elect to be treated a part of the S corporation in computing its taxable income.

S. 875 would provide authority to the Secretary of the Treasury regarding information returns of subchapter S subsidiaries.

V. SUMMARY OF SELECTED PROPOSALS RELATING TO AGRICULTURE

The conference report to H.R. 5542, the Taxpayer Relief Act of 2000, also included the following proposals that would affect the tax treatment of taxpayers in the agriculture industry:[30]

1. Farm, Fish and Ranch Risk Management Accounts ("FFARRM")

The proposal would allow taxpayers engaged in an eligible business to establish FFARRM accounts. An eligible business would be any trade or business of farming in which the taxpayer actively participates, including the operation of a nursery or sod farm or the raising or harvesting of crop-bearing or ornamental trees[31]. An eligible business would also include the trade or business of commercial fishing in which the taxpayer actively participates. The term "commercial fishing" has the meaning given such term by section (3) of the Magnuson-Stevens Fishery Conservation and Management Act (16 U.S.C. 1802) and includes the trade or business of catching, taking or harvesting fish that are intended to enter commerce through sale, barter or trade.

Contributions to a FFARRM account would be deductible and would be limited to 20 percent of the taxable income that is attributable to the eligible business. The deduction would be taken into account in determining adjusted gross income and would reduce income attributable to the eligible business for all income tax purposes other than the determination of the 20 percent of eligible income limitation on contributions to a FFARRM account. Under the proposal, contributions made on or before the due date (without regard to extensions) of the taxpayer's return for a taxable year would be deemed to have been made on the last day of such year.

A FFARRM account would be taxed as a grantor trust and any earnings would be required to be distributed currently. Thus, any income earned in the FFARRM account would be taxed currently to the farmer or fisherman who established the account.

Contributions to a FFARRM account would not reduce earnings from self-employment. Accordingly, distributions would not be included in self-employment income.

Amounts may remain on deposit in a FFARRM account for up to five years. Any amount that has not been distributed by the close of the fourth year following the year of deposit

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[30] Variations of these proposals also were considered and passed by the Senate in the 106th Congress as part of the Senate's consideration of H.R. 8, the Death Tax Elimination Act of 2000. These proposals are also included in S. 312, the Tax Empowerment and Relief for Farmers and Fisherman Act," introduced in the 107th Congress by Senators Grassley, Baucus and others.

[31] An evergreen tree that is more than 6 years old when severed from the roots (and thus eligible for capital gains treatment on cutting) would not be considered an ornamental tree for this purpose.

would be deemed to be distributed and includible in the gross income of the account owner. Distributions for the year would be considered to first be made from the earnings that are required to be distributed. Additional amounts distributed for the year would be considered to be made from the oldest deposits.

Distributions from a FFARRM account may not be used to purchase, lease, or finance any new fishing vessel, add capacity to any fishery, or otherwise contribute to the overcapitalization of any fishery. The Secretary of Commerce shall implement regulations enforcing this restriction.

A taxpayer who has ceased to engage in an eligible business may not maintain a FFARRM account. If the taxpayer does not engage in an eligible business during two consecutive taxable years, the balance in the FFARRM account would be deemed to be distributed to the taxpayer on the last day of such two-year period.

If the taxpayer who established the FFARRM account dies, and the taxpayer's surviving spouse acquires the taxpayer's interest in the FFARRM account by reason of being designated as the beneficiary of the account at the death of the taxpayer, the surviving spouse would "step into the shoes" of the deceased taxpayer with respect to the FFARRM account. In other cases, the account would cease to be a FFARRM account on the date of the taxpayer's death and the balance in the account would generally be deemed distributed to the taxpayer on the date of death.

A FFARRM account would be a trust that is created or organized in the United States for the exclusive benefit of the taxpayer who establishes it. The trustee must be a bank or other person who demonstrates to the satisfaction of the Secretary that it will administer the trust in a manner consistent with the requirements of the section. At all times, the assets of the trust must consist entirely of cash and obligations which have adequate stated interest (as defined in section 1274(c)(2)) and which pay such adequate interest not less often than annually. The trust must distribute all income currently, and its assets may not be commingled except in a common trust fund or common investment fund. Additional protections, including rules preventing the trust from engaging in prohibited transactions or from being pledged as security for a loan, are provided.

Penalties would apply in the case of excess contributions and failures to make required distributions.

2. Exclusion of rental income from SECA tax

Generally, SECA taxes are imposed on an individual's net earnings from self-employment. Net earnings from self-employment generally means gross income (including the individual's net distributive share of partnership income) derived by an individual from any trade or business carried on by the individual less applicable deductions. An exclusion from net earnings from self-employment is allowed for certain real estate rentals. Under this present-law rule, net earnings from self-employment for an owner or tenant of land do not include income from the rental of real estate and from personal property leased with the real estate unless: (A)

the rental income is received under an arrangement between the owner or tenant of the land and another individual that provides: (1) such other individual shall produce agricultural or horticultural commodities on such land; and (2) there shall be material participation by the owner or tenant with respect to any such agricultural or horticultural commodities; and (B) there is material participation by the owner or tenant with respect to any such agricultural or horticultural commodities. Other rules apply to rental payments received by an individual in the course of the individual's trade or business as a real estate dealer.

The proposal would provide that net earnings from self-employment for an owner or tenant of land do not include income from the rental of real estate except under certain lease agreements (rather than an arrangements) between the owner or tenant of land and another individual. Under this proposal, an owner or tenant of land would have self-employment income only where (A) the rental income is received under a lease agreement between the owner or tenant of land and another individual which provides: (1) such other individual shall produce agricultural or horticultural commodities on such land; and (2) there shall be material participation by the owner or tenant in the production or management of the production of such agricultural or horticultural commodities; and (B) there is material participation by the owner or tenant with respect to any such agricultural or horticultural commodities.

3. Exclusion of conservation reserve program payments from SECA tax

Generally, SECA tax is imposed on an individual's self-employment income within the Social Security wage base. Net earnings from self-employment generally means gross income (including the individual's net distributive share of partnership income) derived by an individual from any trade or business carried on by the individual less applicable deductions. A recent court decision found that payments made under the Department of Agriculture's conservation reserve program are includible in an individual's self-employment income for purposes of SECA tax.

The proposal would provide for purposes of the SECA tax that net earnings from self-employment do not include conservation reserve program payments.

4. Exemption of agricultural bonds from private activity bond volume limits

Interest on bonds issued by States and local governments is excluded from income if the proceeds of the bonds are used to finance activities conducted or paid for by the governmental units (sec. 103). Interest on bonds issued by these governmental units to finance activities carried out and paid for by private persons ("private activity bonds") is taxable unless the activities are specified in the Internal Revenue Code. Private activity bonds on which interest may be tax-exempt include bonds issued to finance loans to first-time farmers for the acquisition of land and certain equipment ("aggie bonds").

The volume of tax-exempt private activity bonds that States and local governments may issue in each calendar year (including aggie bonds) is limited by State-wide volume limits. For 2002, the volume limits will be the greater of: (1) $75 per resident of the State; or (2) $225 million. The volume limits do not apply to private activity bonds to finance airports, docks and

wharves, certain governmentally owned, but privately operated solid waste disposal facilities, certain high speed rail facilities, and to certain types of private activity tax-exempt bonds that are subject to other limits on their volume (qualified veterans' mortgage bonds and certain empowerment zone and enterprise community bonds).

The proposal would exempt "aggie bonds" from the private activity bond volume limits.

5. Modifications to section 512(b)(13)

While generally exempt from Federal income tax, charitable, educational, religious, and certain other organizations described in Code section 501(a) are subject to tax on any unrelated trade or business income (secs. 511-514). The tax applies to gross income derived by an exempt organization from any unrelated trade or business regularly carried on by it, less allowable deductions directly connected with the carrying on of such trade or business, both subject to certain modifications. An unrelated trade or business is defined as any trade or business of a tax-exempt organization the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of the charitable, educational, religious, or other nonprofit purpose and function constituting the basis for its exemption (sec. 513(a)).

In general, interest, rents, royalties and annuities are excluded from the unrelated business income ("UBI") of tax-exempt organizations. However, section 512(b)(13) treats otherwise excluded rent, royalty, annuity, and interest income as UBI if such income is received from a taxable or tax-exempt subsidiary that is 50 percent controlled by the parent tax-exempt organization. In the case of a stock subsidiary, "control" means ownership by vote or value of more than 50 percent of the stock. In the case of a partnership or other entity, control means ownership of more than 50 percent of the profits, capital or beneficial interests. In addition, present law applies the constructive ownership rules of section 318 for purposes of section 512(b)(13). Thus, a parent exempt organization is deemed to control any subsidiary in which it holds more than 50 percent of the voting power or value, directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary).

Under present law, interest, rent, annuity, or royalty payments made by a controlled entity to a tax-exempt organization are includible in the latter organization's UBI and are subject to the unrelated business income tax to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity.

The Taxpayer Relief Act of 1997 (the "1997 Act") made several modifications, as described above, to the control requirement of section 512(b)(13). In order to provide transitional relief, the changes made by the 1997 Act do not apply to any payment received or accrued during the first two taxable years beginning on or after the date of enactment of the 1997 Act (August 5, 1997) if such payment is received or accrued pursuant to a binding written contract in effect on June 8, 1997, and at all times thereafter before such payment (but not pursuant to any contract provision that permits optional accelerated payments).

The proposal would provide that interest, rent, annuity, or royalty payments made by a controlled subsidiary to a tax-exempt parent is not UBI except to the extent that such payments exceed arm's length values, as determined under sec. 482 principles.

6. Charitable deduction for contributions of food inventory

Under present law, the maximum charitable contribution deduction that may be claimed by a corporation for any one taxable year is limited to 10 percent of the corporation's taxable income for that year (disregarding charitable contributions and with certain other modifications) (sec. 170(b)(2)).

Corporations also are subject to certain limitations based on the type of property contributed. In the case of a charitable contribution of short-term gain property, inventory, or other ordinary income property, the amount of the deduction generally is limited to the taxpayer's basis (generally, cost) in the property. However, special rules in the Code provide an augmented deduction for certain corporate contributions. Under these special rules, the amount of the augmented deduction is equal to the lesser of (1) the basis of the donated property plus one-half of the amount of ordinary income that would have been realized if the property had been sold, or (2) twice the basis of the donated property. To be eligible for the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis. The valuation of food inventory has been the subject of ongoing disputes between taxpayers and the IRS. S corporations, personal holding companies, and service organizations are not eligible donors.

The proposal would amend section 170 to expand the augmented deduction such that any taxpayer, rather than only a C corporation, engaged in a trade or business would be eligible to claim an enhanced deduction for donations of food inventory under section 170(e)(3).

The value of the enhanced deduction could be no greater than twice the taxpayer's basis in the donated property. The proposal would provide in the case of a cash method taxpayer, that the taxpayer's basis in the donated food equal half of the fair market value of the donated food.

The proposal would modify and clarify the determination of fair market value for the donation of food inventory. Under the proposal, the fair market value of donated food which cannot or will not be sold solely due to internal standards of the taxpayer, lack of market, or similar circumstances would be determined without regard to such factors and, if applicable, by taking into account the price at which the same or similar food items would be sold by the taxpayer at the time of the contribution or in the recent past.

7. Coordinate farmers and fisherman income averaging and the alternative minimum tax

An individual taxpayer engaged in a farming business as defined by section 263A(e)(4) may elect to compute his or her current year tax liability by averaging, over the prior three-year period, all or portion of his or her taxable income from the trade or business of farming. The averaging election is not coordinated with the alternative minimum tax. Thus, some farmers may become subject to the alternative minimum tax solely as a result of the averaging election.

The proposal would extend to individuals engaged in the trade or business of fishing the election that is available to individual farmers to use income averaging. It would also coordinate farmers and fishermen income averaging with the alternative minimum tax. As a result, a farmer would owe alternative minimum tax only to the extent he or she would owe alternative minimum tax had averaging not been elected. This result is achieved by excluding the impact of the election to average farm income from the calculation of both regular tax and tentative minimum tax, solely for the purpose of determining alternative minimum tax.

8. Cooperative marketing to include value added processing through animals

Under present law, taxable cooperatives in essence are treated as pass-through entities in that the cooperative is not subject to corporate income tax to the extent the cooperative timely pays patronage dividends. Tax-exempt cooperatives (sec. 521) are cooperatives of farmers, fruit growers, and like organizations organized and operated on a cooperative basis for the purpose of marketing the products of members or other producers and turning back the proceeds of sales, less necessary marketing expenses on the basis of either the quantity or the value of products furnished by them.

The IRS takes the position that a cooperative is not marketing the products of members or other producers where the cooperative adds value through the use of animals (e.g., farmers sell corn to cooperative which is feed to chickens which produce eggs).

The proposal would provide that marketing products of members or other producers includes feeding products of members or other producers to cattle, hogs, fish, chickens, or other animals and selling the resulting animals or animal products.

9. Extend declaratory judgment procedures to farmers' cooperative organizations

Cooperatives may deduct from their taxable income amounts distributed to patrons in the form of patronage dividends, and certain other amounts paid or allocated to patrons, to the extent the net earnings of the cooperative from business done with or for patrons, provided that there is a pre-existing obligation to distribute such amounts (sec. 1382). Cooperatives that qualify as farmers' cooperatives under section 521 may claim additional deductions for dividends on capital stock and patronage-based distributions of nonpatronage income.

Under present law, there is limited access to judicial review of disputes regarding the initial or continuing qualification of a farmer's cooperative described in section 521. The only remedies available to such an organization are to file a petition in the U.S. Tax Court for relief following the issuance of a notice of deficiency or to pay tax and sue for a refund in a U.S. district court or the U.S. Court of Federal Claims.

In limited circumstances, declaratory judgment procedures are available, which generally permit a taxpayer to seek judicial review of an IRS determination prior to the issuance of a notice of deficiency and prior to payment of tax. Examples of declaratory judgment procedures that are available include disputes involving the initial or continuing classification of an organization exempt from tax described in section 501(c)(3), a private foundation described in section 509(a), or a private operating foundation described in section 4942(j)(3), the qualification of retirement

plans, the value of gifts, the status of certain governmental obligations, or eligibility of an estate to pay tax in installments under section 6166.[32] In such cases, taxpayers may challenge adverse determinations by commencing a declaratory judgment action. For example, where the IRS denies an organization's application for recognition of exemption under section 501(c)(3) or fails to act on such application, or where the IRS informs a section 501(c)(3) organization that it is considering revoking or adversely modifying its tax-exempt status, present law authorizes the organization to seek a declaratory judgment regarding its tax exempt status.

Declaratory judgment procedures are not available under present law to a cooperative with respect to an IRS determination regarding its status as a farmers' cooperative under section 521.

The proposal would extend the declaratory judgment procedures to cooperatives. Such a case may be commenced in the U.S. Tax Court, a U.S. district court, or the U.S. Court of Federal Claims, and such court would have jurisdiction to determine a cooperative's initial or continuing qualification of as a farmers' cooperative described in sec. 521.

10. Small ethanol producer credit

"Small ethanol producers" are allowed a 10-cents-per-gallon production income tax credit on up to 15 million gallons of production annually. This credit is in addition to the 53-cents-per-gallon benefit available for ethanol generally.

Under present law, cooperatives in essence are treated as pass-through entities in that the cooperative is not subject to corporate income tax to the extent the cooperative timely pays patronage dividends. Under present law, the only credits that may be flowed-through to cooperative patrons are the rehabilitation credit (sec. 47), the energy property credit (sec. 48(a)), and the reforestation credit (sec. 48(b)), but not the small ethanol producer credit.

The proposal would: (1) provide that the small producer credit is not a "passive credit"; (2) allow the credit to be claimed against the alternative minimum tax; (3) repeal the present-law rule that the amount of the credit is included in income; and (4) define small ethanol producer to be a person who, at all times during the taxable year, has a productive capacity for alcohol not in excess of 60,000,000 gallons.

The proposal would also allow cooperatives to elect to pass-through small ethanol producer credits to its patrons. The credit would be allowed to a patron in that proportion of the credit the cooperative elects to pass-through for that year as the amount of patronage of that patron for that year bears to total patronage of all patrons for that year.

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[32] For disputes involving the initial or continuing qualification of an organization described in sections 501(c)(3), 509(a), or 4942(j)(3), declaratory judgment actions may be brought in the U.S. Tax Court, a U.S. district court, or the U.S. Court of Federal Claims. For all other Federal tax declaratory judgment actions, proceedings may be brought only in the U.S. Tax Court.

11. Payment of dividends on stock of cooperatives without reducing patronage dividends

Cooperatives, including tax-exempt farmers' cooperatives, are treated like a conduit for Federal income tax purposes since a cooperative may deduct patronage dividends paid from its taxable income. In general, patronage dividends are amounts paid to patrons (1) on the basis of the quantity or value of business done with or for its patrons, (2) under a valid enforceable written obligation to the patron to pay such amount, which obligation existed before the cooperative received such amounts, and (3) which is determined by reference to the net earnings of the cooperative from business done with or for its patrons.

Treasury Regulations provide that net earnings are reduced by dividends paid on capital stock or other proprietary capital interests. The effect of this rule is to reduce the amount of earnings that the cooperative can treat as patronage earnings. That reduces the amount that cooperative can deduct as patronage dividends.

The proposal would allow cooperatives to pay dividends on capital stock without those dividends reducing excludable patronage-sourced income to the extent that the cooperative's organizational documents provide that the dividends do not reduce amounts owed to patrons from patronage.

APPENDIX
Data for Figure 6

Table A-1.--All Business Returns and Business Returns With Net Income, 1997, by Entity Type

Business	Total number	Number with net income	Percentage with net income
Nonfarm sole proprietorship returns	17,176,486	12,702,663	74.0
C corporation returns	2,257,829	1,092,078	48.4
S corporation returns	2,452,254	1,555,396	63.4
Partnership returns	1,758,627	1,091,826	62.1
Farms (Schedule F)	2,160,954	721,466	33.4
All business entities	28,258,404	18,718,825	66.2

Source: IRS Statistics of Income