



Small Business Tax Benefits and the American Recovery and Reinvestment Act of 2009

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Summary

In a bid to arrest a sharp downturn in the U.S. economy that is thought to have begun in late 2007, Congress passed and President Obama signed in February 2009 a bill to stimulate the economy known as the American Recovery and Reinvestment Act of 2009 (ARRA, P.L. 111-5). Among its many provisions, the act contains a variety of tax cuts and spending initiatives, whose estimated 10-year cost comes to \$787 billion. The tax provisions account for 36% of that amount, or \$285.6 billion. Most of this cost is due to tax benefits for individuals, as the 10-year cost of the business tax provisions totals \$6.2 billion, or about 2% of the total cost of the tax incentives.

This report identifies the tax provisions in ARRA that have a significant potential to benefit a large number of small firms in a wide range of industries. It also explains the intended purpose of each provision and discusses how it might affect the performance of small firms in the next year or two. It will not be updated.

An important and problematic issue in determining how most small firms are likely to be affected by the business tax provisions in ARRA is the definition of a small firm. No standard or uniform definition undergirds the federal laws and regulations that provide assistance to small business. Instead, a variety of standards (e.g., employment or asset size) is used to identify eligible firms. In collecting and releasing economic data on small business, the Small Business Administration defines a small firm as any firm with 500 or fewer employees in a recent year. A similar definition implicitly guides the analysis presented here.

A review of the business tax provisions included in ARRA suggests that 11 of them have the potential to benefit a large number of small firms in a broad range of industries. They include one-year extensions of the bonus depreciation allowance, the enhanced expensing allowance, and the option to claim a refundable tax credit in lieu of the bonus depreciation allowance for unused research and alternative minimum tax credits from tax years starting before 2006.

Five of the provisions are targeted at small firms: (1) extension of the enhanced expensing allowance through 2009; (2) extended net operating loss carryback period for losses incurred in 2008; (3) temporary increase in the exclusion of gain on the sale of small business stock; (4) temporary reduction of the recognition period for the built-in gains tax for S corporations; and (5) lower estimated tax payments for certain small business owners in 2009. The six other tax provisions could offer significant benefits to many small as well as large firms.

Excluded from the list are tax provisions in ARRA that target specific sectors (e.g., the credit for production of electricity from renewable sources), and that encourage investors to purchase government bonds (e.g., credit for recovery zone bonds) or buy equity in entities that invest in low-income and economically distressed communities (e.g., new markets tax credit).

On the whole, the provisions seem intended to spur greater investment and hiring in 2009 (and to a lesser extent in 2010) by small firms than otherwise would be the case. They try to accomplish this mainly by temporarily lowering the cost of capital for purchases of certain tangible assets, increasing the cash flow of many small firms, and reducing the after-tax cost of hiring certain individuals. But available evidence suggests that the unanticipated and extraordinary severity of the current economic downturn, as manifested in part by sharp declines in business profits, domestic employment, and gross domestic product (GDP) since early 2008, is outweighing the stimulus imparted by these tax benefits.

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In an effort to stem a sharp decline in domestic economic activity that began in late 2007, Congress passed and President Obama signed in February 2009 an economic stimulus bill known as the American Recovery and Reinvestment Act of 2009 (ARRA, P.L. 111-5). The measure contains a variety of tax cuts, loans and loan guarantees, and spending initiatives, whose estimated 10-year cost comes to \$787 billion. On the whole, the loan and spending provisions account for 64% of that cost (\$501.6 billion), and the tax provisions for 36% (\$285.6 billion). Most of the cost of the tax provisions is due to tax benefits for individuals, as the 10-year cost of the business tax incentives in the act totals only \$6.2 billion, or about 2% of the aggregate cost of the tax cuts.

This report identifies the tax provisions in ARRA that have the potential to benefit a large number of small firms in a broad range of industries and discusses how each provision is likely to affect small firms as a whole in the next year or two. It will not be updated.

The report does not examine other provisions in the act that could benefit many small firms. These provisions can be divided into two categories: (1) financial assistance in the form of federal loans, loan guarantees, and financing for equity investment in certain small firms; and (2) federal spending for a variety of public purposes, including road and bridge construction and repair, upgrading the energy efficiency of low-income housing, and the extension of high-speed Internet access to rural areas. Notable examples of each category include an additional \$630 million for loans and loan guarantees and an additional \$6 million for direct loans administered by the Small Business Administration (SBA) in FY2009; an increase in funds available to SBA-licensed Small Business Investment Companies (SBICs) and a requirement that they invest a minimum of 25% of their funds in smaller companies; \$1.5 billion for the renovation and repair of community health centers; and \$27.5 billion for highway projects administered by the Federal Highway Administration.¹

What Is a Small Firm?

An important and problematic issue in assessing how small firms are likely to be affected by the business tax provisions in ARRA is the definition of a small firm. No standard or uniform definition undergirds the federal laws and regulations aimed at providing assistance to small business. Instead, several criteria are used to identify eligible firms.

This lack of uniformity is readily apparent in existing federal small business tax preferences. Some rely on the size of assets, gross receipts, or employment to identify eligible firms. A few others confer benefits on small firms not through an explicit size limitation but through the design of the preferences themselves. A case in point is the expensing allowance under Section 179 of the Internal Revenue Code (IRC). The maximum allowance, which has varied over time and is set at \$250,000 in 2009, may be claimed by firms that spend \$800,000 or less on qualified depreciable assets and place them in service before the end of that year. But the allowance is reduced dollar for dollar when spending on those assets climbs above \$800,000.² As a result, firms that spend more than \$1,050,000 on qualified assets can claim no allowance in 2009. This

¹ For more details on the SBA programs affected by ARRA, see CRS Report R40241, *Small Business Provisions in the American Recovery and Reinvestment Act of 2009*, by (name redacted) and (name redacted).

² The phaseout threshold also has varied over time.

phaseout rule effectively confines the benefits of the allowance to firms that are relatively small in asset size.

The Small Business Act (P.L. 85-536, as amended) grants the SBA the authority to establish or modify the size standards and limits used to determine eligibility for all federal (non-tax) programs to aid small business. With one notable exception, the SBA uses two standards to determine eligibility for the programs it administers: (1) number of employees and (2) average annual receipts in the previous three years. Application of these standards varies by industry. For example, the standard for firms classified in the mining and manufacturing industries is employment size: a firm in either industry is considered small if it employed an average of 500 or fewer workers in the previous year. In the case of firms classified in the service or retail industries, however, the standard is average annual receipt size: a firm in either industry is considered small if its average annual receipts in the previous three years totaled \$6 million or less. SBA's limits for the two standards currently range from 50 to 1,500 employees, and from \$0.75 million to \$35.5 million average annual receipts. The exception is the financial services industry: the SBA considers firms in that industry small if their assets are valued at \$175 million or less.³ Compounding the confusion over how to define a small firm, the SBA uses a single size standard of 500 or fewer employees to identify the firms eligible for the economic data on small business it collects and publishes.

Ultimately, the definition of a small firm involves making what amounts to arbitrary choices about a standard that applies to all firms in all industries (e.g., employment, assets, revenues) and a size limit for that standard (e.g., fewer than 500 employees, less than \$10 million in assets or gross income). Given the differences among industries in such vital characteristics as sources of income, the technologies used to generate output, production inputs, and the nature of competition, it is reasonable to question whether a single standard should apply to all firms in all industries. And even if interested parties could agree on such a standard, there is no simple, obvious, or logical solution to the problem of where to draw the line between small firms and all other firms. Indeed, the difficult challenges posed by those questions may partly explain why current federal support for small business is built around multiple eligibility criteria. Lawmakers may have no other choice, realistically, for one size seemingly does not fit all firms.

No explicit size standard underlies the following discussion of the tax provisions in ARRA that might benefit many small firms in a wide range of industries. Nevertheless, it seems fair to say that the choice of provisions reflects what could be described as an unspoken consensus among lawmakers and policy analysts over the provisions in the federal tax code that are notably beneficial to small business owners.

Tax Provisions in ARRA That Could Benefit Many Small Firms in a Wide Range of Industries

A review of the business tax provisions included in ARRA suggests that 11 of them have the potential to benefit a large number of small firms in a broad range of industries:

³ These limits are revised periodically. See U.S. Small Business Administration, *Table on Small Business Size Standards Matched to North American Industry Classification System Codes*, effective Aug. 22, 2008; available at <http://www.sba.gov/size>.

- Extension of the bonus depreciation allowance
- Extension of enhanced expensing allowance
- Extended net operating loss carryback period
- Expanded work opportunity credit
- Deferral of income from discharge of business debt
- Increased exclusion of gain on the sale of small business stock
- Reduction in recognition period for built-in gains tax
- Extension of option to monetize a portion of unused pre-2006 research and corporate alternative minimum tax (AMT) credits
- Lower estimated tax payments in 2009 for qualified small business owners
- Credit against employment tax payments for employer COBRA subsidies
- Increase in the exemption amounts for the AMT and an extension through 2009 of the full use of non-refundable personal credits against the tax

Five of them are targeted at small firms: (1) extension of the enhanced expensing allowance through 2009; (2) extended net operating loss carryback period for losses incurred in 2008; (3) temporary increase in the exclusion of gain on the sale of small business stock; (4) temporary reduction of the recognition period for the built-in gains tax for S corporations; and (5) lower estimated tax payments for certain small business owners in 2009. The six other tax provisions could offer significant benefits to small as well as large firms.

Excluded from the list are tax provisions in ARRA that target specific sectors (e.g., the credit for production of electricity from renewable sources), and that encourage investors to purchase government bonds (e.g., credit for recovery zone bonds) or buy equity in entities that invest in low-income and economically distressed communities (e.g., new markets tax credit).

The intended purpose of the 11 tax provisions and their implications for the performance of small firms as a whole in the near term are discussed below.

On the whole, the provisions seem intended to spur greater investment and hiring in 2009 (and to a lesser extent in 2010) by small firms than otherwise would be the case. (The intended purpose and main short-term effects of each provision are summarized in the table below.) ARRA tries to accomplish this mainly by temporarily lowering the cost of capital for purchases of certain tangible assets, increasing the cash flow of many small firms, and reducing the after-tax cost of hiring certain individuals. But available evidence suggests that the unanticipated and extraordinary severity of the current economic downturn, as manifested in part by sharp declines in business profits, domestic employment, and gross domestic product (GDP) since early 2008, is outweighing the stimulus imparted by these tax benefits.⁴

⁴ According to estimates by the Bureau of Economic Analysis at the U. S. Department of Commerce, real gross domestic product dropped 2.6% (on an annual basis) from the first quarter of 2008 to the first quarter of 2009, and after-tax corporate profits fell 16% (also on an annual basis) from the first quarter through the fourth quarter of 2008. And the Bureau of Labor Statistics at the U.S. Department of Labor reports that from December 2007 through June 2009, the United States experienced a net loss of 6.5 million non-farm payroll jobs.

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While it is difficult to determine how small firms on the whole are responding to the tax incentives in ARRA, there is a readily available rough indicator of the stimulus they could provide: the revenue effects of ARRA as estimated by the Joint Committee on Taxation (JCT). For many business tax incentives, the larger the revenue loss they produce, the greater their effect on some key aspect of business activity, whether it be hiring, cash flow, investment, or sales. According to the JCT, the five tax provisions that are targeted at small firms could produce a combined revenue loss of \$5.7 billion in FY2009; the six other tax provisions that could benefit many small firms are expected to result in a combined revenue loss of \$52.0 billion in the same year.⁵ These amounts should not be seen as equivalent to the added output by companies of all sizes that could arise from the 11 tax provisions. A significant share of the estimated revenue loss represents a deferral of tax liability, which is to say that the deferred taxes will have to be paid in some future tax year. Still, the estimated revenue loss measures the extent to which companies of all sizes take advantage of the tax incentives, and at least some of that usage could eventually show up as greater investment or hiring by certain companies.

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More of the same may be in store for the U.S. economy in 2009. According to the latest survey of 53 leading business economists about their short-term forecasts for the economy, the average or “consensus” forecast has real GDP declining 2.6% in 2009 from its level in 2008, corporate profits falling 12.4% in the same period, and the unemployment rate rising from an average of 5.8% in 2008 to 9.3% in 2009. (See *Blue Chip Economic Indicators*, vol. 34, no. 7, July 10, 2009, p.2.)

⁵ U.S. Congress, Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the Conference Agreement for H.R. 1, the “American Recovery and Reinvestment Act of 2009,”* JCX-19-09, Feb. 12, 2009.

Table I. Small Business Tax Provisions in the American Recovery and Reinvestment Act of 2009

Tax Provision in the American Recovery and Reinvestment Act of 2009 (ARRA)	Internal Revenue Code Section	Nature of the Provision	Estimated Combined Revenue Effect in FY2009 and FY2010^a	Likely Short-Term Effect on Small Firms
Tax Provisions Targeted at Small Firms				
Five-Year Carryback of Net Operating Losses from 2008 by Eligible Small Firms	Section 172	Allows firms with \$15 million or less in average annual gross receipts in past three years to carry back NOLs from 2008 up to five years instead of two years	-\$4,033 million	Could boost the cash flow of some small firms
Extension Through 2009 of Enhanced Expensing Allowance	Section 179	Allows firms to deduct up to \$250,000 of cost eligible assets placed in service in 2009, within certain limits	-\$1,067	May encourage some small firms to make investments in 2009 that they are planning for future years
Exclusion of Gain on Sale of Eligible Small Business Stock	Section 1202	Allows investors to exclude 75% (instead of 50%) of any gain they realize on the sale of eligible small business stock they acquire between Feb. 18, 2009 and Dec. 31, 2010	+\$8	May increase equity investment in some small firms in 2009 and 2010
Temporary Reduction in Recognition Period for Built-In Gains Tax for S Corporations	Section 1374	Reduces the recognition period from 10 years to seven years for corporate tax on sale of appreciated assets in 2009 or 2010 by S corporations that once were organized as C corporations	-\$185	Could boost cash flow of some S corporations
Reduced Estimated Tax Payments for Some Small Business Owners in 2009	Section 6654	Allows individuals who had an adjusted gross income in 2008 of less than \$500,000 and can prove that over half their income came from a small business to base their estimated tax payments for 2009 on 90% of their tax liability for 2008	\$0	Could lead to a small rise in cash flow for some small firms in 2009 only; any taxes not paid in 2009 will have to be paid in 2010
Business Tax Provisions That Could Benefit Many Small Firms				
Extension Through 2009 of Bonus Depreciation Allowance	Section 168(k)	Allows any firm to deduct 50% of the cost of eligible assets placed in service in 2009	-\$37,804 million	Could convince some small firms to advance to 2009 investments planned for later years

Tax Provision in the American Recovery and Reinvestment Act of 2009 (ARRA)	Internal Revenue Code Section	Nature of the Provision	Estimated Combined Revenue Effect in FY2009 and FY2010^a	Likely Short-Term Effect on Small Firms
Temporary Expansion of the Work Opportunity Tax Credit	Sections 1221 and 51	Permits employers to claim the credit for unemployed veterans and disconnected youth on 2009 and 2010 only	-\$113	Gives small firms an incentive to hire eligible individuals instead of others who do not qualify for the credit, or to replace current employees with eligible individuals
Deferral of Income from Discharge of Business Debt	Sections 61(a) and 108	Allows firms of all sizes that buy back or exchange their own debt at a discounted price in 2009 and 2010 to defer their discharge-of-indebtedness income	-\$34,916	Might allow some small firms with adequate cash reserves and positive tax liabilities to lower their tax payments in 2009 and 2010
Extension Through 2009 of Option to Claim Unused AMT and Research Tax Credits Instead of Bonus Depreciation Allowance	Section 168(k)(4)	Allows firms that could claim a bonus depreciation allowance in 2009 to claim instead as refundable credit a portion of their unused research and AMT credits from tax years before 2006	-\$1,013	Could increase cash flow of some small firms
Increase in Income Threshold for AMT and Extension of Use of Personal Credits Against the AMT	Section 6432	Increases the AMT exemption amount for joint filers to \$70,950 and for single filers to \$46,700 in 2009. Extends through 2009 a rule that allows individuals to use non-refundable personal credits to the full extent possible against the AMT and regular income tax	-\$84,774	Could reduce the federal income tax liability of many small business owners in 2009

a. Joint Committee on Taxation, Estimated Budget Effects of the Revenue Provisions Contained in the Conference Agreement for H.R. 1, the American Recovery and Reinvestment Act of 2009, JCX-19-09, (Washington: Feb. 12, 2009)

Source: Congressional Research Service

ARRA Tax Provisions Targeted at Small Firms

Enhanced Expensing Allowance for 2009: Section 1202 of the Act and IRC Section 179

In computing their income tax liability, business taxpayers are allowed to deduct from gross income all the costs they incurred in earning it. For many of these costs, the full amount is deducted in the year when the production inputs are purchased, or in the year when the items made from the inputs are sold.

But purchases of capital goods and other durable business assets receive different treatment under the tax rules for cost recovery. Their cost generally is recovered not in the year of purchase but over a number of years intended to approximate the actual useful lives of the assets. Over time, the assets lose value through wear and tear and obsolescence. This decline in value is known as economic depreciation. Current tax law allows firms to claim a deduction for the depreciation of their tangible assets; most deductions are based on the depreciation schedules for what is known as the Modified Accelerated Cost Recovery System (MACRS).

Recovering the cost of an asset faster than the rate at which its actual value declines is known as accelerated depreciation. Under this method of cost recovery, firms deduct more of the cost of an asset in the present and less in the future than they would under depreciation schedules based on rates of economic depreciation. This forward shift in the deduction schedule lowers current tax liabilities at the expense of higher tax payments in the future, all other things being equal. Since a deduction is generally worth more to a firm today than in the future, accelerated depreciation has the effect of reducing the marginal effective tax rate on new investments in qualified assets; this reduction in turn lowers the cost of capital for those investments, making them more attractive to business owners and managers.⁶ Expensing, which involves writing off the entire cost of an asset in the year when it was acquired or placed in service, is the most accelerated method of depreciation.

The deferral of income tax entailed by accelerated depreciation also temporarily boosts the cash flow of firms making qualified investments, all other things being equal. The increase is greater for longer-lived assets than shorter-lived ones. An increase in cash flow could trigger a rise in investment by firms that rely heavily on internal funds to finance new investments.

⁶ More specifically, bonus depreciation lowers marginal effective tax rates on the returns to investment in qualified assets by raising the net present value of depreciation allowance. This effect is more pronounced for longer-lived assets than shorter-lived assets. For example, in an analysis of the corporate response to the bonus depreciation that was in effect from 2002 to 2004, Matthew Knittel of the Office of Tax Analysis at the Treasury Department estimated that a 50% bonus depreciation allowance lowered the average marginal tax rate for 3-year, 5-year, and 7-year assets by 27%, but the average reduction in the average rate for 10-year, 15-year, and 20-year assets came to 37%. See Matthew Knittel, *Corporate Response to Accelerated Depreciation: Bonus Depreciation for Tax Years 2002-2004*, OTA working paper 98 (Washington: Treasury Department, May 2007), table 2.

Impact of ARRA

ARRA extends through 2009 an enhanced expensing allowance under IRC Section 179. While there is no size limit on the firms that can benefit from the allowance, its design effectively confines its use to smaller firms. The current allowance had expired at the end of 2008.⁷

Under the expensing allowance, firms may deduct up to \$250,000 of the cost of new and used qualified assets purchased and placed in service in 2009; the maximum allowance decreases, dollar for dollar, when a firm's total spending on those assets that year exceeds \$800,000. Unlike the bonus depreciation allowance that ARRA extended through 2009, the expensing allowance will remain in effect after 2009, but its maximum amount and phaseout threshold are scheduled to drop so that by 2011 and thereafter, the allowance will be fixed at \$25,000 and the threshold at 200,000. The allowance may be claimed for purchases of machinery, equipment, and business software; it does not apply to purchases of real property like commercial or industrial buildings.

In combination, the bonus depreciation and expensing allowances extended by ARRA substantially (but temporarily) speed up the depreciation of qualified assets by allowing firms to deduct between 50% and 100% of the cost of those assets purchased and placed into service in 2009. Firms taking both allowances are required to claim the expensing allowance first, followed by any bonus depreciation allowance, and then by any regular depreciation deduction allowed under the MACRS they can take on their remaining adjusted basis in eligible assets.⁸

The JCT has estimated that the extension of the enhanced expensing allowance through 2009 will produce a revenue loss of \$331 million from FY2009 to FY2013, and \$206 billion from FY2009 to FY2018, relative to federal tax law before the enactment of ARRA.⁹ The loss decreases over time because it is front-loaded, which is to say that use of the allowance reduces tax payments in the first few years but raises them in later years.

In extending the bonus depreciation and expensing allowances through the end of 2009, Congress evidently was intending to spur a temporary rise in business investment. There is ample support for such an approach in both theory and empirical reality.

In theory, a time-limited investment tax incentive like the enhanced expensing allowance should alter the timing of qualified investments, but not necessarily the total amount invested over time. By lowering the cost of capital for purchases of qualified assets during 2009 only, the enhanced allowance, particularly in combination with the extended bonus depreciation allowance, gives many large and small firms an incentive to move forward qualified investments they planned to make in later years. The reduction in the cost of capital is greater for longer-lived assets than it is for shorter-lived ones, as the bonus depreciation allowance causes a larger increase in the present value of depreciation allowances for the former than for the latter, and the enhanced expensing allowance simply amplifies this effect, to the extent it can be used.¹⁰ So in theory, the allowances

⁷ The current small business expensing allowance was established by the Economic Stimulus Act of 2008 (P.L. 110-185), which restricted its use to qualified assets bought and placed into service in 2008 only.

⁸ For more details on the prescribed order in which these depreciation allowances are taken, see CRS Report RL31852, *Small Business Expensing Allowance: Current Status, Legislative Proposals, and Economic Effects*, by (name redacted), p. 3.

⁹ Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the Conference Agreement for H.R. 1*, pp. 3-4.

¹⁰ Darrel Cohen and Jason Cummins, *A Retrospective Evaluation of the Effects of Temporary Partial Expensing*, staff (continued...)

could be expected to spur a bigger rise in spending on qualified assets with a recovery period of 10 to 20 years than on qualified assets with a recovery period of three to seven years. Moreover, standard economic models of the impact of income taxes on business investment suggest that the allowances are likely to initiate a process where business investment rises right after they go into effect, rises again just before they expire, and then drops after they do expire.¹¹ Reflecting the temporary nature of the stimulus, the domestic capital stock eventually could return to the level it would have reached without the allowances.

In addition, several recent studies have concluded that business investment is moderately sensitive to tax incentives. On the whole, they indicate that the elasticity or responsiveness of investment to changes in the effective tax rate is around -0.5; this means that a 10% reduction in the tax rate eventually leads to an increase in investment of 5%.¹² In combination, the bonus depreciation allowance and the expensing allowance can substantially lower the effective tax rate on the returns to investment in qualified assets.

How are small firms as a whole likely to respond to the two temporary investment tax incentives?

There are good reasons to doubt that most small firms will substantially increase their investment in response to the two accelerated depreciation allowances—though it would not be surprising if they were to spend more than they otherwise would on the most heavily subsidized qualified assets. This expectation is tied to recent U.S. experience with partial expensing allowances, what is known about the effectiveness of temporary investment tax incentives, and perhaps above all, the weak climate for domestic business investment.

Available research findings indicate that the bonus depreciation allowances that were available from the final quarter of 2001 through the end of 2004 had a modest impact on the U.S. economy.¹³ A 2006 study by economists Christopher House and Matthew Shapiro estimated that in 2003, the allowances may have increased gross domestic product (GDP) by \$10 billion to \$20 billion and may have been responsible for the creation of 100,000 to 200,000 jobs.¹⁴ The same researchers estimated that purchases of longer-lived assets (i.e., assets with a recovery period of 10 to 20 years under the MACRS) received a subsidy from the allowances that was three to five times greater than the subsidy for shorter-lived assets (i.e., assets with a recovery period of three to seven years). As a result, House and Shapiro concluded that investment in the more heavily subsidized assets rose by as much as 40% relative to what might have occurred without the allowances. Another study found that the same partial expensing allowances had “only a very

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working paper 2006-19, Federal Reserve Board, Divisions of Research & Statistics and Monetary Affairs, April 2006, pp. 3-5.

¹¹ Ibid., p. 9.

¹² Jonathan Gruber, *Public Finance and Public Policy* (New York: Worth Publishers, 2005), p. 675.

¹³ The Jobs Creation and Worker Assistance Act of 2002 (P.L. 107-147) allowed firms to deduct up to 30% of the cost of the same assets covered by the current bonus depreciation allowance in the year when they were purchased. To qualify, the assets had to be purchased between September 10, 2001, and September 11, 2004, and placed in service no later than December 31, 2004. This 30% bonus depreciation allowance increased to 50% under the Jobs Creation and Worker Assistance Act of 2003 for qualified assets purchased and placed into service after May 5, 2003, and before January 1, 2005.

¹⁴ Christopher House and Matthew D. Shapiro, *Temporary Investment Tax Incentives: Theory with Evidence from Bonus Depreciation*, working paper 12514 (Cambridge, MA: National Bureau of Economic Research, Sept. 2006), p. 34.

limited impact ... on investment spending, if any.”¹⁵ As supporting evidence, the researchers cited the results of a 2005 survey conducted by the Institute for Supply Management that indicated that less than 10% of the 115 respondents said the bonus depreciation allowances had a significant influence on the timing of their capital spending in the previous two years.¹⁶ In addition, the Congressional Budget Office has noted that there was a lack of solid evidence that the allowances affected the timing of investment around the expiration date, or that they strongly affected investment in the assets that received the greatest subsidy.¹⁷

There appear to be no similar studies of the impact of the IRC Section 179 expensing allowance on the timing or long-term level of business investment.

Still, it is not entirely clear why the earlier bonus depreciation allowances did not have the impact on business investment that some economists and lawmakers had expected. Analysts cite several factors that could explain why their combined short-term effects were so modest. First, most firms may have expected Congress to extend the 50% allowance beyond 2004, lessening their incentive to accelerate the timing of planned qualified investments. Second, many firms may have found it impossible to undertake planned future investments within the time frame for the allowances; for many firms, the planning horizons for new qualified investments may have been too long to take advantage of the allowances. And last but not least, many firms may have had too little income, or too many loss carryforwards, from 2001 to 2004 to benefit from the allowances.

Some of the same factors may be affecting use of the allowances in 2009. Although lower capital costs should encourage some additional investment by small firms, most of the tax benefit from the allowances in 2009 may end up going to firms that would have made qualified investments without the subsidies. Because both tax incentives were available in 2008, it is also possible that some investments that had been planned for 2009 were moved up to 2008.¹⁸

But the current slump in domestic economic activity, coupled with the considerable uncertainty surrounding when and how the economy will recover, a growing reluctance among companies to spend the cash they have, and the difficulties many small firms are having obtaining funds from lenders, appears to be having a stronger effect on small business investment so far in 2009 than the two expensing allowances.

Since late 2007, domestic economic activity has been caught in a worsening recession that has shown few signs of abating. From the first quarter of 2008 through the first quarter of 2009, real gross domestic product fell at an average annual rate of 2.6%. Corporate profits, a major factor in business investment, dropped 21% in 2008, when measured on a seasonally adjusted annual basis. U.S. production in manufacturing, mining, and utilities decreased by 13.4% from May 2008 to May 2009, and total capacity use in the three sectors was 68.3% in May 2009, down from 78.9% a year earlier.

¹⁵ Cohen and Cummins, *A Retrospective Evaluation of the Effects of Temporary Partial Expensing*, p. 20.

¹⁶ *Ibid.*, p. 19.

¹⁷ Congressional Budget Office, *Options for Responding to Short-Term Economic Weakness* (Washington: Jan. 2008), p. 15.

¹⁸ Tax Policy Center, *Tax Stimulus Report Card on Conference Bill* (Washington, Brookings Institution and Urban Institute, Feb. 13, 2009), p. 22.

In response, firms of all employment sizes have been eliminating or postponing investment projects. From the first quarter of 2008 through the first quarter of 2009, real business investment in equipment and software, the main assets targeted by the both the expensing and bonus depreciation allowances, declined at an average annual rate of 15%. Some economic forecasters are predicting that business spending on new plant and equipment will fall more in 2009 than it did in 2008.¹⁹

Small firms have not been immune to the effects of the recession on capital spending. The NFIB, a leading trade association for the U.S. small business community, recently reported that small business owners “continue to defer any (investment) project not essential to the survival of the firm.”²⁰ According to the latest NFIB survey of small business owners, only 5% expressed the belief that the period from June through August 2009 will be a good time to expand operations; their actual combined earnings from February through April 2009 were 43% lower than they were from November 2008 through January 2009; and only 20% of owners said they plan to make a capital expenditure in the period from June through December 2009.²¹ The reluctance to invest in capital goods reflects not only widespread pessimism among small business owners about the prospects for a sharp rebound in consumer spending in the next year or so, but also a strong interest among those owners in conserving the cash they have and recent sharp cutbacks in the lines of credit available to many small firms.²²

Five-Year Carryback of Net Operating Losses for Qualified Small Firms: Section 1211 of the Act and IRC Section 172

In general, federal tax law allows firms that incur a net operating loss (NOL) to use that loss to lower taxable income in a tax year when they earn (or earned) positive net income. The reduction in taxable income for that year should result in a partial or full refund of any income taxes paid. An NOL arises when a firm’s deductions exceed its gross income.

Under IRC Section 172, firms can carry an NOL back to each of the two tax years preceding the loss year, or carry the NOL forward to each of the 20 tax years following the loss year. Unless a firm elects not to do so, it is required to carry an NOL back two years before applying any remaining loss to a future tax year. There are some exceptions to the two-year limitation on NOL carrybacks. For instance, NOLs incurred in the 2001 or 2002 tax years can be carried back up to five years, and taxpayers may carry back up to three years any portion of an NOL that is due to what are known as “eligible losses,” which include farming and natural disaster losses.

ARRA adds another exception by permitting eligible small firms to carry back more than two and fewer than six years (or from 2003 to 2005) NOLs that began or ended in the 2008 tax year. Those losses can still be carried forward up to 20 years. C and S Corporations, partnerships, and sole proprietorships can take advantage of this exception only if a firm’s average annual gross

¹⁹ Institute for Supply Management, *Economic Decline to Continue Throughout 2009*, news release, May 5, 2009, available at <http://www.ism.ws>.

²⁰ William C. Dunkelberg and Holly Wade, *NFIB Small Business Economic Trends: May 2009*, p. 1; available at <http://www.nfib.org>.

²¹ Dunkelberg and Wade, *NFIB Small Business Economic Trends: June 2009*.

²² See Andrew Martin, “A Credit Squeeze for Small Business Owners,” *New York Times*, June 19, 2009, p. B1; and Martin Neil Bailly and Douglas J. Elliott, *The US Financial and Economic Crisis: Where Does It Stand and Where Do We Go From Here*, Initiative on Business and Public Policy, Brookings Institution, June 2009.

receipts in the previous three tax years totaled \$15 million or less. In the case of firms that did not exist during each of the three tax years before 2008, the gross receipts test applies to the period in which they had business income.

The JCT has estimated that the extended NOL carryback period will result in a revenue loss of \$2.1 billion from FY2009 to FY2013, and \$1.0 billion from FY2009 to FY2018, relative to federal tax law before the enactment of ARRA.²³ The loss is front-loaded, as eligible firms with NOLs in 2008 that carry them back an additional three years would have that much less to carry forward.

How many small firms are likely to benefit from the extended carryback period for NOLs? It cannot be determined from available small business data how many firms are eligible to claim this temporary tax benefit and how many eligible firms had NOLs in 2008. So the question cannot be answered for the time being.

In theory, the provision could lead eligible firms to do more of anything requiring the expenditure of funds in 2009 than they otherwise would. Use of the extended carryback period for a 2008 NOL makes it possible for a company to receive a refund equal to the amount of the NOL sometime in 2009 or 2010 of federal income taxes it paid in 2003 to 2005. For example, this refund, when paired with the reduction in the cost of capital for qualified investments and boost in cash flow arising from the two accelerated depreciation provisions in ARRA, could allow the company to purchase in 2009 assets that are eligible for both depreciation allowances that it otherwise might not consider acquiring until the economy begins a sustained recovery. This outcome is especially likely for eligible small firms that are profitable (despite the recession) but having difficulty raising capital from lenders or investors. Of course, eligible firms that have no immediate profitable investment opportunities could use any tax refund for numerous other purposes, including increasing employee wages, hiring additional workers, or spending more on research and development.

Nonetheless, there are several reasons to question whether the extended NOL carryback provision will have such an impact on many eligible firms in 2009.

One important consideration is the link between the provision and the cost of capital for business investment or consumer spending, which accounts for about 70% of real GDP. In general, business spending on structures and equipment is apt to rise when a majority of firms expect their current capacity to deliver goods and services to be insufficient to meet projected increases in demand, and when the expected rate of return on investment in those assets exceeds the cost of capital. But the extended NOL carryback has no direct effect on the cost of capital or consumer spending, making it a relatively ineffective means of stimulating the economy.

In addition, small firms receiving an infusion of cash during a sustained economic downturn may be more inclined to hold on to it for the time being than to use it to increase investment or hire more workers.²⁴ The considerable uncertainty over when the U.S. economy will begin to grow again and what forces will drive the growth may reinforce this inclination.

²³ Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the Conference Agreement for H.R. 1*, p. 4.

²⁴ CRS Report RL34535, *Net Operating Losses: Proposed Extension of Carryback Period*, by (name redacted), p. 5.

It also appears that some of the firms that could claim the extended NOL carryback provision would not benefit from it, further restricting its potential to stimulate increased investment and employment among small firms. Basically, the provision mainly benefits small firms that experienced a loss in 2008 but were mostly profitable during the four or five preceding years. Newer firms with a string of losses in recent years would reap no immediate benefit from it, nor would small firms whose owners can offset any business losses with income from other sources.²⁵

Exclusion of Gain on the Sale of Qualified Small Business Stock: Section 1241 of ARRA and IRC Section 1202

Current tax law allows individuals and other non-corporate taxpayers (e.g., partnerships and S corporations) to exclude from gross income up to 50% of any gain on the sale or exchange of qualified small business stock (QSBS). The gain on any QSBS issued by a single firm that may be excluded in a tax year is limited to the greater of \$10 million, less any gain excluded in previous tax years, or 10 times a taxpayer's adjusted basis in the stock. When this provision was added to the tax code in 1993, the maximum tax rate on long-term capital gains was 28%. While this rate has been lowered several times since then and now stands at 15%, the portion of any gain on the disposition of QSBS that is subject to taxation is still taxed at a rate of 28%. As a result, the effective tax rate for gains on the sale of this stock is 14%, compared to an effective rate of 15% on any gains on the sale or exchange of other long-term capital assets. The partial exclusion is treated as a preference item for the purpose of computing the individual AMT.²⁶

To qualify for this preferential treatment, a stock must be acquired by a qualified taxpayer at its original issue and held for at least five years. The stock must also be issued by a C corporation that had adjusted gross assets valued at no more than \$50 million and used 80% or more of its assets in the active conduct of one or more qualified trades or businesses, when the stock was issued.

The partial exclusion is intended to augment the flow of equity capital to small start-up firms that are having difficulty raising funds from traditional sources such as angel investors, banks, and venture capital firms. It does so by boosting the potential after-tax returns an investor could earn by buying and selling QSBS, relative to comparable alternative investments. There are no known studies of how effective the partial exclusion has been in achieving its intended purpose.

Under the ARRA, 75% of any gain on a QSBS acquired after February 17, 2009, and before January 1, 2011, may be excluded from taxation. This temporary expansion in the exclusion means that any gain on qualified stock realized by an investor in the highest tax bracket under the regular income tax will be taxed at an effective rate of 7% under the regular income tax and 12.9% under the AMT.

The JCT has estimated that the provision will lead to a revenue gain of \$9 million from FY2009 to FY2013, and a revenue loss of \$807 million from FY2009 to FY2018, relative to federal tax law before the enactment of ARRA.²⁷ Most of the revenue loss is projected to occur from FY2014

²⁵ Tax Policy Center, *Tax Stimulus Report Card on Conference Bill*, p. 26.

²⁶ For more details on the design of the partial exclusion and its impact on capital markets, see U.S. Congress, Senate Committee on the Budget, *Tax Expenditures*, committee print, 110th Cong., 2d sess. (Washington: GPO, Dec. 2008), pp. 485-491.

²⁷ Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the Conference* (continued...)

to FY2016, as the JCT expects many taxpayers who purchase QSBS in 2009 and 2010 to sell it five or six years later.

The provision is likely to spur greater equity investment in small firms that can issue QSBS than otherwise would be the case. But how large that increase could turn out to be is difficult to project. The search for a plausible answer is hampered by a lack of evidence on the effectiveness of the partial exclusion as a tool for boosting equity investment in new small firms. It is also hindered by the uncertainty surrounding the near-term outlook for the economy and business profits. Investing in small start-up firms has always entailed considerable risk, but the current economic downturn and the large losses suffered by many investors and financial institutions in the previous two years appear to have compounded this risk. There is some evidence that investors have responded to this heightened risk by substantially reducing their investment in small start-up firms. The amount of domestic investment by venture capital firms fell from \$7.7 billion in the first quarter of 2008 to \$3.0 billion in the same quarter of 2009.²⁸ A temporary rise in the partial exclusion may not be enough to arrest this trend.

Temporary Reduction in the Recognition Period for Built-In Gains for Subchapter S Corporations: Section 1251 of the Act and IRC Section 1374

Owners of firms have two basic options for deciding in which legal organizational form to operate. The firms can be organized in a way that subjects them to an entity-level income tax, or they can be organized as some kind of passthrough entity, thus avoiding an entity-level tax. C corporations are subject to a tax on their net income, while passthrough entities such as partnerships and S corporations are not taxed on their net income. Instead, the net income and other tax items (e.g., NOLs, deductions, and credits) of these entities pass through to their owners according to their ownership shares, which means that any net income is added to the owners' taxable income from other sources and reported on their individual tax returns. An important consideration in selecting a legal organizational form is the tax burden on the returns to investment associated with each form.

An S corporation offers the tax advantage of passthrough treatment, while retaining the non-tax advantages of corporate status under federal securities law and state law. For tax purposes, an S corporation and its shareholders are treated more like a partnership and its partners than a C corporation and its shareholders. To qualify as an S corporation, a business entity must satisfy certain requirements with regard to its capital structure and the size and composition of its shareholders.

Under current law, S corporations that once were organized as C corporations generally are subject to a corporate-level tax, during what is known as a 10-year recognition period, on any net built-in gains they realize on the sale, exchange, or distribution of assets they held at the time of conversion. The gains occurred when an S corporation operated as a C corporation; so the gains are regarded as built into the assets the latter held when it converted to the former. The tax is limited during the recognition period to the aggregate net built-in gain at the time of the

(...continued)

Agreement for H.R. 1, p. 4.

²⁸ Small Business Administration, Office of Advocacy, *Quarterly Indicators: First Quarter 2009* (Washington, May 8, 2009).

conversion. An S corporation's 10-year recognition period commences on the first day of the first tax year when a corporation that once was a C corporation begins to operate for tax purposes as a newly minted S corporation. No built-in gains tax applies to S corporations that never were organized as a C corporation, or to S corporations that have no assets acquired from a C corporation in a non-recognition transaction, or to assets an S corporation acquires during the period when its S election is valid.

IRC Section 1374(d)(8) extends the built-in gains tax to any net recognized built-in gain an S corporation realizes during the recognition period from the sale or distribution of assets it acquired in a carryover basis transaction with a C corporation. In such a transaction, the S corporation's basis in the acquired assets is based, in whole or in part, on the C corporation's basis in those assets at the time of the acquisition.

The built-in-gains tax is computed by applying the highest corporate income tax rate (35% under current law) to an S corporation's net recognized built-in gain for the tax year. Such a gain is defined as the lesser of (1) the amount that would be the taxable income of the S corporation if only the recognized built-in gains and recognized built-in losses were considered, or (2) the corporation's actual taxable income. The amount of gain that can be taxed in a year is limited to the excess of an S corporation's net unrealized built-in gain over the net recognized built-in gain from previous years. Net unrealized built-in gain is the excess of the fair market value of the corporation's assets on the first day it operates as an S corporation over its aggregate basis in those assets.

There are several ways in which the tax can be reduced in a tax year. Any net operating losses carried forward from tax years when an S corporation operated as a C corporation can be deducted from the net recognized built-in gain of the S corporation. Capital losses that are carried forward from years after the conversion may be used to offset any net recognized built-in gains. And any business tax credits that are carried forward from tax years when the corporation operated as a C corporation may be used to reduce the built-in gains tax of the S corporation.

In enacting the built-in gains tax in 1986, Congress was trying to prevent C corporations from converting to S corporations mainly to avoid paying a corporate tax on any gains from the sale or exchange of appreciated assets, or their distribution to individual shareholders, as part of a complete liquidation.²⁹ The Tax Reform Act of 1986 (P.L. 99-514) repealed what was then known as the General Utilities doctrine, which allowed C corporations to make tax-free distributions to individual shareholders before the firms were liquidated. As a result of the repeal, when C corporations distribute appreciated assets to individual shareholders or sell them as part of a complete liquidation, any gains are subject to taxation at both the corporate and individual levels. IRC Section 1374 imposes a double tax on the sale, exchange, or distribution of appreciated assets held by a C corporation at the time it converts to an S corporation: a corporate-level tax applies to net recognized built-in gains that the S corporation realizes during the 10-year recognition period, and the firm's shareholders must also pay taxes on the gains.

ARRA shortens the recognition period from 10 years to 7 years for S corporations that sell in 2009 or 2010 appreciated assets they held at the time of their conversion from a C corporation. This means that no built-in gains tax will be imposed on those transactions if the tax year immediately preceding either of those years represents the seventh year of an S corporation's

²⁹ Deanna Walton Harris and Paul Kugler, *The Tax Adviser*, vol. 40, no. 6, June 2009, p. 369.

recognition period. The 10-year recognition period will be reinstated for qualified assets sold or otherwise disposed of in 2011 and beyond.

The provision gives owners of S corporations formed through the conversion of a C corporation from 1999 to 2002 more flexibility in responding to the current economic downturn. In 2009 and 2010, they can sell appreciated assets without paying the tax and retain or invest the proceeds as a means of bolstering their prospects for surviving the downturn. Or they can hold on to those assets for another few years in the hope they will fetch higher prices once the economy recovers. Sharp declines in the fair market value of real estate and marketable securities and dramatic losses of liquidity in financial markets in the past two years triggered the recession.

There appear to be no estimates of the number of S corporations that could take advantage of the temporary reduction in the recognition period for the built-in gains tax. The JCT has estimated the provision is likely to produce a revenue loss of \$31 million in FY2009, \$154 million in FY2010, and \$318 million from FY2009 through FY2013.³⁰ S corporations cannot be considered a major presence in the small business sector: in 2005, for instance, they accounted for 11% of all business tax returns, regardless of employment size.

Reduced Estimated Tax Payments for Some Small Business Owners in 2009: Section 1212 of the Act and IRC Section 6654

Current federal tax law requires individuals to pay 90% of their expected tax liability for the current tax year through withholding or estimated tax payments. An individual's estimated tax is his or her combined income and self-employment tax (if any), after allowing for any estimated tax credits.

Individuals who are not exempt from the penalty for failing to pay an estimated tax can avoid the penalty by taking one of the following steps: (1) pay at least 90% of the estimated tax for the current tax year; (2) pay 100% of the tax shown on the previous year's return if a taxpayer's adjusted gross income (AGI) was \$150,000 or less; (3) pay 110% of the tax shown on the previous year's return if a taxpayer's AGI was over \$150,000; or (4) pay any of those estimated taxes in installments under an annualized income installment method.

ARRA changes these rules to permit qualified individuals to base their estimated tax payments for tax years beginning in 2009 on 90% of their tax liability for the previous year. The requirements of previous law resume in 2010 and thereafter. An individual qualifies for this special treatment if he or she had an AGI of less than \$500,000 in the 2008 tax year and can prove that over 50% of the gross income reported on the person's tax return was "income from a small business." A small business in this instance is defined as a trade or business with an average employment of less than 500 persons for the calendar year when the individual's 2008 tax year ended.

The provision is intended to increase the cash flow of qualified small firms at a time when their profits are being squeezed by a severe recession with no end in sight. As a result, it may improve the chances of surviving the economic downturn for some of them. But any taxes not paid in 2009 must be paid in 2010. So if the recession were to extend into next year, the rise in estimated tax

³⁰ Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the Conference Agreement for H.R. 1*, p. 4.

payments could prove to be an untimely financial burden for the firms that took advantage of the reduction in payments in 2009.

According to the JCT, the provision could result in a revenue loss of \$275 million in FY2009 and a revenue gain of the same amount in FY2010.³¹

ARRA Tax Provisions That Might Benefit Many Small Firms

Extension of the Bonus Depreciation Allowance Through 2009: Section 1201 of the Act and IRC Section 168(k)

ARRA extends through 2009 a bonus depreciation allowance that was created by the Economic Stimulus Act of 2008 (P.L. 110-185) and expired at the end of that year. The allowance is equal to 50% of the adjusted basis of new qualified assets bought in 2009; the allowance does not apply to used qualified assets. It may be claimed by firms of all sizes for assets that fall into one of the following categories: (1) assets subject to the MACRS with recovery periods of 20 years or less, (2) water utility property, (3) off-the-shelf computer software, and (4) qualified leasehold property that has been improved. In addition, a firm may benefit from the allowance only if it is the original user of a qualified asset, and it places the asset in service in 2009; a one-year extension of this deadline is available for certain assets with a recovery period of 10 or more years and for certain transportation property.

In combination, the bonus depreciation and expensing allowances extended by ARRA substantially (but temporarily) speed up the depreciation of qualified assets by allowing firms to deduct between 50% and 100% of the cost of those assets purchased and placed into service in 2009. Firms taking both allowances are required to claim the expensing allowance first, followed by any bonus depreciation allowance, and then by any regular depreciation deduction allowed under the MACRS they can take on their remaining adjusted basis in eligible assets.³²

The Joint Committee on Taxation (JCT) has estimated that the extension of the bonus depreciation allowance through 2009 will produce a revenue loss of \$17.7 billion from FY2009 to FY2013, and \$6.0 billion from FY2009 to FY2018, relative to federal tax law before the enactment of ARRA.³³ The loss decreases over time because it is front-loaded, which is to say that use of the allowance reduces tax payments in the first two years but raises them in later years.

In extending the bonus depreciation and expensing allowances through the end of 2009, Congress evidently was attempting to spur a temporary rise in business investment. There is ample support for such an approach in both theory and empirical reality.

³¹ Ibid., p. 4.

³² For more details on the prescribed order in which these depreciation allowances are taken, see CRS Report RL31852, *Small Business Expensing Allowance: Current Status, Legislative Proposals, and Economic Effects*, by (name redacted), p. 3.

³³ U.S. Congress, Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the Conference Agreement for H.R. 1, the American Recovery and Reinvestment Act of 2009*, JCX-19-09 (Washington: Feb. 12, 2009), pp. 3-4.

In theory, a time-limited investment tax incentive like the bonus depreciation allowance should alter the timing of qualified investments, but not necessarily the total amount invested over time. By lowering the cost of capital for purchases of qualified assets during 2009 only, the two allowances have the potential to speed up the timing of qualified investments firms planned to make in later years or postponed because of the recession. The reduction in the cost of capital is greater for longer-lived assets than it is for shorter-lived ones, as the bonus depreciation allowance causes a larger increase in the present value of depreciation allowances for the former than for the latter, and the enhanced expensing allowance amplifies this effect, to the extent it can be used.³⁴

In addition, several recent studies have concluded that business investment is moderately sensitive to tax incentives. On the whole, they indicate that the elasticity or responsiveness of investment to changes in the effective tax rate is around -0.5; this means that a 10% reduction in the tax rate eventually leads to an increase in investment of 5%.³⁵ In combination, the bonus depreciation allowance and the expensing allowance can substantially lower the effective tax rate on the returns to investment in qualified assets.

How are small firms as a whole likely to respond to the two temporary investment tax incentives? There are good reasons to doubt that most small firms will substantially increase their investment in response to the two accelerated depreciation allowances—though it would not be surprising if they were to spend more in 2009 than they otherwise would on the most heavily subsidized qualified assets. This expectation is tied to recent U.S. experience with partial expensing allowances, what is known about the effectiveness of temporary investment tax incentives, and perhaps above all, the weak climate for domestic business investment.

Available studies of the impact of the bonus depreciation allowance that was in effect from late 2001 through 2004 indicate that the allowance had only a modest impact on the economy and business investment. (See page 9 for a summary of the main findings of these studies.)

It is not entirely clear why the earlier bonus depreciation allowances had less of a stimulative effect than some economists and lawmakers had expected. Analysts cite several factors that could explain why their combined short-term effects were so muted. First, most firms may have expected Congress to extend the 50% allowance beyond 2004, lessening their incentive to accelerate the timing of planned qualified investments. Second, many firms may have found it impossible to undertake planned future investments within the time frame for the allowances; for many firms, the planning horizons for new qualified investments may have been too long to take advantage of the allowances. And last but not least, many firms may have had too little income in 2001 to 2004 to benefit from the allowances.

Some of the same factors may be affecting use of the allowances in 2009. Although lower capital costs should encourage some additional investment by small firms, most of the total tax benefit from the allowances in 2009 may end up going to firms that would have made qualified investments without the subsidies. These are firms that still have profits and adequate access to

³⁴ Darrel Cohen and Jason Cummins, *A Retrospective Evaluation of the Effects of Temporary Partial Expensing*, staff working paper 2006-19, Federal Reserve Board, Divisions of Research & Statistics and Monetary Affairs, April 2006, pp. 3-5.

³⁵ Jonathan Gruber, *Public Finance and Public Policy* (New York: Worth Publishers, 2005), p. 675.

funds to finance new investments. Because both tax incentives were available in 2008, it is also possible that some investments that had been planned for 2009 were moved up to 2008.³⁶

Still, the current slump in domestic economic activity, coupled with the considerable uncertainty surrounding when and how the economy will recover, a growing reluctance among companies to spend the cash they have, and the difficulties many small firms are having obtaining funds from lenders appear to be having a stronger effect on small business investment so far in 2009 than the two expensing allowances.

Expanded Work Opportunity Tax Credit: Section 1221 of the Act and IRC Section 51

The work opportunity tax credit (WOTC) is a wage subsidy delivered through the tax code that is intended to encourage employers of all employment sizes to hire individuals from specified disadvantaged groups whose rates of unemployment historically have been relatively high. Before the enactment of ARRA, there were nine such groups, including members of families receiving benefits under the Temporary Assistance for Needy Families program for any 9 months in the 18 months before the hiring date, individuals who reside in an empowerment zone, an enterprise community, a renewal community, or a rural renewal county and are between the ages of 18 and 39 on the day they are hired, and ex-felons whose hiring date falls within one year of the date of conviction or release from prison.³⁷

An employer who hires an individual from one of those targeted groups is allowed to claim a non-refundable credit equal to 40% of the first \$6,000, or \$2,400, in qualified wages paid to that individual during his or her first year of employment, with the exception of veterans with service-connected disabilities and summer youth hires. Generally, the credit may be taken only for qualified individuals who work over 400 hours in their first year of employment. If such an individual works 400 hours or fewer during the first year of employment, the credit is lowered to 25% of the first \$6,000 in qualified wages, or \$1,500. No credit may be claimed for a qualified employee who works fewer than 120 hours in the first year of employment. And no credit may be claimed for qualified individuals who have not been certified as eligible by a state employment agency, with the assistance of local participating agencies.³⁸ The WOTC is scheduled to expire for qualified individuals who begin to work after August 31, 2011.

An employer claiming the credit must reduce its deduction for wages by the amount of the credit. In addition, the credit cannot exceed 90% of an employer's income tax liability. If the credit is greater than that threshold, after certain other non-refundable credits have been taken, then the excess may be carried back one year or forward up to 20 years. And for tax years beginning in 2007 and thereafter, the WOTC may be claimed against the alternative minimum tax.

ARRA temporarily enlarges the population of individuals eligible for the credit by adding two groups to the list of targeted groups for 2009 and 2010 only: (1) unemployed veterans who served on active duty for more than 180 days or were discharged from active duty because of a "service-

³⁶ Tax Policy Center, *Tax Stimulus Report Card on Conference Bill* (Washington, Brookings Institution and Urban Institute, Fe. 13, 2009), p. 22.

³⁷ For a complete listing of the targeted groups, see CRS Report RL30089, *The Work Opportunity Tax Credit (WOTC)*, by (name redacted), pp. 2-4.

³⁸ For more details on the certification process, see *Ibid.*, pp. 4-5.

connected disability” at any time during the five years before the hiring date and received unemployment compensation for a minimum of four weeks during the year before that date; and (2) disconnected youth, who are defined as individuals between the ages of 16 and 24 who lack basic skills and have not held a regular job or regularly attended school in the six months before the hiring date.

To what extent will small firms as a whole benefit from this temporary expansion? No estimates are available, but there are several reasons to question whether the expanded WOTC is likely to spark a wave of job creation among small firms. Given that the economy contracted in four of the six quarters from the fourth quarter of 2007 through the first quarter of 2009 and shed 5.7 million more jobs than it created from December 2007 through April 2009, it seems unlikely that a one-time maximum tax credit of \$2,400 per qualified worker would be sufficient to convince many small firms to hire more low-wage workers in the next year or so. The credit is only immediately beneficial to firms with tax liabilities, but business profits have declined sharply in recent quarters and show few signs of reversing course anytime soon. Then again, it is possible that many of the small firms that take the expanded credit in the next year or two will end up receiving a tax benefit for jobs that they would have created in any event. One of the major findings of a 2001 study of the use of the credit done for the U.S. Department of Labor was that the credit played “little or no role” in the recruitment efforts of the 16 employers interviewed for the analysis. This finding suggested the employers would have hired the members of the targeted groups without the credit.³⁹

It can be argued that the JCT implicitly endorses the view that the expanded WOTC is likely to have little or no impact on job creation among small firms in 2009 and 2010: it has estimated that the provision will lead to a revenue loss of \$32 million in FY2009 and \$222 million from FY2009 through FY2013.⁴⁰

Deferral of Income from Discharge of Business Indebtedness: Section 1231 of the Act and IRC Sections 61(a) and 108

In general, when a debt owed by a business taxpayer is cancelled or discharged, the amount of the discharged debt is considered an addition to its gross income. So it comes as no surprise that current tax law requires a debtor (or related party) that buys back or exchanges its own debt for less than the amount owed to include the amount that is forgiven (i.e., the difference between the original price and the realized price of the discharged debt) in gross income. For tax purposes, the amount of forgiven debt is known as discharge-of-indebtedness (DOI) income.

A simple example can illustrate the intended application of this general rule. Suppose a C corporation borrowed \$1 million three years ago by selling long-term bonds. Also assume that current interest rates on corporate bonds are much higher than they were when the bonds were issued, owing to a lack of liquidity and turmoil in credit markets, and that the corporation’s credit rating is much lower than when it issued the bonds because the U.S. economy has fallen into a severe recession. As a result, the \$1 million in bonds are now worth only \$500,000. If the corporation were to repurchase the debt at its current market value (or exchange it for other debt

³⁹ Ibid., p. 10.

⁴⁰ Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions in the Conference Agreement to H.R. 1*, p. 4.

that is also valued at \$500,000), the \$500,000 difference between the original value and the current value would be considered taxable income in 2009.

There are several exceptions to this general rule. A taxpayer may exclude any DOI income from gross income under the following circumstances:

- the debt is discharged under a Chapter 11 bankruptcy
- the debt is discharged when the taxpayer was insolvent
- the discharged debt is qualified farm indebtedness
- the discharged debt is qualified real property business indebtedness
- the discharged debt is qualified principal residence indebtedness, and it is discharged before January 1, 2013

ARRA temporarily modifies the tax treatment of DOI income to allow any firm (regardless of employment size) that buys back or exchanges its own debt at a discounted price in 2009 and 2010 to defer any DOI income from the transaction. DOI income realized in 2009 must be ratably included in income in each of the five tax years starting after 2014 (or from 2015 to 2020). Any DOI realized in 2010 must be included ratably in income in each of the five tax years also starting after 2014 (or from 2015 to 2020). In 2011 and each succeeding tax year, the tax treatment of DOI income reverts to what it was before the enactment of ARRA.

The JCT has estimated that the provision will result in a revenue loss of \$43 billion from FY2009 through FY2013.⁴¹

How are small firms in general likely to benefit from this provision? It is difficult to determine from available data on small business finances to what extent firms with 500 or fewer employees will take advantage of the temporary deferral of DOI income. Still, a debate continues to percolate over which small firms will benefit from the deferral.

Backers of the provision contend that allowing small firms to defer the recognition of DOI income realized in 2009 and 2010 will improve their chances of surviving the current economic downturn by increasing their cash flow and reducing their level of indebtedness. In their view, DOI income is burdensome partly because the transactions that produce it seldom yield enough cash to pay any tax on it. This burden could worsen during the current recession. For example, a taxpayer who had been counting on other assets or sources of capital to pay any taxes on its DOI income may find that sharp declines in the values of those assets and a lack of liquidity in financial markets have made it difficult to raise the needed funds.

But critics point out that the main beneficiaries of this temporary tax benefit are likely to be firms that already have adequate reserves of cash to repurchase debt. In their view, these firms would be likely to repurchase their debt in a recession with or without the temporary deferral of DOI income under ARRA; so for them, it can be argued, the deferral constitutes a windfall gain. At the same time, according to some critics, the provision is likely to be of little or no benefit to the firms that have the greatest need of assistance: namely, those who lack the cash reserves to lower

⁴¹ Ibid., p. 4.

their level of debt. Many of those firms have net operating losses as a result of the current recession, rendering the option to defer DOI income of no immediate benefit.

One-Year Extension of Option to Claim Unused Alternative Minimum Tax and Research Tax Credits in Lieu of Bonus Depreciation: Section 1201 of the Act and IRC Section 168(k)(4)

Under the Housing and Economic Recovery Act of 2008 (P.L. 110-289), C corporations that purchased and placed into service between April 1, 2008, and December 31, 2008, assets eligible for the bonus depreciation allowance established by the Economic Stimulus Act of 2008 were given the option of claiming a refundable tax credit for a portion of their unused research tax credits and AMT credits from tax years starting before 2006, instead of a bonus depreciation allowance. The refundable credit was known as the bonus depreciation amount, and it was equal to the lesser of 20% of the difference between the bonus depreciation allowance a corporation could take and the MACRS depreciation deduction that it could take without the bonus depreciation allowance; or 6% of the sum of the corporation's unused AMT and research tax credits from tax years beginning before 2006; or \$30 million.

To claim the refundable credit for unused research tax credits, a corporation had to increase its tax liability limitation under the general business credit (of which the research credit is a component) by the bonus depreciation amount. This amount could not exceed the corporation's unused research credits, reduced by any amount allocated to its tax liability limitation under this provision for earlier tax years. Corporations that claimed the refundable credit were required to depreciate assets eligible for the bonus depreciation allowance in 2008 using the straight-line method over the appropriate recovery period under the MACRS.

ARRA extends the option of claiming the refundable tax credit in lieu of a bonus depreciation allowance through 2009. As with the 2008 version, the credit has the potential to expand the cash flow of corporations that elect to use it by as much as \$30 million in 2009 or 2010. A firm may claim the entire amount of a refundable credit, regardless of whether or not it has a tax liability. Since firms make it a priority to reduce their tax payments as much as possible over time, a key consideration in choosing between the refundable credit and the bonus depreciation allowance is the long-term tax consequences of each option. Some corporations may lower their federal tax burden more by taking the allowance instead of the refundable credit.

How many small corporations are likely to benefit from the temporary extension of the refundable credit? It is difficult to say. There are no known estimates of how small C corporations are likely to use to it. The current economic downturn is forcing many of them into bankruptcy or liquidation, and many of the small corporations still operating are losing money, cutting their staffing and production capacity, and conserving their cash in a determined bid to outlast the worst of the recession. So surviving small corporations seem unlikely to invest large amounts in 2009 in the assets eligible for the bonus depreciation allowance. And without this investment, no corporation of any size can benefit from the refundable credit. In the current recession, the biggest obstacle to widespread use of the credit by firms with unused research and AMT credits from tax years beginning before 2006 appears to be the requirement that a corporation must purchase assets eligible for the bonus depreciation allowance in order to use the credit.

This requirement may explain why the JCT expects little revenue loss from use of the refundable credit in 2009. It has estimated that expected claims for the extended refundable credit will lead

to a revenue loss of \$20 million in FY2009, \$984 million in FY2010, and \$875 million from FY2009 to FY2013.⁴² At a maximum amount of \$30 million for each claim for the credit, the projected revenue loss for FY2010 implies that fewer than 33 corporations will benefit from it that year.

COBRA Premium Assistance for Employers: Section 3001 of the Act and IRC Section 6432

Title X of the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA, P.L. 99-272) allows individuals who lose their employer-sponsored health insurance because of certain changes in their employment or family status to continue their coverage under that insurance for up to 18 months. Under the act, all employers with 20 or more full-time employees that offer group health insurance to employees must offer continued coverage to employees faced with a loss of coverage owing to a qualified event. Such an event includes voluntary and involuntary loss of employment and a reduction in work hours.⁴³ Employers that fail to comply with the COBRA continuation coverage rules for a qualified individual are subject to an excise tax of \$100 for each day of non-compliance.

An eligible beneficiary must elect COBRA coverage within 60 days of the day he or she loses coverage under an employer-sponsored health plan because of a qualifying event, or the day the beneficiary receives official notice of his or her right to choose COBRA coverage. Before the passage of ARRA, employers were allowed to charge eligible beneficiaries the entire amount of the premium for the COBRA coverage, plus an administrative fee equal to 2% of the premium. Continued coverage for an employee and his or her spouse and dependent children can last as long as 18 months, and the coverage can be extended in certain circumstances.

Not all workers are eligible for COBRA coverage under federal law. Employees of firms with fewer than 20 employees, or firms that offer no health insurance to current employees, cannot receive continued coverage under COBRA. In addition, employees who lose their jobs because their employer goes out of business, and employees of a firm that stops providing health insurance to all of its workers, do not qualify for COBRA coverage.

Having access to COBRA coverage provides no guarantee that unemployed eligible beneficiaries will have an additional 18 months of health insurance coverage through their last employer. The cost of a COBRA premium can be prohibitive for someone living on unemployment benefits alone. In 2008, the average monthly unemployment benefit was around \$1,200, whereas the average COBRA premium came to \$400 a month for individual coverage and \$1,078 a month for family coverage. The cost of coverage—especially for families—may explain why the COBRA participation rate among eligible unemployed individuals has been relatively low.⁴⁴

To help many of the individuals who have been laid off in the current recession retain their employer-sponsored health insurance, Congress added a provision to ARRA that subsidizes their

⁴² Ibid., p. 3.

⁴³ Spouses and dependent children can also experience qualifying events that result in their loss of health insurance coverage. For more details on these events and the rules governing COBRA coverage, see CRS Report R40142, *Health Insurance Continuation Coverage Under COBRA*, by (name redacted).

⁴⁴ See CRS Report R40420, *Health Insurance Premium Assistance for the Unemployed: The American Recovery and Reinvestment Act of 2009*, coordinated by (name redacted), p. 2.

cost of COBRA coverage.⁴⁵ The subsidy is equal to 65% of the cost of COBRA coverage for up to nine months for an eligible beneficiary and is delivered through the tax code. Individuals receiving the subsidy pay no more than 35% of their COBRA premium, and their former employers are required to pay the remainder. The federal government reimburses employers making the payments either through a credit against their employment taxes or a tax refund, if the total cost of their premium subsidies exceeds their employment tax liability.

In 2009, the full subsidy (65% of the cost of COBRA coverage) is available for individuals whose modified adjusted gross income (MAGI) does not exceed \$125,000 for single filers and \$250,000 for joint filers. Partly to limit its revenue cost, the full subsidy phases out for taxpayers with higher incomes and is not available for single filers with MAGIs of \$145,000 or more and joint filers with MAGIs of \$290,000 or more. Qualified individuals must have involuntarily lost their jobs between September 1, 2009, and December 31, 2009. The subsidy applies to up to nine months of COBRA coverage that commences on or after February 17, 2009; it does not apply to coverage that began before the enactment of ARRA. If a qualified person gains access to other group insurance coverage or becomes eligible for Medicare during those nine months, he or she is no longer eligible for the subsidy.

There are separate enrollment periods for two groups of unemployed individuals who were involuntarily terminated on or after September 1, 2008. One pertains to qualified individuals who did not elect COBRA coverage when they lost their jobs; the other covers individuals who chose the coverage after September 1 and before February 17, 2009, but discontinued it because it proved unaffordable. Employers are responsible for notifying individuals who qualify for the subsidy and chose previously not to maintain coverage under COBRA. While these individuals could end up beginning their COBRA coverage months after their jobs were terminated, the 18-month period of COBRA eligibility is still based on the date they stopped working.

It is almost impossible to determine with a high degree of accuracy how many individuals will take advantage of the subsidy. At the same time, there is reason to think that the average worker may find the cost of COBRA coverage with the subsidy burdensome. In 2008, employees with employer-provided health insurance paid, on average, 16% of the cost of their own coverage and 27% of the cost of family coverage.⁴⁶ With the subsidy, they pay 35% of the cost of COBRA coverage. After the nine-month subsidy ends, unemployed individuals will have to bear 102% of the premium to maintain their COBRA coverage until their 18-month period of eligibility expires.

Nor is it known how many small firms will receive the COBRA subsidy for paying for 65% of the cost of COBRA coverage for former employees. In 2008, 62% of firms with three to 199 employees offered health insurance to employees, compared to 99% of firms with 200 or more employees.⁴⁷ Nearly 41 million workers between the ages of 18 and 64 received employer-provided health insurance in 2007, or about 50% of all private-sector non-elderly workers with such coverage.⁴⁸

⁴⁵ See *ibid.*, pp. 3-5.

⁴⁶ Karyn Schwartz, *The COBRA Subsidy and Health Insurance for the Unemployed*, Kaiser Commission on Medicaid and the Uninsured, Kaiser Family Foundation (Washington: March 2009), p. 2.

⁴⁷ Kaiser Family Foundation, *Employer Sponsored Health Insurance — A Comparison of the Availability and Cost of Coverage for Workers in Small Firms and Large Firms* (Washington: Nov. 2008).

⁴⁸ Paul Fronstin, *Sources of Health Insurance and Characteristics of the Uninsured: Analysis of the March 2008 Current Population Survey*, Issue Brief No. 321 (Washington: EBRI, Sept. 2008).

In the current economic slump, small firms making COBRA payments could face added strains on their cash flow as a result. Though they are reimbursed by claiming a credit against their quarterly employment tax payments by filing Form 941, they must pay for the share of the cost of COBRA coverage not paid by eligible former employees when the premiums are due. If a firm's employment tax liability in a quarter is less than its COBRA payments during that period, then the firm must request a tax refund from the Internal Revenue Service for the excess. Extended delays in receiving reimbursement for COBRA payments could force some small firms that already are losing money to further scale back their operations to conserve cash.

The JCT has estimated that the COBRA subsidy will result in a revenue loss of \$24.8 billion from FY2009 through FY2013. Almost 58% of the loss is projected to occur in FY2009.⁴⁹

Increase in the Income Threshold for and Extension of Use of Non-refundable Personal Tax Credits against the Alternative Minimum Tax: Sections 1011 and 1012 of the Act and IRC Section 55

Current federal tax law requires individuals to compute their income tax liability under both the regular tax and the AMT and pay whichever is greater.⁵⁰ An individual taxpayer pays the AMT if his or her tentative alternative minimum tax (TAMT) exceeds his or her regular tax. An individual's TAMT is generally equal to the sum of (1) 26% of the first \$175,000 of the taxpayer's alternative minimum taxable income (AMTI) above an exemption amount and (2) 28% of the remaining AMTI. As is true for the regular tax, long-term capital gains and dividends are taxed at a maximum rate of 15% through 2010. The highest rate for the AMT (28%) is less than the highest rate for the regular tax (35%).

A taxpayer's AMTI is his or her regular taxable income modified by certain adjustments and tax preferences. Several tax preferences under the regular tax are added to this income, including tax-exempt interest on certain private-activity bonds, excess depletion allowances, and the excess of accelerated depreciation over straight-line depreciation for certain assets placed in service before 1987. In addition, adjustments are made to some deductions allowed under the regular tax. These differences can be positive, increasing AMTI, or negative, decreasing AMTI. Notable adjustments include differences between the depreciation rates for certain assets under the AMT and regular tax; a denial of certain itemized deductions that are allowed under the regular tax; and the excess of the fair market value over the amount actually received on incentive stock options. The personal exemptions and standard deductions that enter into the determination of regular taxable income do not affect AMTI.

An individual taxpayer's exemption amount depends on his or her filing status. In 2009, the amounts are \$70,950 for married taxpayers filing jointly and \$46,700 for unmarried single filers. Without a change in current tax law, the amounts are scheduled to revert in 2010 to the amounts that were in effect from 1993 to 2000: \$45,000 for married joint filers and \$33,750 for unmarried single filers. The AMT exemption is reduced by 25% of the amount by which a taxpayer's AMTI exceeds certain thresholds. For joint filers, the exemption begins to phase out when AMTI rises

⁴⁹ Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the Conference Agreement for H.R. 1*, p. 6.

⁵⁰ For more details on the origin, design, and economic effects of the individual AMT, see CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, by (name redacted).

above \$150,000; for single filers, the phaseout threshold is \$112,500. This means that each additional dollar of AMTI above these thresholds lowers the exemption by \$0.25.

Once an individual's TAMT has been calculated, it can be reduced by a variety of personal and business credits. Some of these credits can be permanently used to lower AMT liability (e.g., the child tax credit, the savers credit, the foreign tax credit and the work opportunity tax credit). Others are temporary in that they may be used only if authorized by an act of Congress.

Individuals who pay the AMT in a tax year are allowed a credit that can be used only to offset the regular income tax the next time they pay it. The AMT credit may be carried forward indefinitely. It is intended to prevent the double taxation of income associated with tax preferences involving deferral: once under the AMT and a second time in another year under the regular tax.

ARRA raised the AMT exemption for married couples filing jointly from \$69,950 in 2008 to \$70,950 in 2009, and for unmarried single filers from \$46,200 in 2008 to \$46,700 in 2009. Without this provision, the 2009 amounts would have fallen to \$45,000 for joint filers and \$33,750 for unmarried single filers.

ARRA also extends through 2009 a rule that allows individual taxpayers to use non-refundable personal tax credits to the full extent of their regular tax and AMT liabilities through 2009. Without this provision, the amount of such credits (with three exceptions) that could be claimed would be limited to the excess of a taxpayer's regular tax liability over his or her TAMT determined without the AMT foreign tax credit. There is no limit on the amount of the child tax credit, the adoption credit, and the retirement savings contribution credit that can be used to offset a taxpayer's regular tax and AMT liabilities.

In combination, the two AMT provisions of ARRA have the effect of reducing the overall burden of the AMT in a year when the economy is mired in a deep recession and giving little reason to believe a robust recovery is imminent. This reduction means that consumers as a whole have more disposable income than they otherwise would. Not adopting an AMT patch for 2009 might have subjected an additional 26 million individual taxpayers to the AMT, relative to the number of individuals who paid the AMT in 2008.⁵¹ In the absence of the patch, the taxable income of those taxpayers above the exemption amounts would be taxed at a higher marginal rate under the AMT (26%) than under the regular tax (15% or 25%).⁵² Allowing individuals to use the full amount of non-refundable personal credits against the regular tax and the AMT mainly benefits higher-income taxpayers.⁵³

It is not known how many small business owners are likely to benefit from the two provisions, but it may be less than a majority. In 2007, according to an estimate by the Tax Policy Center jointly managed by the Urban Institute and the Brookings Institution, 19% of individual taxpayers

⁵¹ Tax Policy Center, *Tax Stimulus Report Card on Conference Bill* (Washington: Urban Institute and Brookings Institution, Feb. 13, 2009), p. 19.

⁵² Without an AMT patch for 2009, the exemption amount for a married couple filing jointly would be \$45,000, and \$33,750 for an unmarried single filer. The patch contained in ARRA raises the exemption amounts to \$70,950 and \$46,700, respectively. The marginal tax rate under the AMT on taxable income between those exemption amounts for each class of filer is 26%. By contrast, the marginal tax rate under the regular tax in 2009 is 15% for joint returns with taxable income between \$16,700 and \$67,900; it is 25% for joint returns with taxable income between \$67,900 and \$137,050, and single returns with taxable income from \$33,950 and \$82,250.

⁵³ *Ibid.*, p. 20.

with small business income (or 6.2 million out of a total of 32 million) paid the AMT at a rate of 26%. Another 4% of those individuals paid the AMT at a rate of 28%, and the remaining 77% of individuals with small business income paid the regular tax at rates ranging from 10% (13% of taxpayers) to 35% (1% of taxpayers).⁵⁴ A similar breakdown for a later tax year is not available.

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⁵⁴ Tax Policy Center, *Table T07-0131: Distribution of Tax Units with Small Business Income, 2007*, Urban Institute and Brookings Institution, available at <http://www.taxpolicycenter.org>.

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