## 11. C. Small Business

### 1. Graduated corporate rate structure

Under present law, corporate taxable income is subject to tax at a five-step graduated rate structure. The corporate tax rates under present law are:

| Taxable income | Tax rate (percent) |
|---|---|
| $0 to $25,000 | 17 |
| $25,000 to $50,000 | 20 |
| $50,000 to $75,000 | 30 |
| $75,000 to $100,000 | 40 |
| Over $100,000 | 46 |

The proposal would widen the existing corporate tax rate brackets and lower the rate in the first bracket. Under the proposal, corporate tax rates would be:

| Taxable income | Tax rate (percent) |
|---|---|
| $0 to $25,000 | 15 |
| $25,000 to $50,000 | 20 |
| $50,000 to $100,000 | 30 |
| $100,000 to $150,000 | 40 |
| Over $150,000 | 46 |

Under this proposal, the maximum reduction in tax liability (for corporations with $150,000 or more of taxable income) would be $6,000.

### 2. Increase in minimum accumulated earnings credit

In addition to the regular corporate income tax, present law imposes an accumulated earnings tax of 27-1/2 percent to 38-1/2 percent on improperly accumulated corporate earnings where the accumulation occurs in an attempt to avoid the individual income tax. In computing the base on which this tax is imposed, there is excluded an amount equal to the earnings and profits of the taxable year which are retained for the reasonable needs of the business. This is known as the accumulated earnings credit. Present law provides a minimum credit of $150,000 of earnings which may be accumulated before any accumulated earnings are subject to this tax.

The proposal would increase the minimum accumulated earnings credit to $250,000. However, this increase would not apply to specified service corporations whose principal business consists of the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

### 3. Investment credit for used property

Present law provides a 10-percent regular investment credit. A taxpayer may claim this regular investment credit for the cost of up to $100,000 of used qualifying property acquired by purchase each taxable year.

The proposal would increase the annual cost limitation on used property for purposes of the 10-percent regular investment credit from $100,000 to $200,000.

4. Time for furnishing Form W-2 to terminated employees

Section 6051(a) of the Code requires an employer to furnish to an employee who has terminated employment prior to the close of the calendar year a Form W-2 on the day the employee receives his or her last salary payment.

The Internal Revenue Service has recently published regulations which provide that the employer may furnish a Form W-2 to an employee whose employment terminates prior to the close of the calendar year at any time after the termination but no later than January 31 of the following year. However, if an employee who terminates employment prior to the close of the calendar year requests earlier receipt of a Form W-2, and if there is no reasonable expectation on the part of the employer and employee of further employment during the calendar year, then the employee must be given a Form W-2 on or before the later of the 30th day after the request or the 30th day after the last salary payment.

The proposal would codify the general approach of these regulations.

5. Deferred application of Revenue Procedure 80-5 and Revenue Ruling 80-60 relating to inventory writedowns

In Revenue Procedure 80-5 and Revenue Ruling 80-60, the Internal Revenue Service provided rules which require taxpayers to conform their method of inventory accounting to that method of inventory accounting approved by the Supreme Court in Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979). For taxpayers with excess inventories (inventories in excess of foreseeable demand) that have been erroneously written down for tax purposes, these pronouncements require that the writedowns be taken back into income.

These Internal Revenue Service pronouncements, which were issued on February 8, 1980, are applicable to 1979 taxable years. Taxpayers contend that by waiting until 1980 to release the pronouncements, the IRS has prevented them from being able to comply in 1979 with certain Treasury regulations that would have mitigated the income recapture required under the Thor Power decision.

The proposal would delay the implementation of Revenue Procedure 80-5 and Revenue Ruling 80-60 to taxable years beginning after 1979 and would give taxpayers the opportunity to take mitigating action under the Treasury regulations.

6. Increase in maximum number of subchapter S shareholders

Under present law, one of the requirements that a corporation must meet in order to be eligible to elect to be treated as a subchapter S corporation is that it have no more than 15 shareholders.

The proposal would provide for an increase in the maximum number of shareholders in a subchapter S corporation from 15 to 25.

7. <u>Exemption from excise taxes for certain fuels used in inter-city, local, and school buses</u>

Present law imposes a manufacturers excise tax of 4 cents per gallon on gasoline and a retailers excise tax of 4 cents per gallon on diesel fuel and other special motor fuels used or sold for use in a highway motor vehicle. The Energy Tax Act of 1978 provided that a credit or refund of these taxes could be obtained if these fuels were used in a bus while engaged in (a) the furnishing (for compensation) of certain passenger land transportation available to the general public, or (b) the transportation of students or employees of schools. However, that Act did not permit the owners or operators of buses to purchase fuel tax-free even if the fuel was to be used in a qualifying activity.

The proposal would allow a taxpayer to purchase gasoline or other fuel tax-free for use in such qualifying activities if the taxpayer registers with the Internal Revenue Service and establishes that the fuel will be used in these activities.

8. <u>Reserves for market-making activities</u>

Under present law, a securities dealer must recognize any gain on the sale of equity securities, even if he is making a market for the securities. Generally, this gain will be treated as ordinary income.

The proposal would allow certain dealers in corporate securities to defer for 10 years the net gain (up to $1 million) from the sale of small business equity securities where the dealer is making a market in the security.

Under the proposal, a corporation which is engaged in market making activities during the taxable year would be allowed to establish a deductible reserve for the net gains for that year from the sale of certain small business equity securities in which it makes a market. The deduction would be equal to the addition to the taxpayer's reserve. However, the reserve could not exceed $1 million. Moreover, the deduction could not exceed the taxpayer's taxable income for the year nor could it exceed 30 percent of the fair market value of the taxpayer's average monthly inventory positions in over-the-counter equity securities carried for market making activities for the year.

This provision would apply to equity securities held by the taxpayer for sale in the ordinary course of its trade or business which are not traded on a registered security exchange and which are of corporations that had $25 million or less of debt and equity outstanding on the last day of the preceding taxable year.

Under the proposal, the amount of an addition to the reserve for a taxable year would not be taken back into income until the earlier of (1) the tenth year following the year of the addition, or (2) the year the amount is withdrawn from the reserve. (A withdrawal is deemed to be from the earliest remaining addition to the reserve.)

SMALL BUSINESS PROPOSALS

| | Fiscal years 1981 | 1982 | 1983 | 1984 | 1985 | Calendar year 1981 |
|---|---|---|---|---|---|---|
| | (Millions of dollars) | | | | | |
| Small Business | | | | | | |
| 1. Corporate rate reduction (15%, 20%, 30%, 40%, 46%; 25k, 50k, 100k, 150k) | -304 | -710 | -783 | -852 | -927 | -675 |
| 2. Increase in accumulated earnings credit | 1/ | 1/ | 1/ | 1/ | 1/ | -- |
| 3. Increase in used equipment eligible for investment credit to $200,000 in 1981 | -101 | -226 | -242 | -252 | -262 | -229 |
| 4. Elimination of certain W-2 filing requirements | -- | -- | -- | -- | -- | -- |
| 5. Deferral of application of revenue ruling on inventory writedowns 2/ | 3/ | 3/ | 3/ | 3/ | 3/ | -- |
| 6. Increase in number of subchapter S shareholders to 25 | 4/ | 4/ | 4/ | 4/ | 4/ | 4/ |
| 7. Exemption from excise tax on certain fuels used in intercity, local and school buses | -1 | 3/ | 3/ | 3/ | 3/ | 3/ |
| 8. Reserves for market making activities | -40 | -90 | -70 | -40 | -20 | -90 |
| Total | -446 | -1,026 | -1,095 | -1,144 | -1,209 | -994 |

1/ Indeterminate with respect to both amount and timing but could be substantial

2/ Loss of $25 million in fiscal year 1980 and a comparable gain in later years, primarily 1990.

3/ Negligible.

4/ Loss of less than $5 million

Joint Committee on Taxation
August 21, 1980