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Small Business Tax Preferences: Legislative Proposals in the 109th Congress

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Small Business Tax Preferences: Legislative Proposals in the 109th Congress

Summary

Some policy issues seem to be permanently embedded in the congressional legislative agenda. One such issue is the taxation of small firms and its effects on their formation, performance, and growth. Some contend that the current tax burden on small firms serves as a drag on their growth and thus should be reduced. Others see no solid economic rationale for targeting tax relief at small business owners.

The federal tax code contains a number of provisions granting targeted tax relief to small firms in a wide range of industries. Most of these provisions take the form of deductions, exclusions and exemptions, credits, deferrals, and preferential tax rates. Nonetheless, some policymakers want to do more to reduce the tax burden on small business owners. A variety of proposals to enhance existing small business tax preferences or create new ones are being considered in the 109th Congress. This report describes those proposals. It will be updated to reflect new and significant legislative activity.

In the 108th Congress, two tax bills with a strong potential to lower the tax burden on many small business owners were enacted: the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA, P.L. 108-27) and the American Jobs Creation Act of 2004 (AJCA, P.L. 108-357). JGTRRA moved forward to 2003 the phased-in cuts in individual income tax rates established by the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16), and it made various enhancements in the small business expensing allowance under section 179 of the Internal Revenue Code (IRC) from 2003 through 2005. AJCA extended these enhancements through 2007, lowered the maximum expensing allowance for heavy-duty sport utility vehicles from $100,000 to $25,000, limited the amount of business start-up costs that may be amortized in the first five years of a new trade or business, and loosened some restrictions on the ownership of subchapter S corporations.

A growing number of proposals to expand certain existing small business tax preferences or create new ones are being considered in the 109th Congress. At least two bills to extend permanently the enhancements in the expensing allowance made by JGTRRA have been introduced: H.R. 1091 and H.R. 1388. S. 543 would double the maximum receipt size (from $5 million to $10 million) of subchapter C corporations and partnerships with corporate partners allowed to use the cash-basis method of accounting for tax purposes. In addition, at least three bills (H.R. 118, S. 16, and S. 160) would establish either a refundable or non-refundable tax credit for some of the cost to small employers of providing health benefits to employees. Finally, at least four bills would give small employers robust tax incentives to offer at least partial compensation to reservist employees while they are serving in active duty and to hire replacement workers for activated reservist employees: H.R. 838, S. 11, S. 38, and S. 240.

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Some policy issues never seem to disappear from the congressional legislative agenda. One such issue is the taxation of small firms and its effect on their rates of formation, economic performance, and prospects for growth. Some argue that the current tax burden on many small firms serves as a drag on their growth and should be reduced. Others discern no sound economic rationale for targeting tax relief at small business.

Underscoring the enduring allure of small entrepreneurial firms and the considerable political influence of small business owners, the federal tax code contains a number of provisions that target tax relief at small firms in a wide range of industries. Nonetheless, some federal policymakers would like to further reduce the tax burden on small business owners. A variety of proposals to enhance existing small business tax preferences or create new ones have been introduced in the 109th Congress. This report describes these proposals.

Existing Small Business Tax Preferences

Firm size may play an important role in the performance of certain industries and behavior of certain markets, but it has no discernible influence on the organization of the federal tax code. The code makes no explicit or formal distinction between the taxation of small firms and all other firms. For example, there are no separate sections in the code addressing the tax treatment of small and large firms. Instead, current tax law contains a number of provisions scattered throughout its many chapters that confer preferential treatment on small firms but not on larger ones. Most of these provisions take the form of deductions, exclusions and exemptions, credits, deferrals, and preferential tax rates. Tax preferences such as these generally have the effect of lowering the marginal effective tax rate on the returns to new and old investments by small firms relative to all other firms. In addition, a few tax code provisions benefit small firms by reducing their cost and administrative burden of complying with tax laws, or by granting tax relief in exchange for the provision of certain fringe benefits (e.g., pension plans) to employees.

Contrary to what one might expect, there is no uniform definition of a small firm in the federal tax code. As a consequence, the criteria used to determine which firms are eligible can vary from one small business tax benefit to the next. For example, some such benefits are available only to firms with annual gross receipts below a certain level, while other benefits are limited to firms under a certain asset size. Some may find it surprising that among the criteria for determining eligibility for small business tax preferences, employment size is seldom used. By contrast, the Small Business Administration relies heavily on employment size to collect and publish data on the economic condition of small business.

Existing small business tax preferences differ in scope and economic importance. Some apply only to small firms in specific industries such as life insurance, banking, and energy production and distribution, while others have the potential to affect virtually every small firm. Those preferences with the broadest reach outside agriculture include the taxation of passthrough entities (including subchapter S corporations), graduated corporate income tax rates, the expensing allowance for certain depreciable business assets, the exemption of small corporations from the corporate alternative minimum tax, the amortization of business start-up costs, cash-basis accounting, the exclusion of gains on certain small business stock, and the tax credit for a portion of the start-up costs of pension plans offered by certain small firms.[1]

Any tax provision that confers preferential treatment on a group of taxpayers is likely to entail a loss of federal revenue in the short run. Owing to both a lack of data and lingering disagreement among analysts over which provisions in the tax code should be considered small business tax benefits, it is unclear how much revenue is lost because of existing small business tax preferences. Nevertheless, recent estimates of the revenue loss associated with significant tax expenditures by the Joint Committee on Taxation and the Treasury Department suggest that the revenue cost is likely to exceed $8 billion in FY2005.[2]

Legislation Enacted in the 108th Congress

During the 108th Congress, two tax bills with a strong potential to reduce the tax burden on many small business owners were enacted: the Jobs and Growth Tax Relief and Reconciliation Act of 2003 (JGTRRA; P.L. 108-27) and the American Jobs Creation Act of 2004 (AJCA, P.L. 108-357).

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[1] For a description of existing small business tax preferences and the economic arguments that have been raised for and against them, see CRS Report RL32254, *Small Business Tax Benefits: Overview and Economic Analysis*, by Gary Guenther.

[2] In FY2005, the projected combined revenue loss for seven of the most important small business tax preferences is $7.960 billion. This estimate applies to the following preferences: partial exclusion of capital gains on small business stock; ordinary income treatment of losses on the sale of eligible small business corporation stock; amortization of business start-up costs; tax credit for start-up costs of small business pension plans; cash accounting for non-agricultural firms; graduated tax rate structure for corporations; and expensing allowance for small business investment in eligible assets. See U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2005-2009*, JCS-1-05 (Washington: GPO, 2005), table 1; and Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2006* (Washington: GPO, 2005), table 19-2.

JGTRRA advanced to 2003 the individual income tax rate cuts established by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16) and initially scheduled to take effect in 2006. More specifically, it lowered the 27% rate to 25%, the 30% rate to 28%, the 35% rate to 33% and the 38.6% rate to 35%. As a result of JGTRRA, these lower rates will remain in effect through 2010.

The act also enhanced the expensing allowance small firms may claim under section 179 of the Internal Revenue Code (IRC). More specifically, under JGTRRA, in 2003 through 2005, the maximum allowance rose from $25,000 to $100,000 and the phase-out threshold for the allowance jumped from $200,000 to $400,000. Additionally, the act indexed both amounts for inflation in 2004 and 2005 and made purchases of off-the-shelf software for business use eligible for the allowance in 2003 through 2005.[3]

AJCA included a number of provisions affecting small business tax benefits. It made two significant changes in the expensing allowance: the act extended each of the enhancements in the expensing allowance under JGTRRA through 2007 but reduced the maximum expensing allowance for heavy-duty sport utility vehicles placed in service after October 22, 2004 from $100,000 to $25,000.[4]

In addition, AJCA modified the sections of the tax code (IRC sections 195, 248, and 708) addressing the tax treatment business start-up and organizational costs. Under previous law, the entire amount of these costs could be amortized over a period of five years. But as a result of AJCA, business taxpayers, regardless of legal form of organization (e.g., partnerships, S corporations, or C corporations), may choose to deduct up to $5,000 of start-up or organizational expenditures in the tax year in which the trade or business commences; this amount must be reduced by the amount by which start-up or organizational spending exceeds $50,000; and any amount not deducted in the first tax year for a trade or business must be amortized over a period of 15 years, starting in the month in which the trade or business begins.

Finally, AJCA made some changes in the tax treatment of S corporations, the vast majority of which are relatively small in asset, employment, or revenue size. It appears that the most important changes were to increase the maximum number of shareholders from 75 to 100, treat the members of a family as a single shareholder, allow individual retirement accounts (IRAs) to serve as a shareholder of a bank organized as an S corporation, and permit the transfer of suspended losses when stock in an S corporation is exchanged between spouses or as part of a divorce.

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[3] For more details on the expensing allowance, the changes made by JGTRRA and AJCA, and their short-term economic effects, see CRS Report RL31852, *Small Business Expensing Allowance: Current Status, Legislative Proposals, and Economic Effects*, by Gary Guenther.

[4] For more details on this change in the depreciation of large sport utility vehicles for tax purposes, see CRS Report RL32173, *Tax Preferences for Sport Utility Vehicles (SUVs): Current Law and Legislative Initiatives in the 109th Congress*, by Gary Guenther.

Legislative Proposals in the 109th Congress

A variety of proposals to enhance existing small business tax preferences or create new ones are receiving consideration in the 109th Congress. They vary in scope and economic importance from non-refundable tax credits for employers of activated military reservists to refundable tax credits for small firms offering health insurance to their uninsured employees.

While there is bipartisan support for many of these proposals in both houses, considerable uncertainty surrounds their prospects for passage. Much of this lack of certainty reflects rising concern among many Members of Congress over the large and growing federal budget deficit. The tax cuts enacted since 2001 have made significant contributions to the deterioration in the federal budget since the late 1990s[5], and more than a few Members of Congress are reluctant to enact additional tax cuts without covering their projected revenue cost through offsetting tax increases or spending reductions.

The proposals are described below under the existing small business tax preferences they would alter or the new preferences they would establish.

Current Small Business Tax Preferences

Expensing Allowance Under IRC Section 179. Under IRC section 179, business taxpayers buying qualified property may deduct (or expense) some or all of its cost (depending on the amount) in the year when it is placed into service, provided certain conditions are met. For the most part, qualified property consists of machinery and equipment, including motor vehicles. The alternative to expensing is to recover the acquisition cost of this property over longer periods through allowable depreciation deductions. Between 2003 and 2007, the maximum expensing allowance is $100,000 for firms operating outside empowerment zones. For firms that conduct all their business within such zones, the maximum allowance during that period is the lesser of $135,000 or the cost of qualified property. In 2008, assuming no change in current law, the maximum allowance for firms operating outside empowerment zones falls to $25,000, its level before the enactment of JGTRRA and AJCA. The allowance begins to phase out, dollar for dollar, when the total cost of qualified property placed in service in a tax year from 2003 through 2007 reaches $400,000.

Two bills to extend permanently the enhancements in the expensing allowance made by JGTRRA have been introduced in the 109th Congress. H.R. 1091, introduced by Representative Phil English on March 3, 2005, would retain the current maximum expensing allowance of $100,000 beyond 2007, raise the phase-out threshold to $500,000 as of January 1, 2006, and index both amounts for inflation after 2007. H.R. 1388, introduced by Representative Wally Herger on March 17,

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[5] The tax cuts enacted in 2001, 2002, and 2003 resulted in estimated revenue losses of 0.4% of gross domestic product (GDP) in 2001, 1.1% of GDP in 2002, and 1.6% of GDP in 2003. See CRS Report RL32502, *What Effects Have the Recent Tax Cuts had on the Economy?*, by Marc Lebonte, pp. 2-3.

2005, would keep the maximum expensing allowance at $100,000, the phase-out threshold at $400,000, and allow both amounts to be indexed for inflation beyond 2007. Neither bill would make off-the-shelf software for business use eligible for the allowance beyond 2007.

An amendment offered by Senator Rick Santorum to the bankruptcy reform bill (S. 256) passed by the Senate on March 10, 2005 contained a provision that would have extended the enhancements in the expensing allowance under JGTRRA through 2009. The amendment failed to attract the 60 votes needed for passage and was withdrawn.

In his budget request for FY2006, President Bush is proposing to extend permanently the changes in the expensing allowance made under JGTRRA.

Cash-Basis Accounting. Under IRC Section 446, business taxpayers must compute their taxable income using the method of accounting they normally employ in keeping their books. Regardless of which method of accounting is used for tax purposes, it must clearly reflect income.

Two methods of financial accounting are widely used in the private sector: cash basis and accrual basis. Under the former, which is the preferred method for self-employed individuals in general, income typically is recorded when it is received in the form of cash or its equivalent, and expenses generally are recorded when they are paid, regardless of when the income is actually earned and the expenses actually incurred. Under accrual-basis accounting, by contrast, income and expenses typically are recorded when the transactions giving rise to them are completed or nearly completed, regardless of when cash or its equivalent is received or paid. More specifically, a company using accrual-basis accounting records income when its right to receive it is legally established and expenses when the amounts are fixed and its liability for them is legally established. Each accounting method has its advantages. On the one hand, cash-basis accounting is simpler to administer. On the other hand, accrual-basis accounting often yields a more accurate measure of a firm's economic income because it is better at matching income with expenses.

Under current federal tax law, firms required to maintain inventories must use accrual-basis accounting in computing taxable income. In addition, C corporations, partnerships with C corporations as partners, trusts subject to taxation on unrelated business income, and legal tax shelters are required to use the same accounting method. But business taxpayers engaged in farming or the commercial cultivation of trees or organized as personal service corporations, or whose average annual gross receipts in the three previous tax years do not exceed $5 million, are permitted to use the cash-basis method of accounting for tax purposes. Business taxpayers whose average annual gross receipts in the three previous tax years do not exceed $1 million may also use the cash-basis method.

S. 543, introduced by Senator Olympia Snowe on March 8, 2005, would allow C corporations and partnerships with corporate partners whose average annual gross receipts in the three previous tax years do not exceed $10 million to use the cash-basis method of accounting for tax purposes. The measure also would make it possible for the same firms that are required to maintain inventories to use the cash-basis method.

An amendment offered by Senator Santorum to the bankruptcy reform bill (S. 256) passed by the Senate on March 10 would have permitted some small non-corporate business taxpayers currently required to maintain inventory to use the cash-basis method of accounting for tax purposes. Eligible taxpayers would have been those non-corporate firms whose average annual gross receipts in the previous three tax years did not exceed $10 million. Owing to insufficient backing, the amendment was withdrawn.

New Small Business Tax Preferences

Tax Credits for Employee Health Benefits. Current federal tax law offers no tax credits for employers that provide health insurance to employees. Instead, there are a variety of tax incentives to encourage individuals to purchase health insurance, either on their own in the individual market or through their employers in the group market.

Generally, employer contributions to employee health plans are excluded from the income of participating employees that is subject to income and payroll taxes. The exclusion typically applies to coverage offered to current and former employees and their spouses, dependents, and survivors. Benefits paid under employer-provided accident or health plans are also excluded from the income of participating employees that is subject to income and payroll taxes to the extent the reimbursements are for medical care. If certain requirements are met, employer health benefits provided through a cafeteria plan may also be excluded from an employee's income subject to both taxes. In addition, current tax law allows employees to exclude from their income subject to income and payroll taxes reimbursements for health care expenses received from their employers through flexible spending arrangements and health reimbursement arrangements.

Self-employed individuals may deduct the total amount paid for health insurance for themselves and their spouses and dependents from their taxable income. These payments, however, may not be deducted from their income subject to payroll taxes.

Individual taxpayers who itemize deductions are allowed to deduct the total amount paid for qualified medical care (including health insurance premiums) for themselves and their spouses and dependents to the extent that total spending for this purpose exceeds 7.5% of their adjusted gross income.

Under the Trade Adjustment Assistance Reform Act of 2002, certain individuals may claim what is known as the health coverage tax credit (HCTC). The HCTC is a refundable credit for 65% of the amount paid for qualified health insurance by the following individuals: those receiving trade adjustment allowances or those who would be eligible to do so if they had not exhausted their regular unemployment benefits; those eligible for the alternative trade adjustment assistance program; and those over age 55 who receive pension benefits through the Pension Benefit Guaranty Corporation.

Finally, under the Medicare Prescription Drug Improvement and Modernization Act of 2003, individuals with qualified high-deductible health insurance plans (and no other health plan except one that provides certain permitted coverage) may establish health savings accounts (HSAs). In 2005, qualified plans are defined as those with deductibles of at least $1,000 for self-only coverage and $2,000 for family coverage and an out-of-pocket expense limit of no more than $5,100 in the case of self-only coverage and $12,000 in the case of family coverage. A HSA is a tax-exempt trust or custodial account. Contributions to a HSA by or on behalf of an eligible individual are deductible in determining his or her adjusted gross income. And employer contributions to these accounts may be excluded from an employee's income subject to income and payroll taxes. There are limits on how much may be contributed to a HSA in a calendar year: the maximum contribution is the lesser of 100% of the annual deductible under an individual's high-deductible health plan or the maximum deductible allowed for a qualified health plan under an Archer medical savings account. Distributions from HSAs for qualified medical expenses may be excluded from taxable income. These expenses do not include health insurance premiums, except for premiums paid for long-term care insurance, health insurance coverage during any period of continuation coverage required by federal law, and health insurance coverage while an individual is receiving unemployment compensation under federal or state law.

Legislative Initiatives in the Current Congress. At least three bills have been introduced in the 109th Congress that would establish either a refundable or non-refundable tax credit for a share of the cost to small employers of providing certain health benefits to employees: H.R. 118, S. 16, and S. 160. While they differ in such important details as credit rate, health plans that qualify for the credit, and eligibility criteria for firms and their employees, they share the policy aim of expanding national health insurance coverage through the incremental step of giving small employers currently not offering health insurance to their employees a robust incentive to do so.

H.R. 118, introduced by Representative Darlene Hooley on January 4, 2005, would establish a refundable tax credit for a portion of the cost to qualified employers of providing health insurance to employees. The credit's rate depends on an eligible firm's employment size. Specifically, a firm with 25 or fewer employees would be eligible for a credit equal to 60% of the total amount it pays for qualified health insurance for employees and their spouses and dependents in a tax year; the credit rate would drop to 40% for firms with 26 to 100 employees; firms with more than 100 employees would be ineligible for the credit. Firms eligible to claim the credit would have to satisfy certain conditions in order to do so. Specifically, no credit could be claimed if an employer contributes less than 65% of the cost of employee health plans, or if an employee health plan covers less than 75% of a firm's employees, or if the employer's share of the overall cost of the plan is less than its share in previous years, or if the plan offers fewer benefits than plans offered by the firm in previous years. Self-employed individuals would be eligible for the credit.

H.R. 118 would also create a non-refundable credit for contributions by small employers to employee HSAs. For each employee, the credit would be equal to the lesser of an employer's contribution to such an account or $200 (or $500 if an employee has family coverage under a qualified high-deductible health plan). Firms eligible to claim the credit would be those with fewer than 100 employees, all of whom had received a minimum of $5,000 in compensation in the previous tax year. The credit would be made part of the general business credit and thus subject to its limitations.

In his budget request for FY2006, President Bush proposes the creation of a refundable tax credit for small employers that contribute to employee HSAs.[6] A small employer is defined as a firm that has an average of fewer than 100 employees on business days. The credit would be equal to 100% of allowable contributions made by such firms; the maximum annual credit per employee would be $200 for employees with individual coverage under their high-deductible health plans and $500 for employees with family coverage. In order to claim the credit, eligible employers would have to maintain high-deductible health plans that are open to all employees. The credit would be excluded from a firm's taxable income, and employers claiming it could not also deduct the expenditures covered by the credit.

S. 16, introduced by Senator Edward Kennedy on January 24, 2005, would establish a refundable tax credit for a portion of the cost to eligible small employers of providing health insurance to qualified employees. The size of the credit per employee would depend on a firm's employment size. Specifically, the credit would be equal to 50% of qualified health insurance expenses up to $1,500 for individual coverage and $3,500 for family coverage for firms with nine or fewer employees; the credit rate would drop to 35% for firms with 10 to 24 employees and to 25% for firms with 25 to 50 employees; firms with more than 50 employees could not claim the credit. Firms would be eligible for the credit only if they pay for at least 75% of the total cost of employee health insurance and have an average of 50 or fewer employees. Start-up firms would be eligible for the credit if they expect to employ 50 or fewer workers in the current calendar year. Self-employed individuals would be eligible for the credit. Firms could claim the credit only for employees who work at least 400 hours in a tax year, are paid at least $5,000 in annual wages, and are ineligible for health benefits under Medicare or Medicaid.

S. 160, introduced by Senator Lisa Murkowski on January 25, 2005, would establish a non-refundable credit for small employers that contribute to employee HSAs. The maximum annual credit per employee would be $200 for individuals with individual coverage under their high-deductible health plans and $500 for those with family coverage. Eligible small employers would be those with fewer than 100 employees who received a minimum of $5,000 in compensation in the previous tax year. The credit would become part of the general business credit, and employers claiming it would be denied a deduction for the expenditures covered by the credit.

Tax Incentives for Small Employers of Activated Reservists. Current tax law offers no incentives for private employers of military reservists to provide partial or full compensation or to compensate for any difference between military and civilian pay during periods when their reservist employees participate in active duty.

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[6] See U.S. Congress, Joint Committee on Taxation, *Description of Revenue provisions Contained in the President's Fiscal Year 2006 Budget Proposal* (Washington: GPO, 2005), pp. 55-57.

Nor does it give employers incentives to hire workers to replace reservist employees when they are serving in active duty.

At least four bills to create such tax incentives for small employers have been introduced in the 109^{th} Congress. It appears that a primary aim of each measure is to lessen the financial difficulties faced by many privately employed reservists and their families and numerous smaller private employers of reservists when large numbers of reservists are activated for extended periods.

H.R. 838, introduced by Representative Tom Lantos on February 16, 2005, would establish a non-refundable credit for firms of all sizes that employ activated reservists. The credit is intended to encourage such firms to provide at least partial compensation to reservist employees when they participate in active duty for extended periods. More specifically, the credit would be equal to the lesser of $30,000 or 50% of actual compensation paid to such employees in a tax year while they are serving in active duty for more than 30 days or "hospitalized for or convalescing from an illness or injury incurred in, or aggravated during, the performance of such active duty," or during the 14 days following the end of active duty. The credit would become part of the general business credit and thus subject to its limitations.

The bill would also create a non-refundable credit for small employers of activated reservists. It is intended to encourage eligible small firms to cover any difference between the civilian and military pay of reservist employees when they serve in active duty, and to reduce the cost to such firms of hiring workers to replace reservist employees who are called to active duty. Eligible small firms would be those with an average of 50 or fewer employees on business days in the tax year. The credit would have two components. In the case of activated reservist employees, the credit would be equal to the lesser of $15,000 or 50% of any excess of an activated reservist employee's average daily compensation in the tax year over the average daily military pay and allowances he or she receives while serving in active duty. Eligible employees would be those who work for an eligible employer for a minimum of 31 days before participating in active duty and are a member of the Ready Reserve. Self-employed individuals could claim the credit. Eligible manufacturing firms would be able to claim a credit for each activated reservist employee equal to the lesser of $30,000 or 100% of any excess of the employee's average daily compensation over the average daily military pay and allowances he or she receives while serving in active duty. In the case of replacement employees, the credit would be equal to the lesser of $6,000 or 50% of the total compensation paid to a worker hired to replace a reservist employee while he or she serves in active duty.

S. 11, introduced by Senator Carl Levin on January 24, 2005, would create a non-refundable credit for eligible small employers of activated reservists. Like H.R. 838, the credit would have two components, one for the wages paid to activated reservist employees and one for the wages paid to employees hired to replace such employees. In the case of activated reservists, the credit would be equal to the lesser of $15,000 or 50% of the actual compensation paid to an activated reservist employee on business days when he or she serves in active duty. Firms having an average of 50 or fewer employees on those days during the tax year would be able to claim the credit. The credit would become part of the general business credit. And in the case of replacement employees, eligible small employers would be able to claim a work opportunity credit under IRC Section 51. Specifically, S. 11 would make it possible for these firms to claim a credit equal to 40% of the wages paid to qualified replacement employees up to $6,000 when they replace activated reservist employees; the period covered by the credit cannot exceed one year. The bill also would require the Government Accountability Office to issue a report to the Senate Finance Committee and the House Ways and Means Committee by June 30, 2005 examining current problems in recruiting reservists, potential problems arising from offering higher pay to reservists serving in active duty than to members of the armed forces serving in same capacity, the impact of the employer wage credit on hiring and retention rates for reservist employees in the private sector, and any compliance problems associated with the credit.

S. 38, introduced by Senator Patty Murray on January 24, 2005, would create a non-refundable credit for eligible small firms that employ activated reservists and replacements for these reservists. Firms having 50 or fewer employees on business days in the tax year would be eligible for the credit. Like S. 11, the credit would have two components. In the case of activated reservist employees, the credit would be equal to the lesser of $15,000 or any excess of the employee's average daily qualified compensation over the average daily military pay and allowances he or she receives when serving in active duty. Qualified employees must have worked for an eligible firm a minimum of 91 days before they participate in active duty and be members of the Ready Reserve. In the case of replacement employees, the credit would be equal to the lesser of $15,000 or the compensation paid to such employees when they replace activated reservists. Self-employed individuals could claim either credit. Firms claiming the credit would not also be allowed to deduct the expenditures covered by the credit.

Finally, S. 240, introduced by Senator John Kerry on February 1, 2005, would also create a non-refundable credit for eligible small firms that employ activated reservists and replacements for these reservists. Firms having an average of 50 or fewer employees on business days during the tax year would be eligible to claim the credit. The credit for activated reservists would be equal to the lesser of $15,000 or 50% of any excess of a qualified employee's average daily compensation for the tax year over the average daily military pay and allowances he or she receives in the tax year while serving in active duty. Qualified employees would be those who have worked a minimum of 91 days for an eligible firm before commencing active duty and are members of the Ready reserve. Qualified self-employed individuals could claim the credit. The credit for replacement employees would be equal to the lesser of $6,000 or 50% of the compensation paid to employees hired to replace activated reservist employees. Firms claiming the credit would also be permitted to deduct any expenditures covered by the credit. Eligible small manufacturing firms would be able to claim an enhanced credit for activated reservist employees equal to the lesser of $40,000 or any excess of a qualified employee's average daily compensation for the tax year over the average daily military pay and allowances he or she receives while serving in active duty. They would also be able to claim an enhanced credit for the wages paid to individuals hired to replace activated reservist employees.