

**DESCRIPTION OF POSSIBLE PROPOSALS TO REDUCE
TAX COMPLEXITY FOR SMALL BUSINESS**

Scheduled for a Public Hearing

Before the

SUBCOMMITTEE ON OVERSIGHT

of the

HOUSE COMMITTEE ON WAYS AND MEANS

on June 23, 1998

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The House Committee on Ways and Means Subcommittee on Oversight has scheduled a public hearing on June 23, 1998, on various proposals relating to individuals and small business. Among the issues before the Subcommittee are proposals to expand the availability of expensing for small business. This document,¹ prepared by the staff of the Joint Committee on Taxation, contains a description of present-law rules, description of proposals to expand the availability of expensing, and analysis of such proposals.

¹ This document may be cited as follows: Joint Committee on Taxation, *Description of Possible Proposals to Reduce Tax Complexity For Small Business* (JCX-49-98), June 22, 1998.

PRESENT LAW, DESCRIPTION, AND ANALYSIS OF PROPOSALS RELATING TO EXPENSING

Present Law

In general

Under present law, 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 (MACRS) of section 168, which determines depreciation by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.

Expensing under Code section 179

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment can elect to deduct up to \$18,500 (for taxable years beginning in 1998) of the cost of qualifying property placed in service for the taxable year (Code sec. 179).² 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. Buildings and their structural components are not section 179 property.

The \$18,500 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).

² The amount permitted to be expensed under Code section 179 is increased by up to an additional \$20,000 for certain property placed in service by a business located in an empowerment zone (sec. 1397A).

The Small Business Job Protection Act of 1996 increased the amount of qualified property allowed to be expensed under Code section 179 to \$25,000. The increase is phased in as follows:

<u><i>Taxable year beginning in--</i></u>	<u><i>Maximum expensing</i></u>
1997	\$18,000
1998	\$18,500
1999	\$19,000
2000	\$20,000
2001	\$24,000
2002	\$24,000
2003 and thereafter	\$25,000

All component members of a controlled group are treated as one taxpayer for purposes of the expensing allowance and the application of the phase-out range (sec. 179(d)(6)). The limitations apply at both the partnership (and S corporation) and partner (and shareholder) levels. The increased expensing allowance is allowed for purposes of the alternative minimum tax (i.e., it is not treated as an adjustment for purposes of the alternative minimum tax). The section 179 expensing deduction may be recaptured if the property is not used predominantly in a trade or business (sec. 179(d)(10)).

Start-up costs

Present law provides for capitalization and 5-year amortization of start-up expenditures of a trade or business, organizational expenditures of a corporation, and organizational expenses of a partnership (secs. 195, 248, and 709). Start-up expenditures under section 195 are defined to include any amount paid or incurred in connection with (1) investigating the creation or acquisition of an active trade or business, (2) creating an active trade or business, or (3) any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business. In addition, such expenditures include any amount that, if paid or incurred in connection with the operation of an existing trade or business, would be allowable as a deduction for the taxable year in which paid or incurred. Start-up expenditures do not include any amounts for which a deduction is allowed (1) for interest paid or incurred within a taxable year on indebtedness (sec. 163(a)), (2) for taxes paid or incurred (sec. 164), or (3) for research and experimental expenditures (sec. 174).

Treatment of purchases of computer software

Under present law, the cost of purchases of computer software for use in a trade or business or held for the production of income generally will be depreciated on a straight-line basis over a 36-month period, unless the software is a section 197 intangible asset. However, if

the charge for computer software is included in the price of computer hardware and is not separately identified, then the charge for such software must be depreciated in the same manner as the cost of the hardware, which is generally treated as 5-year property under section 168(e)(3)(B).

Description of Proposals

Increase availability of expensing under section 179

The phase-in of the dollar limit on expensing to \$25,000 could be accelerated to be effective for taxable years beginning after 1998, or the dollar amount could be increased to an amount greater than \$25,000. Alternatively, the availability of section 179 could be expanded by increasing the \$200,000 phase-out amount so that taxpayers with a greater amount of investment in qualifying property for a taxable year could qualify for section 179 expensing.

Permit expensing for a limited amount of start-up costs

A specified dollar amount of start-up expenditures could be permitted to be expensed in the current taxable year rather than amortized over a 5-year period. By limiting the amount of such start-up expenditures eligible for expensing, the proposal's benefit could be limited to small businesses with more limited start-up costs.

Permit expensing of computer software

A deduction could be permitted in the year of purchase for non-customized computer software up to a specified dollar limit.

Analysis of Proposals

Increase availability of expensing under section 179

In general, any increase in expensing provides an incentive for certain businesses to increase investments in capital assets and simplifies reporting for eligible businesses. Accordingly, increasing the phase-in of the dollar limit on expensing to \$25,000 more rapidly or increasing such dollar limit beyond \$25,000 would provide simplification by eliminating depreciation recordkeeping requirements for more property, a benefit of section 179 expensing that the Congress has recognized in the past as important. However, because present-law section 179 contains an income limitation, taxpayers with low amounts of taxable income cannot take advantage of its benefits. Any unused amounts are carried forward, subject to limitation, to the subsequent year. Thus, some businesses may not be able to use the increased expensing in the current year.

The proposal to increase the \$200,000 phase-out amount would be viewed as appropriate if that amount is considered too low as a result of inflation or because start-up purchases of business property often exceed that amount. The \$200,000 phase-out means that section 179 expensing is more accurately described as a benefit to businesses with a low annual investment in qualified property, rather than as a benefit to small businesses. Thus, a small manufacturing business may not qualify for section 179 expensing, while a large service business may. In addition, the \$200,000 phase out may act to defer investment.

Permit expensing for a limited amount of start-up costs

Allowing a specified dollar amount of start-up costs to be expensed in a taxable year would provide simplification by eliminating recordkeeping requirements needed in order to amortize such expenses under present law. In order to target the simplification benefit to small business, the dollar amount could be set at a level that would exclude large undertakings. On the other hand, it could be argued that the cost to the Federal government of providing expensing (compared to the present-law amortization rule) would outweigh the simplification benefit to taxpayers starting a business or organizing a corporation or partnership.

Permit expensing of computer software

Many small business taxpayers acquire commercial, non-customized computer software programs to assist them in their businesses. The volume of such acquisitions has increased in recent years as the use of computers in small businesses has increased. In addition, as the pace of technological development increases, the useful life of most computer software decreases. Requiring depreciation of such software increases the recordkeeping requirements for all businesses, although the significance of such increased recordkeeping will be greater for small businesses. A proposal to permit expensing of the costs of such computer software would (1) eliminate these recordkeeping requirements and (2) would reflect more accurately the fairly limited useful life of most computer software.

Imposition of a dollar limit on the availability of expensing of computer software or some other limitation could target the benefit of this proposal to small businesses. However, as pointed out with respect to the dollar limit on expensing under section 179, a dollar limitation may merely target the incentive to a business with a low annual investment in computer software, irrespective of the size of the business.