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P.L. 115-97, the 2017 Tax Revision, and Small Business Taxation

Small business owners have long been an influential player in domestic debates over tax policy. This role stems in part from the widely held view that small firms make uniquely valuable and substantial contributions to the U.S. economy. Current federal tax law contains a number of tax benefits (or preferences) that are only available to eligible small firms (as defined in each of the provisions).

One of the key policy issues in the recent congressional debate over tax reform concerned how to tax small business income. The issue was particularly important for congressional proponents of reforming the federal tax code in order to simplify it, improve the code's equity effects, and remove barriers to faster economic growth. These objectives raised the question of whether small firms should continue to receive special tax treatment.

Small business owners generally have agreed that their priorities for reforming the tax code are: (1) to lower the tax burden on small business income and the cost of tax compliance for all small firms, and (2) to establish parity between the tax rates for corporate and non-corporate net business income.

Impact of Previous Law

To understand how federal tax law affects small business income in general, it is useful to first consider how a small business is defined for tax purposes. The answer is that there is no uniform or standard definition. Rather, several different criteria are used (including asset, receipt, and employment size) in tax provisions targeted at small firms.

Business income is taxed according to how a business is legally organized. Basically, a business has two choices: to operate as a C corporation or a passthrough entity. The latter can be a partnership (including a limited liability company or LLC), S corporation, or sole proprietorship (largely a self-employed person). The profits of a C corporation are taxed at two levels. First they are taxed at the corporate level; then they are taxed a second time at the individual level of the owners when the profits are distributed to them as dividends or capital gains. By contrast, the profits of passthrough entities (whether distributed or not) are taxed only once: at the individual level of the owners. Under the tax rules that apply to 2017 income, the top corporate income tax rate was 35% and the top individual income tax rate 39.6%. Capital gains and dividends were taxed at a top rate of 23.8%. This rate structure meant that passthrough net income was taxed more favorably than corporate net income.

Some mistakenly believe that small companies are organized as passthrough entities and large firms as C corporations. The truth is that most businesses are small. In 2014, for example, firms with $500,000 or less in receipts accounted for 68% of C corporation income tax returns, 70% of S corporation returns, 89% of partnership returns, and 98% of returns by sole proprietors. Still, large C and S corporations and partnerships generate much of the economic activity associated with these entities. In 2014, firms with over $50 million in receipts accounted for 91% of total C corporation receipts, 40% of total S corporation receipts, and 71% of partnership receipts; by contrast, large sole proprietorships contributed little to total sole-proprietorship income.

In general, the tax burden for a small business (or any business for that matter) depends primarily on the statutory rate at which its income is taxed, and on any tax preferences it is allowed to claim.

Regarding statutory rates, the federal income tax has had a graduated rate structure for corporate (through 2017) and non-corporate income. As a result, a firm's marginal tax rate depends on both its taxable income and whether it is organized as a C corporation or a passthrough entity.

Regarding tax preferences, the federal income tax contained at least 13 tax benefits targeted at small firms before the enactment of P.L. 115-97, according to CRS Report RL32254. **Table 1** shows the top five benefits, ranked by their estimated revenue cost in FY2018, under previous tax law. Tax preferences shrink the tax burden of companies by lowering their average effective tax rates. Many small firms also benefit from tax preferences that firms of all sizes may claim, such as the research tax credit; they are not included in **Table 1**.

Table 1. Top Five Small Business Tax Preferences in FY2018, Ranked by Revenue Cost

Small Business Tax Preferences	Federal Tax Code Section	Estimated FY2018 Revenue Cost ($ billions)
Limited expensing allowance	179	$45.7
Graduated corporate income tax rates	11	3.1
Non-farm cash basis accounting	446	2.3
Full exclusion of capital gain on the sale of qualified small business stock	1202	1.3
Nonrefundable credit for small employer cost of employee health insurance	45R	0.7

Source: CRS and the Joint Committee on Taxation.

The most costly small business tax benefit, by far, is the section 179 expensing allowance, which operates as a form of tax deferral. Its estimated FY2018 revenue cost exceeded the combined revenue cost of the other small business tax benefits for which a cost estimate was available by $54 billion (a difference that is projected to decrease to $20.9 billion in FY2020, owing to the deferral effect of the expensing allowance on tax liabilities).

Expensing allows a company to deduct the full cost of an asset in the year when it is placed in service. Such an allowance lowers the cost of capital for the investment, boosts the firm's cash flow, and simplifies its tax accounting for depreciation. As a result of the new tax law, a company may expense up to $1 million of the total cost of qualified assets it places in service during 2018; this amount phases out when the total cost exceeds $2.5 million.

P.L. 115-97 and Small Business Taxation

The impact of any tax reform proposal on the tax burden of small firms is shaped by three elements: (1) the tax rates for individual and corporate net income, capital gains, and dividends; (2) the difference (if any) between the income tax rates for C corporations and passthrough firms; and (3) the availability and extent of small business tax preferences.

In December 2017, the House and Senate agreed on a bill (H.R. 1) to reform key sections of the federal tax code. President Trump signed it into law (P.L. 115-97) on December 22. Key elements of the new tax law affecting small business taxation are shown in **Table 2**.

Table 2. Key Elements in the Taxation of Small Business Income Under Previous Tax Law and P.L. 115-97

Key Elements	P.L. 115-97	Previous Law
Top corporate tax rate	21%	35%
Top individual/ passthrough income tax rates	37/29.6	39.6/39.6
Top capital gains tax rate	21	23.8
Individual and corporate alternative minimum tax (AMT) rates	Individual: 26 or 28 Corporate: 0	Individual: 26 or 28 Corporate: 20
Small business tax preferences	12	13

Source: Compiled by CRS.

P.L. 115-97 lowers the top marginal tax rates on corporate and non-corporate business net income. Specifically, it replaces the graduated corporate tax rate structure (with a top rate of 35%) under previous law with a flat rate of 21%; the top rate for passthrough business net income falls from 39.6% to 29.6% (37% x 0.8, reflecting a 20% deduction for passthrough business income), within certain limits. The new tax law also repeals the corporate alternative minimum tax (AMT) but not the individual AMT.

P.L. 115-97 also makes the following changes in the small business tax preferences available under previous law:

- Increases the expensing allowance under section 179 from $510,000 in 2017 to $1 million in 2018 (and its phaseout threshold from $2.0 million to $2.5 million) and indexes both amounts for inflation beginning in 2019, among other things;
- Exempts firms with average annual gross receipts of $25 million or less in the three previous tax years from the uniform capitalization rules (section 263A);
- Allows firms of the same receipt size to use the cash method of accounting for tax purposes, even if they maintain inventories (section 448);
- Exempts firms with $25 million in average annual gross receipts in the last three tax years from a new requirement under section 163(j) that limits the amount of business interest a firm can deduct in a tax year to 30% of its adjusted gross income; and
- Repeals the graduated rate structure for corporations under section 11, as well as the option to defer the recognition of capital gain on the sale of publicly traded stocks under section 1044.

The cut in the top income tax rates for business profits under P.L. 115-97 is likely to reduce the federal income tax burden, relative to previous law, for many passthrough businesses. The net effect for any particular firm also depends on any tax benefits it gains or loses as a result of the law. Greater uncertainty surrounds the impact of the new tax law on the tax burden of small C corporations. This is because the new tax law sets a flat corporate tax rate (21%) that is greater than the lowest corporate tax rate under previous law (15%).

P.L. 115-97 could also contribute to an increase in the number of sole proprietors in the short run. This is because of the new 20% deduction for non-corporate business income under the newly created section 199A. While various limits and exclusions apply to the use of the deduction, it does have the effect of taxing wage income at a 20% higher rate than the same amount of passthrough business income. For example, for taxpayers subject to the top three individual income tax rates (33%, 35%, and 37%), the deduction lowers the top rate for passthrough business income to 29.6%. Some wage earners may respond by converting their work status to an independent contractor to take advantage of the lower tax rate on passthrough business income.

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