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

Scheduled for a Public Hearing
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Prepared by the Staff
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CONTENTS

Page

INTRODUCTION 1

I. OVERVIEW 2
A. Federal Income Tax Rates 2
B. Definition of "Small Business" 2
C. Choice of Entity 3

II. ECONOMIC ANALYSIS 9
A. Data on Small Business and Agriculture 9
B. Background and Discussion of Issues Related to the Federal Minimum Wage 26
1. History of the Federal Minimum Wage 26
2. The Minimum Wage and Employment 33
3. The Minimum Wage and Poverty 34

III. SELECTED PROVISIONS THAT AFFECT SMALL BUSINESS AND AGRICULTURE 36
A. Expensing Depreciable Business Assets 36
B. Accounting Methods 37
1. In general 37
2. Cash and accrual methods 37
3. Uniform capitalization of inventory costs 38

IV. SUMMARY OF SELECTED PROPOSALS RELATIVE TO AGRICULTURE AND SMALL BUSINESS 40
A. Summary of S. 312, the "Tax Empowerment and Relief for Farmers and Fisherman Act" 40
1. Farm, Fish and Ranch Risk Management Accounts ("FFARRM") 40
2. Exclusion of rental income from SECA tax 41
3. Exclusion of conservation reserve program payments from SECA tax 42
4. Exemption of agricultural bonds from private activity bond volume limits 42
5. Modifications to section 512(b)(13) 42
6. Charitable deduction for contributions of food inventory 43
7. Coordinate farmers and fisherman income averaging and the alternative minimum tax 44
8. Modify cooperative marketing to include value added processing through animals 45
9. Extend declaratory judgment procedures to farmers' cooperative organizations 45
10. Small ethanol producer credit 46
11. Payment of dividends on stock of cooperatives without reducing patronage dividends 47
B. Qualified Small Business Stock 48
C. Proposals Relating to S Corporations 49

APPENDIX 51

INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on June 4, 2002, on issues 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-45-02), May 31, 2002.

I. OVERVIEW

A. Federal Income Tax Rates

U.S. individuals (citizens and residents) are taxed at graduated statutory rates ranging from 10 percent (for taxable income of married joint filers or surviving spouses up to $12,000) to 38.6 percent (for taxable income of married joint filers or surviving spouses over $307,050) for 2002. The intermediate rates are 15 percent, 27 percent, 30 percent, and 35 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, and the benefit of the 34 percent rate is phased out for corporations with taxable income in excess of $15,000,000. 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 is no single criterion used to determine whether a business is "small." Examples of the different

[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 than $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 $49,000 in the case of married individuals filing a joint return (for taxable years beginning in 2002, 2003, and 2004). The exemption amount is completely phased out for married individuals filing a joint return with AMTI in excess of $346,000 and for a corporation with AMTI in excess of $310,000.

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 with respect to quantitative limits 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 stock issuance had aggregate gross assets of not more than $50 million.[10]

C. Choice of Entity

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") generally involve a single level of tax at the owner level.

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 incorporated or as a corporation.[11] 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

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

the corporate level, and is taxed again when distributed as dividends[12] to its shareholders. Corporate deductions and credits reduce only corporate income and are not passed through to 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.[13] 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. 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.[14] 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.[15]

Amounts paid as reasonable compensation to shareholders who are also employees are deductible by the corporation, and thus are taxed 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 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 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.

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[12] 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.

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

[14] Sections 531-537.

[15] Sections 541-547.

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 a 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 equity. This determination requires an examination of the 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.

Partnerships

In general

Partnerships generally are treated for Federal income tax purposes as pass-through entities, not subject to tax at the entity level.[16] 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 (based on the partnership's method of accounting and 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, gain, loss, deduction, and credit.[17] A partner's deduction for partnership losses is limited to the amount of the partner's adjusted basis in his partnership interest.[18] 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.[19]

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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[16] Section 701.

[17] Section 702(a).

[18] Section 704(d). In addition, "passive loss" and "at-risk" limitations limit the extent to which certain types of 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.

[19] Section 705.

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-like treatment for local law purposes and partnership treatment for Federal income tax purposes.[20] LLCs are entities organized under State law. They are neither partnerships nor corporations under applicable State law, but they generally provide limited liability to their owners. An LLC generally affords 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 for Federal income tax purposes; while any single-member unincorporated entity may be disregarded for Federal income tax purposes (i.e., treated as not separate from its owner).[21] These regulations, known as the "check-the-box" regulations, were a response, in part, to the growth of LLCs. The regulations permit a multiple-member LLC to elect to be treated as a partnership, and a single-member LLC to be disregarded (or to be taxed as a corporation).

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 levels 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 and its shareholders that elect subchapter S status (an "S corporation") 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.

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

[20] The first LLC statute was enacted in Wyoming in 1977. All States (and the District of Columbia) now have an LLC statute, though their tax treatment for State tax purposes may differ.

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

nonresident aliens), certain tax-exempt organizations, and certain trusts and estates are permitted 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.[22] 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.[23] Items of income (including tax-exempt income), gain, loss, deduction and credit of the corporation are taken into account in computing the tax of the shareholders (under the corporation's method of accounting and 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 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.[24]

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[25]) 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.[26] 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.[27]

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

[22] Section 1362.

[23] Sections 1363 and 1366.

[24] Section 1367.

[25] 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.

[26] Section 1375.

[27] Section 1374.

corporation and has undistributed earnings and profits.[28] To the extent of such earnings and profits, corporate distributions are treated as 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 Federal tax differences between S corporations and partnerships. For example, corporate liabilities (other than those owed to its shareholders) 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 have only one class of stock, and thus do not offer the same flexibility as partnerships to allocate income or losses to different investors.

[28] Section 1368.

II. ECONOMIC ANALYSIS

A. 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 1999.[29] 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 1999, nonfarm sole proprietorships made up the vast majority of businesses. In 1999, they constituted 66.3 percent of all business entities; over the 22 years, they were never lower than 58 percent of the total.

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[29] 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, 1978-1999

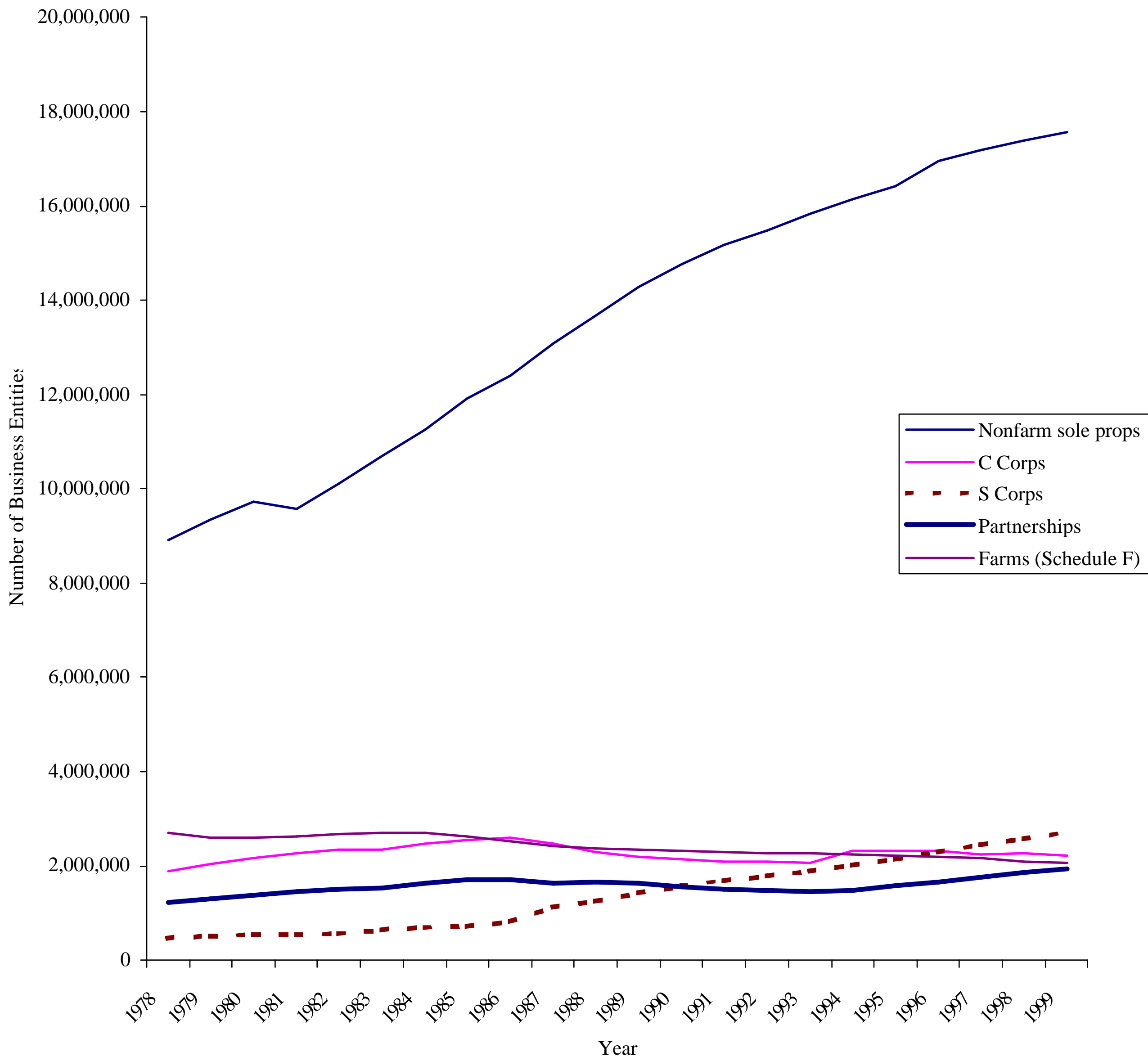


Table 1.–Number of Different Types of Business Returns Relative to All Business Returns, 1978-1999

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
1999	17,575,643	2,210,129	2,725,775	1,936,919	2,067,883	26,516,349

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 1999. The number of farm returns generally declined through the 22-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 1999. 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.[30]

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

Business	1978-1988	1988-1999	1978-1999
Nonfarm sole proprietorship	4.4	2.3	3.3
C corporation	4.1	-4.2	0.7
S corporation	10.1	7.3	8.6
Partnerships	3.0	1.4	2.2
Farms (Schedule F)	-1.3	-1.2	-1.3
Total	3.7	1.5	2.7

Source: Joint Committee on Taxation staff calculations.

[30] 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. Figure 2, Figure 3, and Figure 4 below, display the percentage distribution of different types of business returns for 1978, 1988, and 1999.

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

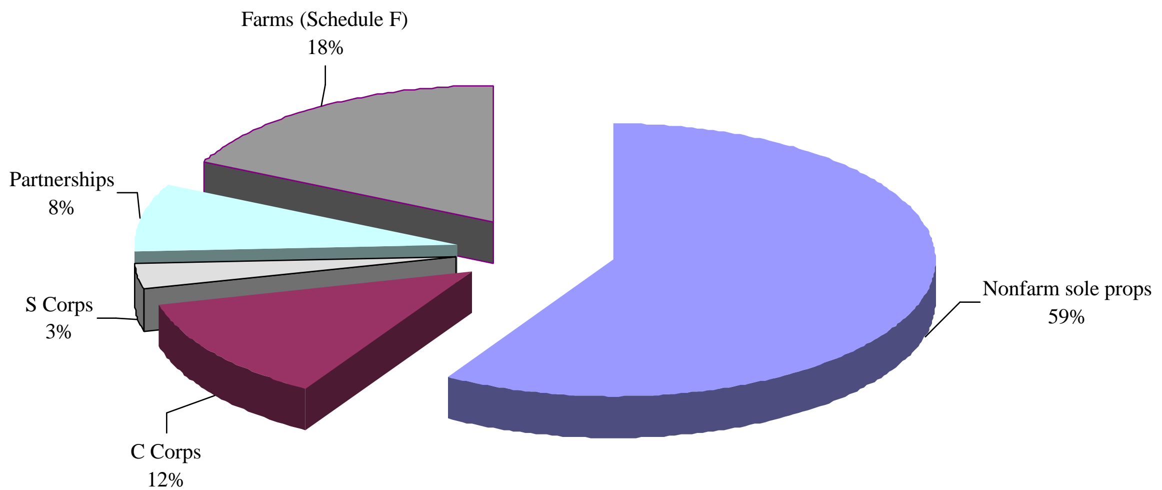


Figure 3.–Percentage Distribution of Different Types of Business Returns, 1988

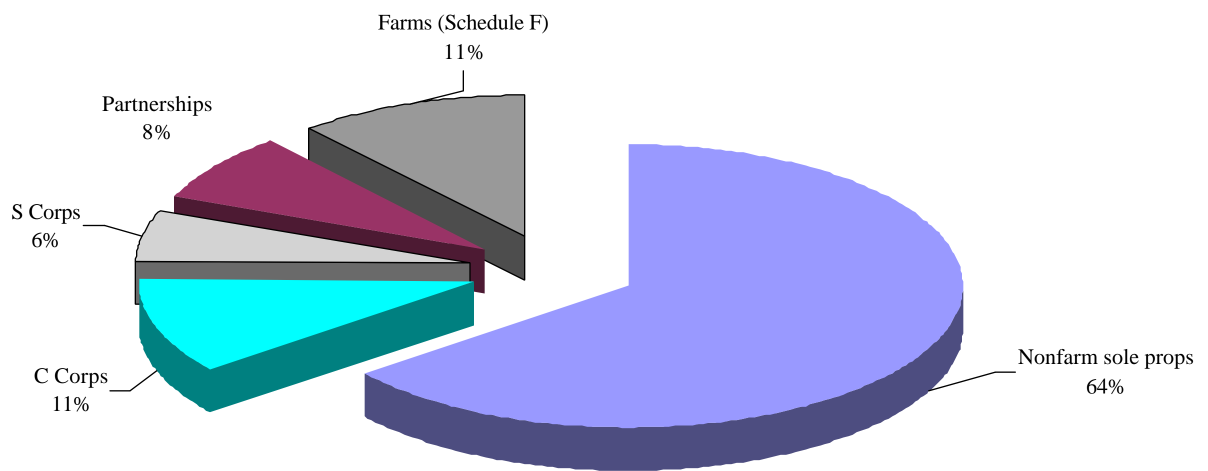
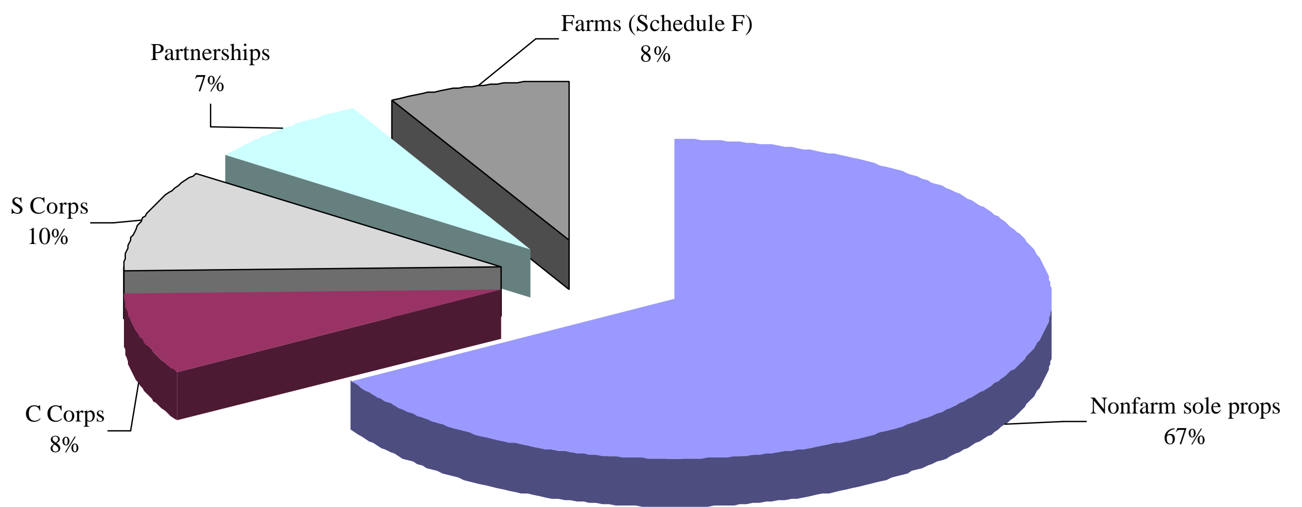


Figure 4.–Percentage Distribution of Different Types of Business Returns, 1999



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 Table 1 and Table 2 and Figure 1, Figure 2, Figure 3, and Figure 4, above. Table 3 and Figure 5, below, decompose the number of partnerships for the period 1989 through 1999 into general partnerships, limited partnerships, and LLCs.[31] Figure 5 documents the rapid growth of LLCs relative to other partnership forms over the past several years.

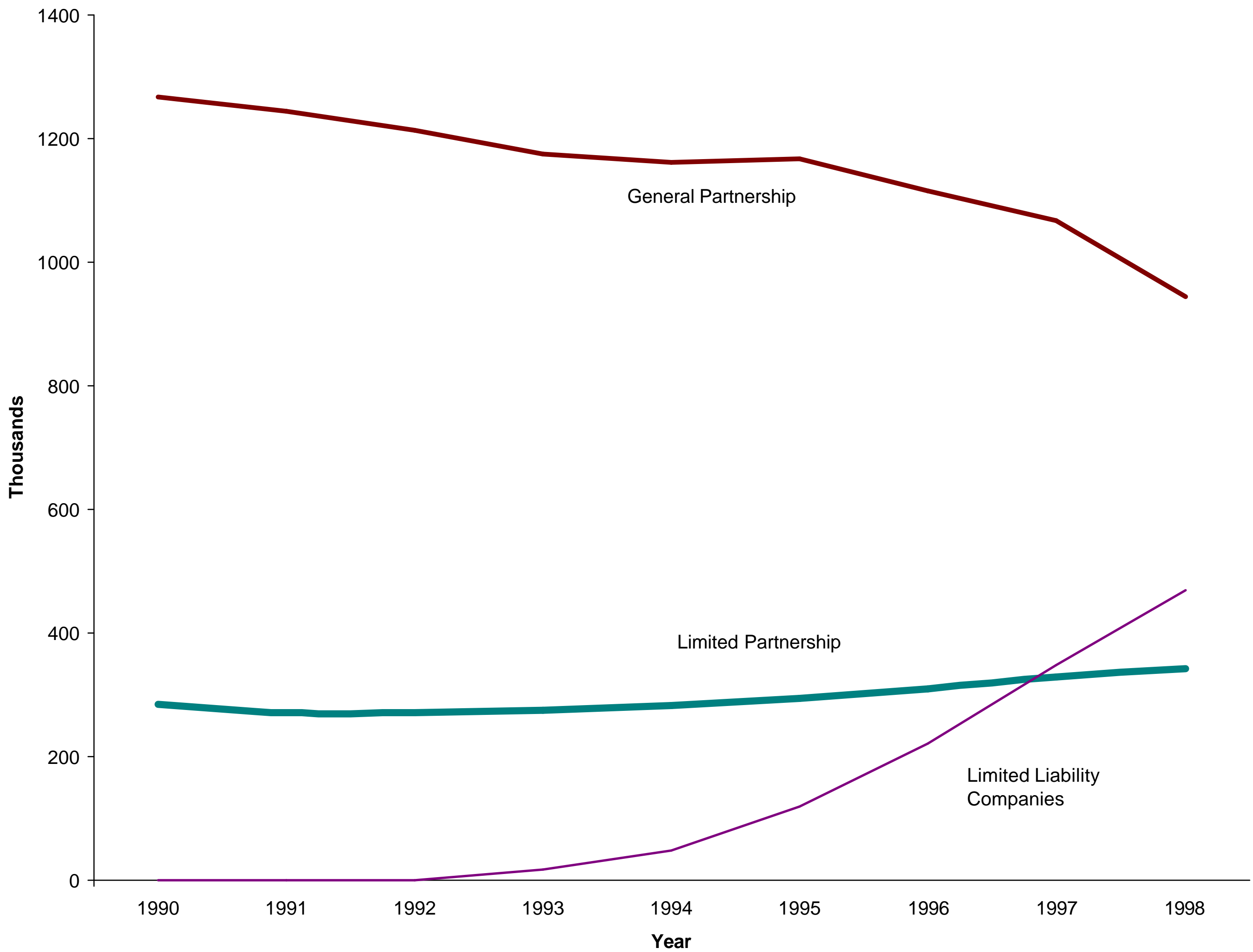
Table 3.–Number of Partnership Returns by Type, 1989-1999

	Type of Partnership		
Year	**General Partnerships** (thousands)	**Limited Partnerships** (thousands)	**Limited Liability Companies** (thousands)
1989	1,341	294	n.a.
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
1999	898	354	589

n.a. - not available.
Source: Alan Zempel and Tim Wheeler, "Partnership Returns, 1999," *SOI Bulletin*, 21, Fall 2001.

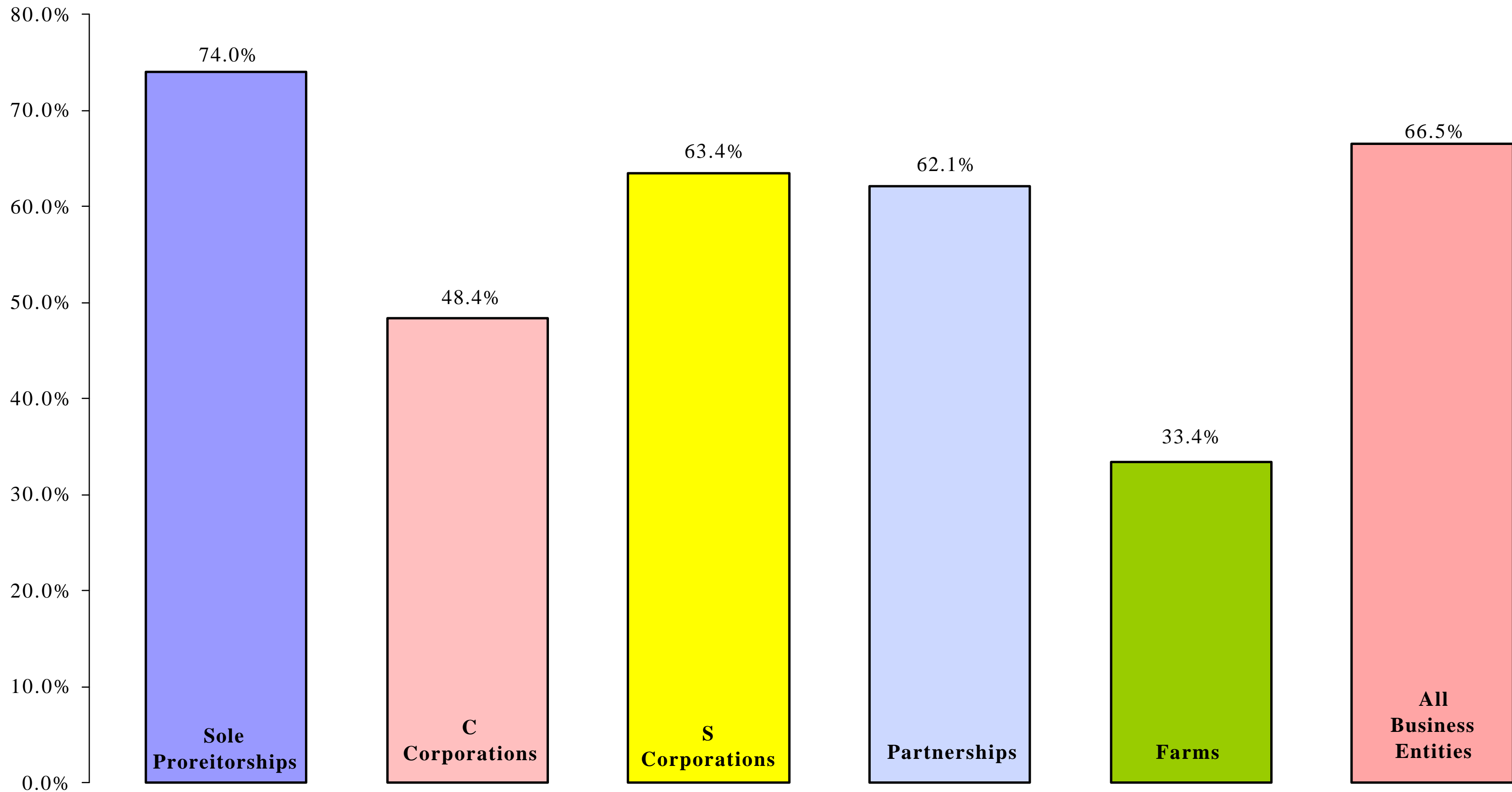
[31] The data in Table 3 may not sum to the total number of partnerships reported in Table 1 because of rounding and because, for 1996 through 1999, Table 3 does not include those businesses that checked either the "limited liability partnership" box or the "other" box on Form 1065, Schedule B, line 1. See, Alan Zempel and Tim Wheeler, "Partnership Returns, 1999," *SOI Bulletin*, 21, Fall 2001.

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.

Table 4, Table 5, Table 6, and Table 7 display 1999 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 700,000 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 eight tenths of one percent of all C corporations, hold 95 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 48 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 22 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 71 percent, and for S corporations there are 26 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 eight tenths of one percent of all C corporations, collect over 80 percent of gross receipts of all C corporations. For partnerships, approximately the eight tenths of one percent of partnership returns with gross receipts in excess of $10 million report nearly 78 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 36 percent of all nonfarm sole proprietorship gross receipts.

Table 4.–Distribution of C Corporations, 1999

	All returns			
			Cummulative percent	
Firms classified by assets less than	Number of returns	Total assets (millions)	Returns	Total Assets
$0	130,728	0	5.91%	0.00%
$25,000	506,544	4,547	28.83%	0.01%
$50,000	239,523	8,750	39.67%	0.03%
$100,000	273,421	19,871	52.04%	0.08%
$250,000	372,024	60,877	68.88%	0.24%
$500,000	243,238	86,506	79.88%	0.45%
$1,000,000	171,648	120,366	87.65%	0.76%
$10,000,000	217,748	596,493	97.50%	2.25%
$50,000,000	30,039	662,085	98.86%	3.91%
$100,000,000	7,562	539,995	99.20%	5.27%
Over $100,000,000	17,654	37,735,971	100.00%	100.00%
Total	2,210,129	39,835,461		

	All returns			
			Cummulative percent	
Firms classified by revenues less than	Number of returns	Gross receipts (millions)	Returns	Gross receipts
$0	230,559	0	10.43%	0.00%
$2,500	60,228	53	13.16%	0.00%
$5,000	32,082	120	14.61%	0.00%
$10,000	47,010	339	16.74%	0.00%
$25,000	107,488	1,846	21.60%	0.02%
$50,000	124,999	4,607	27.25%	0.05%
$100,000	195,495	14,439	36.10%	0.15%
$250,000	343,413	56,654	51.64%	0.55%
$500,000	305,191	110,787	65.45%	1.32%
$1,000,000	264,560	189,018	77.42%	2.64%
$10,000,000	429,038	1,222,229	96.83%	11.18%
$50,000,000	52,889	1,083,944	99.22%	18.75%
Over $50,000,000	17,177	11,631,533	100.00%	100.00%
Total	2,210,129	14,315,569		

Source: JCT calculation from Statistics of Income data.

Table 5.–Distribution of S Corporation, 1999

Firms classified by assets less than	All returns: Number of returns	Total assets (millions)	Cummulative percent: Returns	Total Assets
$0	182,275	0	6.69%	0.00%
$25,000	857,446	7,604	38.14%	0.47%
$50,000	330,062	12,111	50.25%	1.21%
$100,000	325,702	23,235	62.20%	2.64%
$250,000	419,501	68,141	77.59%	6.82%
$500,000	234,689	82,614	86.20%	11.89%
$1,000,000	159,112	110,655	92.04%	18.69%
$10,000,000	195,555	539,704	99.21%	51.82%
$50,000,000	18,541	355,498	99.89%	73.65%
$100,000,000	1,717	118,143	99.96%	80.91%
Over $100,000,000	1,175	310,987	100.00%	100.00%
Total	2,725,775	1,628,692		

Firms classified by revenues less than	All returns: Number of returns	Gross receipts (millions)	Cummulative percent: Returns	Gross receipts
$0	393,817	0	14.45%	0.00%
$2,500	70,789	76	17.04%	0.00%
$5,000	52,032	196	18.95%	0.01%
$10,000	66,795	490	21.40%	0.02%
$25,000	133,120	2,243	26.29%	0.09%
$50,000	170,284	6,315	32.54%	0.29%
$100,000	289,867	21,377	43.17%	0.94%
$250,000	480,583	79,755	60.80%	3.40%
$500,000	371,065	132,347	74.41%	7.47%
$1,000,000	281,359	198,730	84.74%	13.58%
$10,000,000	362,855	1,004,270	98.05%	44.47%
$50,000,000	45,750	929,214	99.73%	73.05%
Over $50,000,000	7,459	876,377	100.00%	100.00%
Total	2,725,775	3,251,390		

Source: JCT calculation from Statistics of Income data.

Table 6.–Distribution of Partnerships, 1999

Firms classified by assets less than	All returns: Number of returns	Total assets (millions)	Cummulative percent: Returns	Total Assets
$0	572,760	0	29.57%	0.00%
$25,000	220,530	2,014	40.96%	0.03%
$50,000	93,307	3,413	45.77%	0.09%
$100,000	135,420	9,829	52.77%	0.25%
$250,000	216,364	35,725	63.94%	0.84%
$500,000	175,806	63,755	73.01%	1.90%
$1,000,000	175,188	124,118	82.06%	3.95%
$10,000,000	296,271	865,193	97.35%	18.25%
$50,000,000	38,943	793,572	99.36%	31.37%
$100,000,000	5,646	393,886	99.65%	37.88%
Over $100,000,000	6,684	3,758,112	100.00%	100.00%
Total	1,936,919	6,049,617		

Firms classified by revenues less than	All returns: Number of returns	Gross receipts (millions)	Cummulative percent: Returns	Gross receipts
$0	0	0	0.00%	0.00%
$2,500	1,258,080	45	64.95%	0.00%
$5,000	27,495	98	66.37%	0.01%
$10,000	34,206	251	68.14%	0.02%
$25,000	57,058	968	71.08%	0.08%
$50,000	66,280	2,469	74.51%	0.23%
$100,000	91,326	6,777	79.22%	0.65%
$250,000	137,109	22,216	86.30%	2.00%
$500,000	92,558	33,296	91.08%	4.03%
$1,000,000	67,362	47,564	94.56%	6.93%
$10,000,000	90,228	249,379	99.21%	22.15%
$50,000,000	11,597	242,561	99.81%	36.94%
Over $50,000,000	3,620	1,033,752	100.00%	100.00%
Total	1,936,919	1,639,376		

Source: JCT calculation from Statistics of Income data.

Table 7.–Distribution of NonFarm Sole Proprietorships, 1999

Firms classified by revenues less than	All returns			
			Cummulative percent	
	Number of returns	Gross receipts (millions)	Returns	Gross receipts
$0	0	0	0.00%	0.00%
$2,500	4,437,464	4,244	25.25%	0.44%
$5,000	1,957,465	7,091	36.39%	1.18%
$10,000	2,323,041	16,852	49.60%	2.94%
$25,000	3,177,383	51,392	67.68%	8.31%
$50,000	2,191,093	77,987	80.15%	16.45%
$100,000	1,540,835	109,075	88.91%	27.84%
$250,000	1,231,961	190,032	95.92%	47.68%
$500,000	450,758	155,378	98.49%	63.91%
$1,000,000	181,039	122,461	99.52%	76.69%
$10,000,000	83,139	157,901	99.99%	93.18%
$50,000,000	1,285	23,811	100.00%	95.67%
Over $50,000,000	180	41,488	100.00%	100.00%
Total	17,575,643	957,712		

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. Table 8 and Table 9 below present data compiled by the SBA from surveys in 1999 by the Bureau of the Census. The SBA estimates that in 1999 there were approximately 5.6 million firms in the United States employing 111 million persons.[32] The SBA estimates that more than 99 percent of the firms in the United States are small business and that these small businesses employ slightly more than 50 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 Table 4, Table 5, Table 6, and Table 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 1999, these two sectors accounted for 61.5 percent of the small businesses in the United States and 59.8 percent of the small business employment. Table

[32] U.S. Small Business Administration, Office of Advocacy, "Statistics of U.S. Businesses: Firm Size Data," http://www.sba.gov/advo/stats/data.html, May 2002.

8 below presents the percentage distribution of small business firms and the percentage distribution of small business employment across various sectors of the United States's economy for 1999.

Table 8.–Percentage Distribution of Small Business Firms and Employment by Sector, 1999

	Percent of all small business firms	Percent of all small business employees
Agriculture, Forestry, Fishing, and Hunting	0.5	0.3
Mining	0.3	0.4
Utilities and Information	1.5	1.8
Construction	12.4	9.7
Manufacturing	5.5	12.3
Wholesale Trade	6.4	6.9
Retail Trade	13.0	11.5
Transportation and Warehousing	2.8	2.7
Finance and Insurance	4.0	3.4
Real Estate and Rental and Leasing	4.0	2.4
Services	48.5	48.3
Other	1.8	0.3

Source: U.S. Small Business Administration, Office of Advocacy, "Statistics of U.S. Businesses: Firm Size Data," http://www.sba.gov/advo/stats/data.html, May 2002.

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, forestry, fishing, and hunting, construction; public utilities and information technology; wholesale trade; real estate, rental and leasing; and service sectors. Large firms provide the majority of employment in the mining, manufacturing; transportation, retail trade; and finance and insurance sectors. In every sector except agriculture, construction, and services, firms employing 100 or more employees provide a majority of the employment.

The data in Table 8 and Table 9 are not comparable to the tax return data reported previously. These data are drawn from employment reports for one week in March 1999. 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, 1999

Industry	Total	Percentage Distribution by Firm Size				
		Employing 0	Employing 1-19	Employing 20-99	Employing 100-499	Employing 500 or more
Agriculture Forestry, and Fishing, and Hunting						
Firms	26,259	16.8%	76.8%	5.1%	0.9%	0.4%
Employees	192,155	0.0%	46.6%	24.4%	13.9%	15.2%
Mining						
Firms	18,828	10.6%	74.3%	10.9%	2.4%	1.8%
Employees	456,645	0.0%	14.0%	16.3%	12.6%	57.1%
Utilities and Information						
Firms	83,715	0.6%	5.8%	1.0%	0.3%	0.3%
Employees	3,901,592	0.0%	0.5%	1.0%	1.1%	14.5%
Construction						
Firms	691,490	14.5%	76.9%	7.6%	0.9%	0.1%
Employees	6,201,626	0.0%	39.8%	31.9%	15.9%	12.5%
Manufacturing						
Firms	311,902	7.4%	65.2%	20.7%	5.2%	1.5%
Employees	16,659,930	0.0%	7.7%	16.0%	17.4%	58.9%
Transportation and Warehousing						
Firms	155,170	14.1%	73.8%	9.6%	1.8%	0.7%
Employees	3,627,057	0.0%	14.2%	15.7%	12.1%	58.0%
Wholesale Trade						
Firms	358,564	9.9%	75.5%	11.5%	2.2%	0.9%
Employees	5,972,022	0.0%	22.9%	25.0%	16.2%	35.8%
Retail Trade						
Firms	730,303	10.5%	79.7%	8.3%	1.2%	0.3%
Employees	14,476,628	0.0%	20.1%	15.4%	8.6%	55.9%
Finance and Insurance						
Firms	223,535	10.8%	79.9%	6.9%	1.6%	0.7%
Employee	5,965,174	0.0%	11.5%	10.3%	10.3%	67.9%
Real Estate and Rental and Leasing						
Firms	242,838	13.6%	80.6%	4.3%	0.9%	0.5%
Employee	1,873,792	0.0%	36.9%	19.5%	14.2%	29.4%
Services						
Firms	2,729,181	3.5%	18.9%	1.3%	0.2%	0.1%
Employee	50,313,454	0.0%	4.0%	2.6%	1.7%	4.5%
Other						
Firms	103,473	56.2%	38.3%	0.2%	0.0%	0.0%
Employee	1,065,586	0.0%	n.a.	0.6%	n.a.	0.0%

Source: U.S. Small Business Administration, Office of Advocacy, "Statistics of U.S. Businesses: Firm Size Data," http://www.sba.gov/advo/stats/data.html, May 2002.

B. Background and Discussion of Issues Related to the Federal Minimum Wage

1. History of the Federal Minimum Wage

The present Federal minimum wage is $5.15 cents per hour.[33] In general, the Federal minimum wage applies to employees of enterprises that have at least $500,000 worth of sales per year. It also applies to employees of smaller firms if the employees are engaged in interstate commerce or in the production of goods for commerce, such as employees who work in transportation or communications or who regularly use the mail or telephones for interstate communications. It also applies to employees of Federal, State, and local government agencies, hospitals and schools, and it generally applies to domestic workers.

Congress first established a minimum wage in 1938 as part of the Fair Labor Standards Act of 1938 ("FLSA"). When enacted in 1938, the Federal minimum wage applied to a smaller universe of employees than it does today. At its inception, the Federal minimum wage applied only to employees engaged in interstate commerce or in the production of goods for interstate commerce. In 1949, Congress expanded the scope of coverage to include employees in the air transport industry. Amendments to the FLSA in 1961 brought employees in the retail trade sector within the ambit of the Federal minimum wage. Amendments in 1966 extended coverage to public schools, nursing homes, laundries and dry cleaners, the construction industry, large hotels, motels, and restaurants, and certain farm employees. In 1974, Congress included all non-supervisory employees of Federal, State, and local governments and many domestic workers.

The FLSA set a minimum wage of $0.25 per hour for 1938 with a scheduled increase to $0.30 for 1939. The Congress has increased the Federal minimum wage numerous times over the past 63 years. Figure 7, below, shows how the value of the Federal minimum wage has changed since 1938. Figure 7 also shows the value of the minimum wage in the past in terms of 2001 dollars. Since 1997, the real, inflation adjusted, value of the minimum wage has eroded as there has been modest inflation and no change in the minimum wage. The real value of the current minimum wage is greater than that which prevailed from 1938 through 1955 and that which prevailed from 1988 through 1995, but less than that which prevailed from 1956 through 1987.[34]

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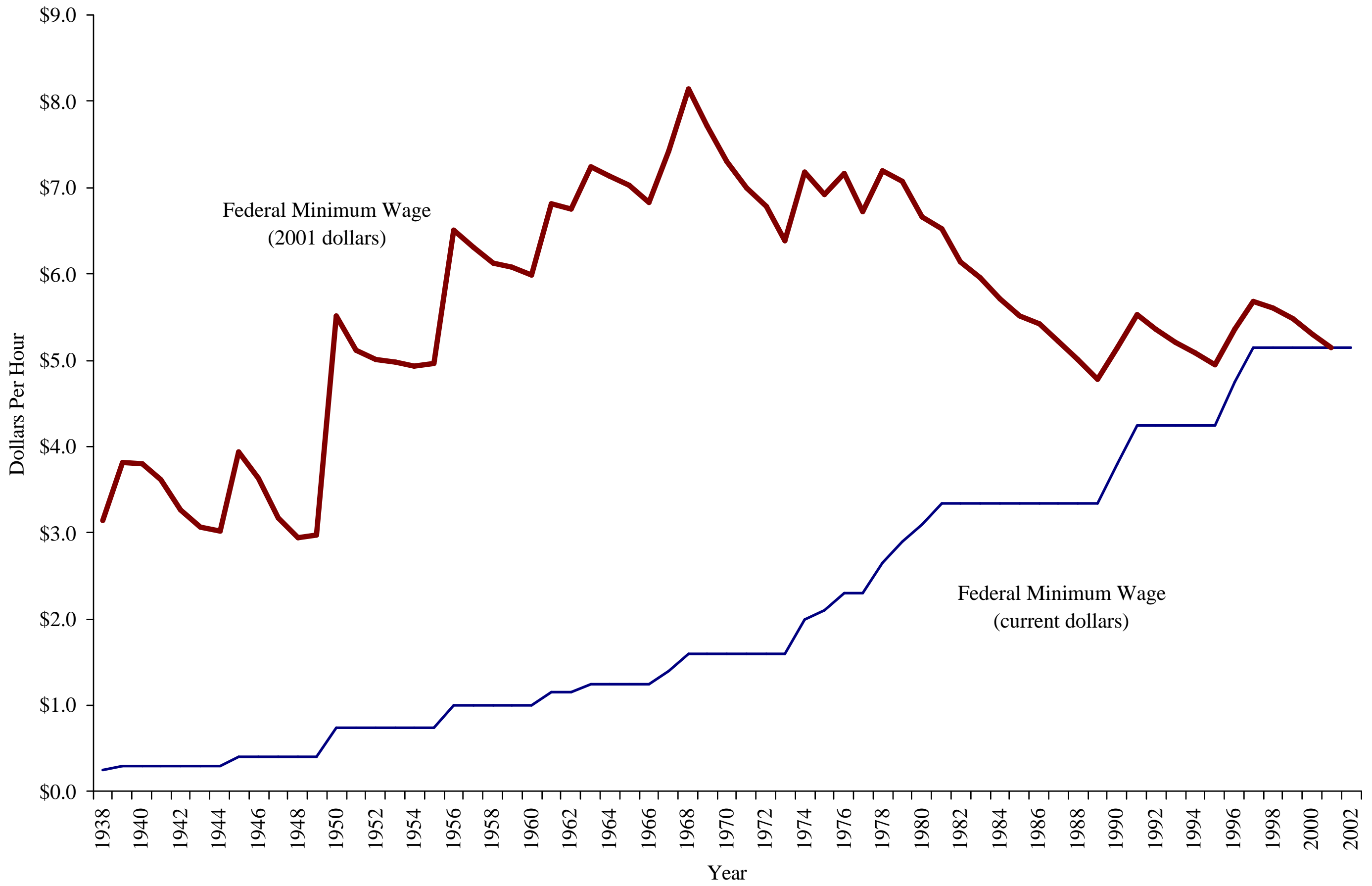
[33] For newly hired employees under age 20, a youth sub-minimum wage of $4.25 per hour prevails during the employee's first 90 calendar days of employment. In addition, certain other employees whose employer is otherwise subject to the Federal minimum wage may be paid less than $5.15 per hour. Among these employees are student-learners (*e.g.*, vocational education students) and full-time students in retail or service establishments, agriculture, or institutions of higher education. An employer may consider tips as part of wages for "tipped employees" and pay tipped employees no less than $2.13 per hour in direct wages. "Tipped employees" are employees who regularly receive more than $30 per month in tips.

[34] Since these data do not take into account non-wage compensation, such as health benefits, these data do not necessarily reflect the relative value of total compensation for minimum wage workers over time.

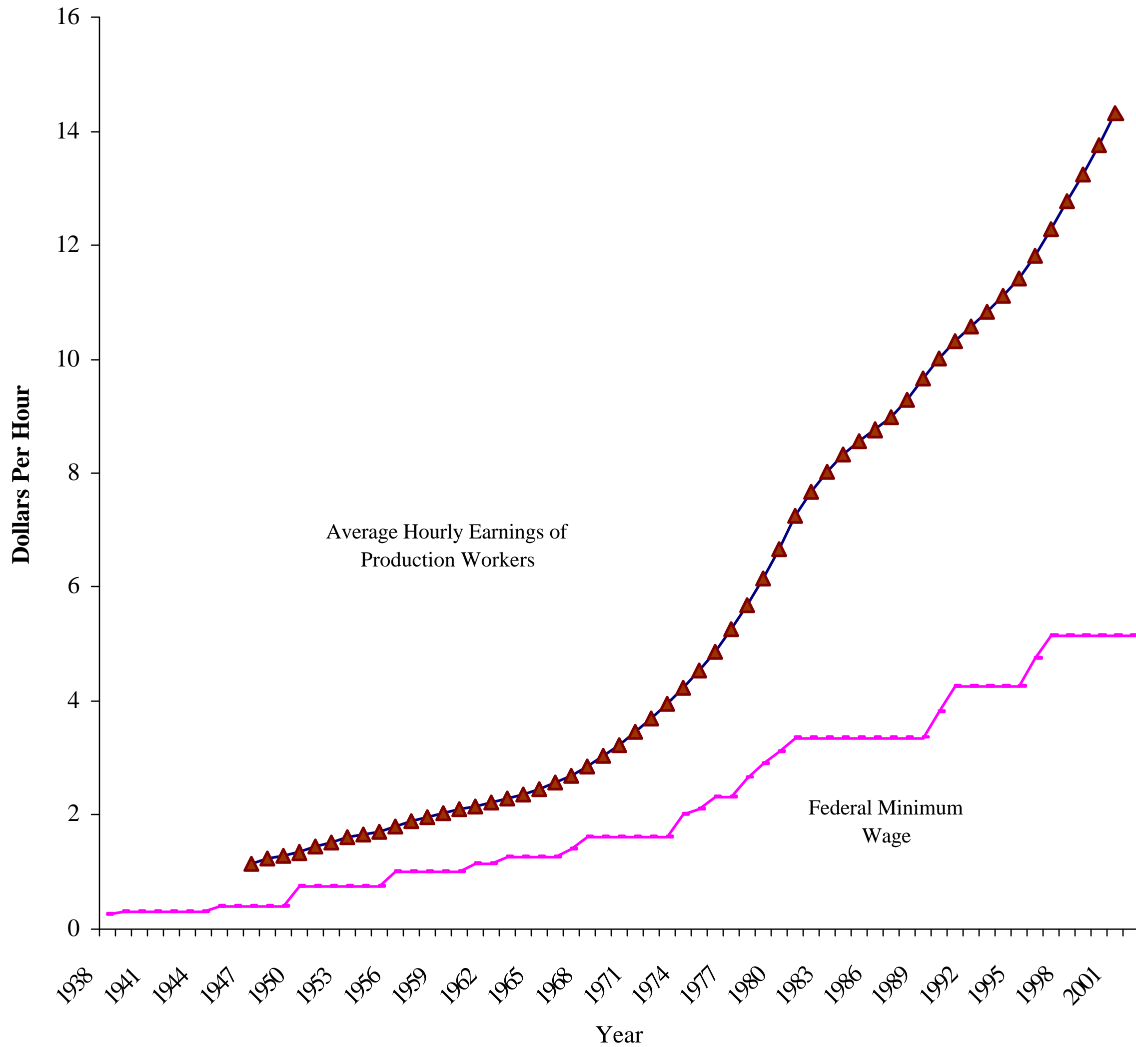
Figure 7.–Minimum Wage in Current and Constant Dollars



Source: Department of Labor, Bureau of Labor Statistics, and calculations of the Staff of the Joint Committee on Taxation.

The 2001 value of past levels of the minimum wage assesses the purchasing power of the minimum wage. An alternative assessment of the value of the minimum wage is to compare the level of the minimum wage to the average value of other wages in the economy. Figure 8, below, plots the value of the minimum wage and the value of the average hourly earnings of production workers annually for the period 1947 through 2001. For 2001, the value of the minimum wage was 36 percent of average hourly earnings. Between 1974 and 2001, the value of the minimum wage compared to average hourly earnings of production workers has varied between 31 and 56 percent. While showing the relative rates of pay of employees receiving the minimum wage and average hourly earnings of production workers, may not accurately reflect the relative total compensation of employees receiving the minimum wage and average hourly earnings of production workers. Employees receiving the minimum wage are less likely to receive other forms of compensation such as pension coverage or employer provided medical benefits. In general, non-wage compensation constitutes a large and growing share of total compensation in the United States. Thus, while showing the relative value of cash wages between an employee receiving the minimum wage and the average production worker, will not accurately reflect the relative economic well being of an employee receiving the minimum wage and the average production worker.

Figure 8.–Federal Minimum Wage Versus Average Hourly Earnings of Production Workers



Source: Department of Labor, Bureau of Labor Statistics.

The Bureau of Labor Statistics has estimated that approximately 72.5 million employees were paid at hourly rates in 2001. Approximately 2.2 million, or 3.1 percent, of these employees

were paid at or below[35] the prevailing Federal minimum wage. Table 10, below, reproduces Bureau of Labor Statistics estimates of the number of employees paid at hourly rates in 2001 by age, sex, race, and by whether the employee was full-time or part-time. The data reveal that while 23 percent of workers paid at hourly rates were age 24 or younger, 54 percent of employees paid the minimum wage were age 24 or younger. A higher percentage of hourly female employees were paid the minimum wage compared to male employees (4.0 percent for women, 2.2 percent for men). The incidence of employees paid the minimum wage was nearly identical by race. Among whites, 3.1 of hourly paid employees were paid the minimum wage. The comparable percentages were 3.0 percent for black hourly paid employees and 3.0 percent for Hispanic hourly paid employees.

Table 10 also documents that while 24 percent of all workers paid at hourly rates were part-time workers in 2001, 62 percent of those workers paid the minimum wage were part-time workers. The predominance of part-time workers among all employees paid at the minimum wage does not mean that part-time work most often leads to minimum wage employment. Indeed, part-time workers paid at the minimum wage comprised 8.0 percent of all part-time workers. Among part-time workers, men were somewhat more likely to be paid at the minimum wage than were women. Of all male part-time workers, 8.3 percent were paid at the minimum wage compared to 7.9 percent for women.

[35] The data reported here and in Table 10 and Table 11, below, are from the U.S. Department of Labor, Bureau of Labor Statistics. These data are for wage workers, excluding the incorporated self-employed. The Bureau of Labor Statistics prepared the estimates from surveys. The data refer to a person's earnings on their sole or principal job, and pertain only to workers who are paid hourly rates. Salaried workers and other non-hourly workers are not included. The presence of workers with hourly earnings below the minimum wage does not necessarily indicate violations of the FLSA as there are exceptions to the minimum wage provisions of the law. In addition, some survey respondents might have rounded hourly earnings to the nearest dollar, and, as a result, reported hourly earnings below the minimum wage even though they earned the minimum wage or higher.

Table 10.–Wage and Salary Workers Paid Hourly Rates with Earnings at or Below the Prevailing Federal Minimum Wage by Selected Characteristics
(numbers in thousands)

Characteristic	2001		
	Workers paid hourly rates		
		Total at or below prevailing Federal minimum wage	
	Total	Number	Percent of hourly-paid workers
SEX AND AGE			
Total, 16 years and over	72,486	2,238	3.1
16 to 24 years	16,602	1,206	7.3
25 years and over	55,884	1,032	1.8
Men, 16 years and over	36,029	784	2.2
16 to 24 years	8,491	473	5.6
25 years and over	27,538	311	1.1
Women, 16 years and over	36,457	1,454	4.0
16 to 24 years	8,111	733	9.0
25 years and over	28,346	721	2.5
RACE, HISPANIC ORIGIN			
White, 16 years and over	59,152	1,861	3.1
Black, 16 years and over	10,014	297	3.0
Hispanic origin, 16 years and over	10,030	302	3.0
FULL- AND PART-TIME STATUS			
Full-time workers	55,232	853	1.5
Part-time workers	17,124	1,378	8.0

Source: Department of Labor, Bureau of Statistics.

Table 11, below, reproduces Bureau of Labor Statistics estimates of the number of employees paid at hourly rates in 2001 by industry. Of the 2.2 million employees paid at the minimum wage in 2001, approximately 1.1 million (48 percent) are employed in eating and drinking establishments. Workers paid at the minimum wage constitute 20 percent of all hourly paid workers in eating and drinking establishments. Among other retail trades approximately 2.6 percent of employees are paid at the minimum wage. These other retail employees paid at the minimum wage account for nearly 12 percent of all employees paid at the minimum wage. After retailing, service industries account for the largest percentage of employees paid at the minimum

wage, as nearly 24 percent of all employees paid at the minimum wage are in service industries. However, these employees comprise only 2.7 percent of all service industry employees.

Table 11.–Wage and Salary Workers Paid Hourly Rates with Earnings at or Below the Prevailing Federal Minimum Wage by Industry
(numbers in thousands)

Characteristic	2001		
	Workers paid hourly rates		
		Total at or below prevailing Federal minimum wage	
	Total	Number	Percent of hourly-paid workers
INDUSTRY			
Private wage and salary workers	63,520	2,100	3.3
Agriculture	1,107	44	4.0
Nonagricultural industries	62,413	2,056	3.3
Mining	317	1	.2
Construction	5,066	28	.6
Manufacturing	12,006	84	.7
Durable goods	7,384	31	.4
Nondurable goods	4,623	52	1.1
Transportation and public utilities	4,211	32	.8
Transportation	2,618	21	.8
Communications and other public utilities	1,593	11	.7
Wholesale and retail trade	17,941	1,356	7.6
Wholesale trade	2,250	16	.7
Retail trade	15,691	1,340	8.5
Eating and drinking places	5,384	1,077	20.0
Finance, insurance, and real estate	2,988	23	.8
Services	19,883	532	2.7
Private households	421	70	16.6
Other service industries	19,462	462	2.4
Personal services, except private households	1,848	101	5.5
Entertainment and recreation services	1,288	87	6.8
Government workers	8,966	138	1.5
Federal	1,823	17	.9
State	2,391	45	1.9
Local	4,752	76	1.6

Source: Department of Labor, Bureau of Statistics.

2. The Minimum Wage and Employment

Economists have long argued that the imposition of a minimum wage above the prevailing wage rate paid in the market place will reduce employment, particularly among young and unskilled workers. This conclusion rests on the observation that the market for lower-wage jobs is competitive. That is, there are many potential employers and employees and lower-wage jobs are generally homogeneous. Under these conditions employers seeking to maximize their profits demand more low-skilled workers when wages are low than when wages are high. That is, the demand curve for low-skilled labor is downward sloping. Individuals are more willing to offer themselves to potential employers, or are willing to work more hours, if wages are high than if wages are low. That is, the supply curve for low-skilled labor is upward sloping. A minimum wage imposed above the market equilibrium wage level determined by the intersection of demand and supply creates "unemployment" by two effects. First, because the minimum wage is higher than the market equilibrium wage, employers will reduce their demand for workers in response to the wage increase. Second, because the minimum wage is higher than the market equilibrium wage, more individuals will offer themselves to potential employers, that is, the supply of labor increases. As the supply of labor increases while the demand for labor decreases, unemployment results. The "unemployment" can manifest itself in several ways. Some of those who were employed at the prevailing market wage prior to the imposition of the higher minimum wage could lose their jobs. Alternatively, workers paid the minimum wage may remain employed but work fewer hours. In a growing economy, new jobs may not be created.[36]

Economists also have undertaken many empirical studies attempting to measure whether, and to what extent, changes in the minimum wage lead to unemployment. Until the last ten years, one could summarize the empirical analyses as concluding that a 10 percent increase in the minimum wage resulted in a one to three percent reduction in employment among low-skilled workers, such as teenagers.[37] Aggregate data generally were the basis for these conclusions. A widely cited 1994 study restricted its analysis to 410 fast food restaurants in New Jersey and Pennsylvania to assess the effects of an increase in New Jersey's minimum wage. That study found that employment increased after the imposition of the higher minimum wage.[38] However,

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[36] In theory, if the labor market for unskilled labor is not competitive, an increase in the minimum wage could lead to an increase in employment. Madeline Zavodny, "Why Minimum Wage Hikes May Not Reduce Employment," *Economic Review*, Second Quarter 1998, Federal Reserve Bank of Atlanta, provides a clear exposition of the case of a monopsonistic (one buyer) labor market.

[37] For critical reviews of the empirical literature relating to minimum wages see David Card and Alan B. Krueger, *Myth and Measurement: The New Economics of the Minimum Wage*, (Princeton, N.J.: Princeton University Press), 1995, and David Neumark, Mark Schweitzer, and William Wascher, "The Effects of Minimum Wages Throughout the Wage Distribution," National Bureau of Economic Research working paper #7519, February, 2000.

[38] David Card and Alan B. Krueger, "Minimum Wages and Employment: A Case Study of the Fast-Food Industry in New Jersey and Pennsylvania," *American Economic Review*, 84, September 1994, pp. 772-793. Card and Krueger also summarize the results of several other

others have criticized that study's methodology and results. A recent study using payroll data, rather than a survey approach, covering many, but not all, of the establishments of the original study found that an increase in New Jersey's minimum wage resulted in a decrease in employment at the fast food establishments in the range of 1.0 to 2.5 percent for each 10 percent of the increase in the minimum wage.[39] Yet further re-examination of Pennsylvania and New Jersey fast food restaurants utilizing a third data source suggests no negative employment effects.[40] In short, the academic battle rages.

The reason why it may be difficult to disentangle the employment effects of a change in the minimum wage is that a change in the minimum wage may have effects beyond those employees whose wages are directly affected. If employers initially respond to an increase in the minimum wage by reducing employment it will likely result in reductions in the production of goods and services. A reduction in the supply of goods generally causes prices to rise. An increase in prices ameliorates the decline in employment, but would be unlikely to completely counteract it.

An increase in the price of low-skilled labor could lead to a change in the composition of firms' labor force, increasing the demand and employment of more skilled workers while reducing the employment of less skilled workers. An increase in the minimum wage would make the cost of low-skilled labor rise compared to higher-skilled labor. To maintain production while keeping costs from rising, firms may make greater use of higher-skilled labor. Such a possibility could result in an indeterminate change in total employment, although low-skilled employees would lose their employment or be employed for fewer hours.

3. The Minimum Wage and Poverty

Advocates of increasing the minimum wage see the minimum wage as an anti-poverty tool. While a family of five with two workers working full time at the minimum wage would have an income sufficient to exceed the poverty level by a few hundred dollars, a family with two children and with a full time minimum wage worker and a half-time minimum wage worker would have an income that was almost two thousand dollars below the poverty level. Increased income from a higher wage would benefit such a family. However, the minimum wage may not be a very efficient anti-poverty tool. As discussed above, increases in the minimum wage may

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studies that likewise compared affected establishments with unaffected establishments and failed to detect negative employment effects from increases in the applicable minimum wage.

[39] David Neumark and William Wascher, "Minimum Wages and Employment: A Case Study of the Fast-Food Industry in New Jersey and Pennsylvania: Comment," *American Economic Review*, 90, December 2000, pp. 1362-1396.

[40] David Card and Alan B. Krueger, "Minimum Wages and Employment: A Case Study of the Fast-Food Industry in New Jersey and Pennsylvania: Reply," *American Economic Review*, 90, December 2000, pp. 1397-1420. In this study, Card and Krueger suggest that certain non-randomness in the compilation of Neumark and Wascher's data may have biased their findings towards a negative employment effect.

result in some low-wage workers losing their jobs or working reduced hours. With such an outcome, the gains against poverty of some come at the expense of lower incomes of others. Furthermore, as discussed above, an increase in the minimum wage could raise the cost of goods and services. Any such inflation in the price of consumer goods and services would erode the economic position of those below the poverty line.

In addition, increasing the minimum wage targets the earnings of low-wage workers and does not specifically target low-income families. The data presented above showed that more than 50 percent of minimum wage workers were age 24 or younger. Those workers include the teenage sons and daughters of middle class families working as cooks at fast food establishments. While some researchers have calculated that more than one third of the earnings gains from an increase in the minimum wage goes to families in the lowest family income decile,[41] others have concluded that less than 20 percent of the earnings gains from an increase in the minimum wage goes to families below the poverty line.[42]

Recent research has suggested that the earned income tax credit ("EITC") may be a better anti-poverty tool than the minimum wage.[43] The reason for this is that the EITC is primarily targeted to low-income families with children. Thus, the teenage minimum wage worker from a middle class family is not helped by the EITC. Additionally, since the EITC increases after-tax wages through the tax code, rather than by mandating a specific minimum pre-tax wage, employers' employment costs do not rise as a result of the EITC. To the extent that the EITC increases labor supply that would drive down the market clearing pre-tax wage, employers' employment costs may even fall.[44] Because employers' employment costs do not rise as a result of increases in the EITC, any negative employment effects of increasing the minimum wage itself are avoided.

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[41] Card and Krueger, *Myth and Measurement*.

[42] Kenneth A. Couch, "Distribution and Employment Impacts of Raising the Minimum Wage," *FRBSF Economic Letter*, February 19, 1999, Federal Reserve Bank of San Francisco.

[43] David Neumark and William Wascher, "Using the EITC to Help Poor Families: New Evidence and a Comparison with the Minimum Wage," National Bureau of Economic Research Working Paper No. 7599, March 2000.

[44] Employers' employment costs with respect to the wages of workers at the minimum wage would not fall as a result of the EITC because they must still pay the minimum wage. Their employment costs could fall if they cut back fringe benefits in response to the EITC.

III. SELECTED PROVISIONS THAT AFFECT 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 2002) 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.

In addition, for qualifying property above the amounts eligible for immediate expensing the Job Creation and Worker Assistance Act of 2002 allows an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of certain depreciable property acquired after September 11, 2001, and before September 10, 2004. The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service. The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In general, depreciable property qualifies for the additional depreciation if the original use begins with the taxpayer and general rules of MACRS apply with (1) an applicable recovery period of 20 years or less, (2) water utility property (as defined in section 168(e)(5)), (3) computer software other than computer software covered by section 197, or (4) qualified leasehold improvement property.

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. 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 rule requiring the use of an accrual method.

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.[45] Subsequently, the IRS expanded the class of small businesses eligible to use the cash method of accounting to qualified taxpayers with average annual gross receipts of $10 million or less unless the taxpayer's principal business activity consists of mining, manufacturing, wholesale trade, retail trade, or a listed information industry.[46]

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 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 good. 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

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

[46] Rev. Proc. 2002-28, 2002-18 I.R.B. 815.

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)).[47]

[47] Sec. 263A(d).

IV. SUMMARY OF SELECTED PROPOSALS RELATIVE TO AGRICULTURE AND SMALL BUSINESS

A. Summary of S. 312, the "Tax Empowerment and Relief for Farmers and Fisherman Act"

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.[48] 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 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

[48] 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.

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, Self-Employment Contributions Act ("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 arrangement) 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 are 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. S corporations, personal holding companies, and service organizations are not eligible donors. The valuation of food inventory contributed by corporations has been the subject of ongoing disputes between taxpayers and the IRS.

The proposal[49] 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

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[49] H.R. 7, the "Community Solutions Act of 2001," as passed by the House of Representatives on July 19, 2001, includes a similar provision, except that H.R. 7 does not change the present-law calculation of the enhanced deduction, does not provide a special basis rule for cash method taxpayers, and provides that the enhanced deduction would be available only for food that qualifies as "apparently wholesome food." In addition, H.R. 7 provides a slightly different definition of fair market value.

or fisherman 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 or fishing income from the calculation of both regular tax and tentative minimum tax, solely for the purpose of determining alternative minimum tax.

8. Modify 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) include 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 remitting to the members or other producers 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 a cooperative which it feeds to chickens that 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 such animals or the resulting 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 of 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 other limited contexts, 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 a tax-exempt 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.[50] 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 could be commenced in the U.S. Tax Court, the U.S. District Court for the District of Columbia, or the U.S. Court of Federal Claims, and such court would have jurisdiction to determine a cooperative's initial or continuing qualification 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 that is generally available for ethanol production.

Under present law, cooperatives in essence are treated as pass-through entities in that a 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 to its patrons are the rehabilitation credit (sec. 47), the energy property credit (sec. 48(a)), and the reforestation credit (sec. 48(b)).

The proposal[51] would: (1) provide that the small ethanol 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 a small ethanol producer to include 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 also would allow cooperatives to elect to pass an amount equal to the small ethanol producer credit through to their patrons. The credit would be allowed to a patron in an

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[50] 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, the U.S. District Court for the District of Columbia, 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.

[51] On April 25, 2002, the Senate passed H.R. 4, as amended by the Senate. Division H of the bill, the "Energy Tax Policy Act of 2002", contains several energy tax incentives, including some that are similar to incentives contained in S. 312.

amount equal to the credit that the cooperative elects to pass through for that year, multiplied by the proportion that the amount of patronage of that patron for that year bears to total patronage of all patrons for that year.

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 in that 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 by the cooperative with or for its patrons, (2) under a valid enforceable written obligation to the patrons to pay such amount, which obligation existed before the cooperative received such amounts, and (3) which are determined by reference to the net earnings of the cooperative from business done with or for its patrons.

Treasury Regulations provide that net earnings of a cooperative 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 a cooperative can treat as patronage earnings, which reduces the amount that a cooperative can deduct as patronage dividends.

The proposal would allow cooperatives to pay dividends on capital stock without such dividends reducing the amount of deductible 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.

B. Qualified Small Business Stock

Under present law, individuals may exclude 50-percent (60-percent for certain empowerment zone businesses) of the gain from the sale of certain small business stock acquired at original issue and held for at least five years. The taxable portion of the gain is taxed at a maximum rate of 28 percent. Forty-two percent of the excluded gain is a minimum tax preference. The amount of gain eligible for the exclusion by an individual with respect to any corporation is the greater of (1) ten times the taxpayer's basis in the stock or (2) $10 million. In order to qualify as a small business, when the stock is issued, the gross assets of the corporation may not exceed $50 million. The corporation also must meet certain active trade or business requirements.

Under present law, individuals may rollover gain from qualified small business stock to other qualified small business stock where the replacement stock is purchased during the 60-day period beginning on the date of sale of the original stock.

Various proposals[52] have been made to modify the small business stock provisions. These proposals include:

- The percentage of excluded gain would be increased to a higher percentage.
- The 5-year holding period requirement would be reduced.
- The minimum tax preference for small business stock would be repealed.
- The $10 million maximum exclusion amount would be increased or eliminated.
- The capital gains tax rate on the taxable portion of the gain would be made the same as for other taxable capital gain.
- The exclusion would be made available to corporate shareholders.
- The $50 million gross asset amount would be increased.
- The working capital limitation would be modified.
- The rules relating to redemptions of small business stock would be modified.
- The 60-day period to make a rollover would be increased to 180 days

[52] These proposals are found in S. 455 (introduced by Sen. Collins and others); S. 1134 (introduced by Sens. Lieberman and Hatch); S. 1676 (introduced by Sen. Kerry); and S. 1823 (introduced by Sens. Collins and Carper).

C. Proposals Relating to S Corporations

S. 1201[53], the "Subchapter S Modernization Act of 2001" would make the following amendments to the provisions of subchapter S, which are summarized in Part I.C, above:

- The maximum number of eligible shareholders would be increased from 75 to 150.
- Certain family members could elect to be treated as one shareholder for purposes of determining the number of shareholders.
- Nonresident aliens would be allowed to be eligible shareholders.
- IRAs could continue to hold bank stock when the bank elects subchapter S status.
- An S corporation could issue nonpartipating preferred stock that would be treated similarly to debt.
- "Straight debt" could include convertible debt.
- Excess passive income would no longer be a terminating event, but instead would be subject to the tax on excess passive income.
- The tax on excess passive income would only apply if the passive income exceeded 60 percent of gross receipts, and capital gain would not be treated as passive income
- The basis in S corporation stock would not be reduced by the amount of the appreciation in charitable contributions made by the corporation.
- Certain losses on the liquidation of subchapter S stock would be treated as an ordinary loss.
- Passive loss deductions would be allowed to an S corporation to the extent generally allowed on a complete disposition of a passive activity.
- Suspended S corporation losses could be transferred where the stock is transferred incident to a divorce.
- Qualified subchapter S corporation trust income beneficiaries would be allowed to treat certain dispositions by the trust as dispositions for purposes of the at-risk rules and the passive loss rules.
- Interest on indebtedness incurred to acquire S corporation stock would be deductible by an electing small business trust.

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[53] S. 1201 was introduced on July 19, 2001, by Senators Hatch, Breaux, Lincoln, Allard, Thompson, and Gramm.

- Unexercised power of appointments would be disregarded in determining potential current income beneficiaries of an electing small business trust.

- The electing small business trust distribution rules would be clarified.

- Excluded cancellation of indebtedness income would not increase the shareholder's basis in its stock (this provision has since been enacted into law.)

- Certain back-to-back loans would be treated as indebtedness.

- Investment securities income of a bank would not be treated as passive income.

- Qualifying director shares in a bank would not be treated as a second class of stock.

- Bad debt reserves of a bank could be recaptured on the making of an S corporation election.

- Inadvertent invalid qualified subchapter S subsidiary elections could be validated.

- Information returns for qualified subchapter S subsidiaries could be made by the subsidiary.

- A sale of an interest in a qualified subchapter S subsidiary would be treated as a sale of the subsidiary's assets.

- The "step transaction" doctrine would not apply to restructurings in connection with the making of a qualified subchapter S subsidiary election.

- All earnings and profits attributable to pre-1983 taxable years would be eliminated.

- No gain or loss on deferred intercompany transactions under the consolidated return regulations would result from a conversion to an S corporation or a qualified S corporation subsidiary.

- Charitable contribution deductions and foreign tax credit carryforwards could offset the tax on built-in gains of former C corporations.

- An S corporation could pay deductible dividends to an ESOP.

- A former S corporation could reelect to be an S corporation upon the enactment of the bill.

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