Congressional Research Service
Informing the legislative debate since 1914

Small Business Tax Benefits: Current Law

Updated January 25, 2023

Congressional Research Service
https://crsreports.congress.gov
RL32254

Congressional Research Service
Informing the legislative debate since 1914

Small Business Tax Benefits: Current Law

SUMMARY

RL32254

January 25, 2023

Gary Guenther
Analyst in Public Finance

The federal tax burden on small firms and its effects on their formation and growth have long been matters of concern for Congress. This abiding interest has contributed to the enactment of targeted tax relief for a number of small businesses.

This report describes the main federal tax benefits for small firms. More specifically, its scope is restricted to tax preferences available only to small firms in a wide range of industries. As such, the report does not include tax benefits targeted at small firms in specific industries, such as the special deduction for small life insurance companies under Internal Revenue Code (IRC) Section 806. Nor does the report address tax provisions that benefit many small firms in a range of industries but are available to firms of all sizes, such as the research tax credit under IRC Section 41 and the Section 199A.

The following small business tax benefits are examined here:

- expensing allowance for machinery and equipment under IRC Section 179;
- cash-basis accounting under IRC Section 446;
- tax credit for the start-up costs incurred by small firms in establishing qualified employee retirement plans under IRC Section 45E;
- tax credit for employers who offer or start a 401(k) plan or a Savings Incentive Match Plan for Employees (SIMPLE) that add automatic enrollment under IRC 45T;
- tax credit for the costs incurred by small firms in complying with the Americans with Disabilities Act under IRC Section 44;
- full exclusion from the capital gains tax on the sale or exchange of qualified small business stock under IRC Section 1202;
- exemption from the limitation on the deduction for business interest expenses under IRC Section 163;
- tax credit for small firms that offer qualified health insurance coverage to employees under IRC Section 45R;
- simplified dollar-value last-in-first-out accounting under IRC Section 474;
- deduction and amortization of business start-up expenses under IRC Section 195;
- ordinary income treatment of losses on the sale of eligible small business stock under IRC Section 1244;
- ordinary loss treatment for loses on the sale of Small Business Investment Company stock under IRC Section 1242;
- exemption from the uniform capitalization rule under IRC Section 263A; and
- use of excess research tax credit to reduce the payroll tax liability of qualified small firms under IRC Section 41.

While available information does not allow for a precise estimate of the forgone federal revenue linked with these small business tax preferences, recent estimates by the Joint Committee on Taxation (JCT) suggest that forgone federal revenue might exceed $18 billion in FY2021.

Contents

Tables

Contacts

Introduction

Small business owners in general have long been praised for their contributions to the U.S. economy, especially their impact on job growth and innovation. Many regard small firms as a vital source of job creation and innovation. Small firms are also celebrated as powerful vehicles for advancing the economic status of minorities, immigrants, and women.

Some view the federal income tax as an obstacle to the formation and growth of small firms because of its negative impact on incentives to work and invest. Others look upon federal taxes as an effective policy tool for increasing small businesses' rates of formation and growth. This report addresses the ways in which the federal income tax system preferentially treats small firms.

Since the 111th Congress, nine bills have been enacted that established new small business tax preferences or extended and/or modified existing ones:[1]

- American Recovery and Reinvestment Act of 2009 (P.L. 111-5),
- Patient Protection and Affordable Care Act (ACA, P.L. 111-148),
- Small Business Jobs Act of 2010 (P.L. 111-240),
- Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312),
- American Taxpayer Relief Act of 2012 (P.L. 112-240),
- Tax Increase Prevention Act of 2014 (P.L. 113-295),
- Protecting Americans from Tax Hikes Act of 2015 (Division Q of the Consolidated Appropriations Act, 2016 [P.L. 114-113]),
- P.L. 115-97 (commonly known as the Tax Cuts and Jobs Act or TCJA), and
- Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act, P.L. 116-94), and
- P.L. 117-169 (commonly known as the Inflation Reduction Act or IRA).

The availability of small business tax benefits raises the question of how a small business should be defined for tax purposes. Two considerations seem paramount in crafting such a definition: (1) choosing the appropriate size measure (e.g., employment, assets, or receipts) and (2) deciding whether the chosen measure should govern eligibility for every federal small business tax benefit.

This report serves two purposes. One is to clarify the definition of a small business for the sake of federal tax policies aimed at supporting small firms. The other is to identify the main nonagricultural small business tax preferences, explain how they are intended to work, and present what is known about the forgone revenue associated with them.

There is considerable federal support for small firms beyond the tax code. These programs and policies are not discussed here. Details on much of this support can be found in several CRS reports.[2]

[1] In this report, the terms *tax benefit*, *tax preference*, and *tax subsidy* are used interchangeably. They all refer to a tax provision that reduces the tax burden of beneficiaries, in this case small businesses. The provision can take the form of a special deduction, exemption, or exclusion; tax credit; preferential tax rate; or tax deferral.

[2] See CRS Report RL33243, *Small Business Administration: A Primer on Programs and Funding*, by Robert Jay Dilger; CRS Report R45576, *An Overview of Small Business Contracting*, by Robert Jay Dilger; and CRS Report R43695, *Small Business Research Programs: SBIR and STTR*, by Marcy E. Gallo.

How Does the Federal Tax Code Define a Small Business?

The U.S. Small Business Administration (SBA) is the primary federal agency for setting small business size standards. Its standards determine eligibility for many of the programs the SBA administers. Federal agencies that reserve a portion of their procurement contracts for small firms generally are required to use SBA size standards to determine eligibility.

The federal tax code does not rely strictly on SBA size standards to determine eligibility for available small business tax benefits. As **Table 1** shows, most of these tax preferences use asset, receipt, or employment size to identify eligible firms.[3] The employment and receipt sizes found in the tax code are much smaller than the sizes used by the SBA to identify small businesses by industry.[4]

One tax provision benefits mainly small firms as a consequence of its design rather than a specified size standard. IRC Section 179 permits businesses to expense (or deduct as a current rather than capital expense) a certain amount of eligible assets in the year they are placed in service. Although the provision's statutory language does not limit use of the expensing allowance to firms of a certain size, IRC Section 179's limitations on its use effectively confine its benefits to relatively small firms.

Different size standards are used to determine eligibility for existing federal small business tax benefits. This lack of uniformity may have a few consequences. On the one hand, it can engender what appears to be an arbitrary distribution of tax preferences among small companies that are otherwise similar in lines of business and size; for example, a company may be eligible for some preferences but not others owing to differing eligibility criteria.[5] On the other hand, the absence of a uniform size standard for federal small business tax preferences perhaps allows lawmakers greater leeway in designing tax benefits to support policy objectives that do not necessarily concern all small businesses.

Main Federal Tax Benefits for Small Business

All business income is subject to federal taxation, but not all such income is taxed alike. The tax burden on a firm's profits depends on several factors. One is how the firm is organized for tax purposes. In essence, there are two choices: C corporations or pass-through entities (i.e., partnerships [including limited liability companies, or LLCs], S corporations, and sole proprietorships). This matters because corporate profits are taxed twice: once at the firm level and

[3] According to one source, the Internal Revenue Code contains at least 24 different definitions of a small business. See Douglas K Barney, Chris Bjornson, and Steve Wells, "Just How Small Is Your Business?" *National Public Accountant*, August 2003, pp. 4-6.

[4] For instance, as of August 2019, the SBA uses an upper limit of 500 employees for small firms in 98 manufacturing industries and an upper limit of $16.5 million or $22.0 million in average annual sales or receipts for small firms in most administrative and support service industries (see CRS Report R40860, *Small Business Size Standards: A Historical Analysis of Contemporary Issues*, pp. 25-30, for more details). By contrast, only firms with no more than 25 full-time employees earning $50,000 or less in wages or salaries may claim the maximum small employer tax credit for health insurance costs under Section 45, and only corporations and partnerships with less than $5.0 million in average annual gross receipts in the previous three years are eligible to use cash-basis accounting when they otherwise would have to use accrual-basis accounting under Section 446.

[5] For instance, two small companies with the same number of employees engaging in the same lines of business may not be eligible for the same tax preferences because they differ in asset and receipt size.

a second time at the shareholder level when profits are distributed as dividends or long-term capital gains. By contrast, the net income of pass-through entities is taxed once at an owner's individual income tax rate, which may or may not be lower than the corporate income tax rate.

The taxation of business income also depends on whether or not the owner of a pass-through entity is subject to the alternative minimum tax (AMT). Pass-through business owners paying the AMT may or may not be taxed at lower rates than they would be under the regular income tax. Corporations were also subject to an AMT from 1987 to 2017, but P.L. 115-97 repealed the tax, starting in 2018.

And as this report shows, firm size affects a company's federal tax burden. Some tax provisions benefit small firms only. There is no formal distinction between the taxation of small- and large-firm income in the federal tax code. Small business tax benefits include deductions, exclusions, exemptions, credits, and deferrals, whose main effect is to reduce a firm's cost of capital for affected investments and increase its short-term cash flow.

This report focuses on federal tax benefits targeted at small firms with the broadest reach outside agriculture. Excluded from these benefits are tax preferences available only to small firms in particular industries, such as life insurance, banking, and energy production or distribution, and tax benefits available to firms of all sizes, such as the Section 41 research tax credit and the Section 168(k) 100% expensing allowance.

Table 1 summarizes the key features of each of the 14 tax benefits examined here. Not included in the list is the taxation of pass-through business profits. Some may find the exclusion puzzling. Most small firms are organized as pass-through businesses, and pass-through business profits may be taxed at lower marginal tax rates than corporate profits distributed as dividends and capital gains among high-income taxpayers, as noted above.

But these considerations alone do not necessarily qualify the tax treatment of pass-through businesses as a small business tax benefit under the analytical framework used here. Numerous pass-through firms are large in employment or receipt size, disqualifying this treatment. The table also excludes the tax deduction for qualified pass-through business income under IRC Section 192 for the same reason.[6]

Excluding sole proprietorships (which are nearly uniformly small), a small minority of pass-through firms are large in employment or receipt size, but they account for a disproportionately large share of pass-through business income. According to Internal Revenue Service (IRS) data for the 2017 tax year, small S corporations ($1 million or less in business receipts) filed 80.8% of S corporation returns but accounted for 10.2% of total S corporation business receipts; large S corporations ($10 million or more in business receipts), by contrast, filed 2.4% of returns but received 62.2% of total business receipts.[7] A similar difference exists among partnerships. IRS data indicate that in 2018, small partnerships ($10 million and less in assets) filed 94.5% of partnership returns and accounted for 25.4% of total business receipts;[8] large partnerships ($50 million and more in assets) filed 1.5% of returns but took in 60.3% of total partnership business receipts.[9]

[6] For more details, see CRS In Focus IF11122, *Section 199A Deduction for Pass-through Business Income: An Overview*, by Gary Guenther, https://www.crs.gov/Reports/IF11122/search/ef77e23e20b649f3bd21cda8e4b6bedb/0.

[7] See https://www.irs.gov/statistics/soi-tax-stats-s-corporation-statistics.

[8] The IRS does not publish data on partnerships by size of receipts.

[9] See https://www.irs.gov/statistics/soi-tax-stats-partnership-statistics.

Table 1. Current Small Business Tax Preferences and Their Estimated Revenue Cost in FY2023

Small Business Tax Preference	Federal Tax Code Section	Nature of the Benefit	Eligible Taxpayers	Current Status	Estimated Revenue Cost in FY2023 Under Current Law ($ billions)
Limited Expensing Allowance	179	Allows firms to deduct as a current expense up to $1.16 million of their expenditures on qualified assets placed in service in 2023; begins to phase out when a firm's total expenditures that year exceed $2.89 million.	No size limit	Permanent	$5.5
Nonagricultural Cash-Basis Accounting	446	Allows eligible partnerships and C corporations (including certain farms) to use the cash method of accounting, regardless of whether they maintain inventories.	C corporations and partnerships with average annual gross receipts of $25 million or less in the previous three tax years.	Permanent	3.0
Exclusion of Gain from the Sale of Qualified Small Business Stock (QSBS)	1202	Allows noncorporate investors to exclude between 50% and 100% (depending on when the QSBS was acquired) of any gain on the disposition of qualified small business stock held for at least five years.	Stock must be issued by C corporation in a qualified business that has $50 million or less in gross assets when the stock is issued.	Permanent	1.8
Tax Credit for Employee Health Insurance Costs	45R	Allows eligible small employers to take a nonrefundable tax credit for nonelective contributions	Employers with 25 or fewer employees whose average annual compensation does not exceed	Permanent	Less than $50 million

Small Business Tax Preference	Federal Tax Code Section	Nature of the Benefit	Eligible Taxpayers	Current Status	Estimated Revenue Cost in FY2023 Under Current Law ($ billions)
		that cover at least 50% of the cost of health plans for participating employees.	double the average wage amount, which is $30,700 in 2023.		
Simplified Dollar-Value LIFO Accounting Method	474	Allows qualified small firms to use a simpler LIFO method in estimating the base-year value of their inventories.	Business taxpayers with average annual gross receipts of $5 million or less in the three previous tax years.	Permanent	1.5
Deduction and Amortization of Business Start-Up Expenses	195	Allows start-up businesses to deduct up to $5,000 of eligible start-up expenses in the year they begin to operate, and to amortize the remaining expenses over 180 months; the deduction phases out, dollar for dollar, when qualified expenses exceed $50,000.	Firms in their first year of business	Permanent	0.2
Tax Credit for Expenses Incurred in Improving the Accessibility of a Business Facility for Disabled Individuals	44	Allows qualified small firms to claim a nonrefundable tax credit for qualified expenses they incur in making their facilities more accessible for disabled persons.	Employers with gross receipts of $1 million or less or 30 or fewer full-time employees in the previous tax year.	Permanent	Less than $50 million
Ordinary Income Treatment of Losses on Sales of Certain Small Business Stock	1244	Allows eligible taxpayers to deduct any loss from the sale, exchange, or worthlessness of qualified small	Individuals and partnerships	Permanent	NA

Small Business Tax Preference	Federal Tax Code Section	Nature of the Benefit	Eligible Taxpayers	Current Status	Estimated Revenue Cost in FY2023 Under Current Law ($ billions)
		business stock as an ordinary loss and not a capital loss.			
Treating Losses on the Sale of Small Business Investment Company (SBIC) Stock as Ordinary Losses	1242	Allows taxpayers who invest in an SBIC to deduct from ordinary income losses from the sale or exchange or worthlessness of SBIC stock.	Any individual investing in an operating SBIC	Permanent	NA
Exemption from the Uniform Capitalization Rule	263A	Exempts qualified small firms from the requirement that firms acquiring or producing real or tangible property for resale include in the estimated value of their inventory the direct cost of the property and indirect costs that can be allocated to it.	Business taxpayers with average annual gross receipts of $25 million or less in the three previous tax years.	Permanent	NA
Application of Section 41 Research Tax Credit Against Employer Share of the Payroll Tax	41(h) and 3111(f)	Allows qualified firms to claim a payroll tax credit of up to $500,000 with their unused research tax credit for the current tax year.	Taxpayers that have less than $5 million in gross receipts in the current tax year and had no gross receipts in any tax year preceding the previous five years.	Permanent	NA
Tax Credit for Pension Plan Start-Up Expenses	45E	Allows qualified small firms to take a nonrefundable tax credit for a portion of the costs they incur	Employers with no more than 100 employees, each of whom received $5,000 or more in compensation in	Permanent	NA

Small Business Tax Preference	Federal Tax Code Section	Nature of the Benefit	Eligible Taxpayers	Current Status	Estimated Revenue Cost in FY2023 Under Current Law ($ billions)
		in establishing new qualified pension plan for employees; the credit may be taken in each of the first three years of the plan.	the previous calendar year.		
Tax Credit for Employers That Add Automatic Enrollment to New or Existing Employee Pension Plans	45T	Allows an eligible employer to claim a $500 nonrefundable tax credit in each of the first three years in which the employer includes automatic enrollment for qualified employee retirement plans.	Employers with no more than 100 employees, each of whom received a minimum of $5,000 in compensation during the previous calendar year.	Permanent	NA
Exemption for Qualified Small Firms from the Limitation on the Deduction for Business Interest	163(j)	Allows eligible small firms to deduct business interest without the limits set by P.L. 115-97.	C corporations and pass-through entities with $25 million or less in average annual gross receipts in the three previous tax years.	Permanent	NA

Source: Compiled by the Congressional Research Service from the following source: Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2020-2024,* JCX-23-20.

It is not known precisely how much revenue is forgone because of the tax benefits in **Table 1**. A rough estimate can be patched together from a 2022 estimate by the Joint Committee on Taxation (JCT) of the revenue forgone because of a variety of federal tax expenditures. This estimate may be conservative because it does not cover every tax benefit in the table. Nevertheless, the JCT analysis suggests that federal small business tax benefits may cost around $12 billion in forgone revenue in FY2023.[10]

[10] U.S. Congress, Joint Committee on Taxation, *Estimates for Federal Tax Expenditures for Fiscal Years 2022-2026*, JCX-22-22, December 22, 2022.

Summary of Current Federal Small Business Tax Preferences

Expensing Allowance for Certain Depreciable Business Assets

Expensing is the fastest form of depreciation. It treats the cost of acquiring a depreciable asset (e.g., machine tool or patent) as a current expense rather than a capital expense. As a result, the asset's full cost is deducted in the year it is placed into service. In the absence of expensing, companies must recover capital costs over longer periods using the appropriate depreciation schedule.

Under IRC Section 179, a company may expense up to $1.16 million of the cost of qualified property—mainly machinery, equipment, standardized computer software, and improvements to nonresidential buildings—placed into service in 2023 and write off any remaining cost using the appropriate depreciation schedule under the Modified Accelerated Cost Recovery System (MACRS).[11] The maximum allowance is indexed for inflation.

The allowance is subject to two limitations. One is the investment limitation, which is the amount at which the maximum expensing allowance begins to phase out. In 2023, that amount is set at $2.89 million; it is indexed for inflation as well. Under this limitation, if the total cost of qualified assets placed in service that year exceeds $2.89 million, the maximum allowance a firm can claim is reduced, dollar for dollar, until it reaches $0. So if the total cost of qualified assets a firm places in service in 2023 equals or exceeds $4.05 million, none of that amount may be expensed. In this case, the entire cost has to be recovered through MACRS allowances.

A second limitation relates to a firm's taxable income in the trade or business in which the assets expensed under IRC Section 179 are used. Specifically, the maximum allowance a firm can take cannot exceed its taxable income from such a trade or business. Any allowance in excess of income may be carried forward up to 20 years.

There is no size limit on the companies that may benefit from IRC Section 179; rather, the phaseout threshold makes the expensing allowance a benefit principally for smaller firms. Large firms such as Google, Microsoft, or Amazon typically spend far more than the maximum investment limit ($3.670 million in 2021) on assets eligible for the allowance.

Congress established the expensing allowance in 1958 to serve several purposes: (1) to lower the cost of capital for relatively small companies; (2) to simplify tax accounting for the same group of companies; and (3) to stimulate increased business investment during periods of weak or negative economic growth.

In theory, the allowance can stimulate business investment in two ways. First, it lowers the user cost of capital for investment in qualified assets, all other things being equal. The user cost (or rental price) of capital is one of the key influences on business investment decisions. It combines the opportunity cost of an investment (i.e., the highest pretax rate of return a company could earn by investing in a low-risk asset like a U.S. Treasury bond) with its direct costs (e.g., depreciation, the actual cost of the asset, and income taxes). In effect, the user cost of capital determines the required after-tax rate of return an investment must earn to be profitable—and thus worth undertaking. In general, the larger the user cost of capital for a particular kind of investment, the

[11] For more details on the current expensing allowance and its economic effects, see CRS Report RL31852, *The Section 179 and Section 168(k) Expensing Allowances: Current Law and Economic Effects*, by Gary Guenther.

fewer such projects companies can profitably undertake. Increases in the user cost of capital can also lower a firm's desired capital stock. In theory, when a change in tax law (e.g., accelerated depreciation for a range of assets) decreases the user cost of capital, businesses can be expected to increase the amount of capital they own, boosting business investment in the short run, all other things being equal. Expensing produces a zero marginal effective tax rate on the returns to investment in qualified assets.[12]

Second, the allowance increases the cash flow of firms using it, all other things being equal. For firms whose cost of internal funds is lower than their cost of external funds such as debt or equity, an increase in cash flow may enable them to undertake new investments.

Table 1 shows that the IRC Section 179 expensing allowance may result in a $5.5 billion revenue loss in FY2023. But the allowance does not necessarily produce a revenue loss. Its revenue effect generally depends on the aggregate amount of U.S. investment in qualified assets in a particular tax year. During periods of rising business investment, the allowance should generate substantial revenue losses because a portion of that investment is expensed under IRC Section 179. But the opposite should happen in periods of declining investment, when the revenue gains from previous use of the allowance exceed the revenue loss from new uses of it. Any shift from revenue loss to revenue gain simply reflects the timing of depreciation deductions under current law.

Firms that write off the entire cost of an asset in the year when it is placed in service under IRC Section 179 cannot claim additional depreciation allowances against future profits from expensed assets. In effect, they exchange a lower tax liability in the present for larger tax liabilities in the future. Companies that make this trade-off come out ahead, particularly in the case of long-lived assets, if the present value of allowable depreciation deductions is greater with expensing than it is with other depreciation schedules.

Historically, Congress has used expensing for relatively short-lived assets to spur greater domestic business investment in periods of economic downturn. For example, in 2003, Congress passed the Jobs Growth and Tax Relief Reconciliation Act of 2003 (JGTRRA, P.L. 108-27), which included a four-fold increase in the IRC Section 179 expensing allowance to $100,000 and a doubling of its phaseout threshold to $400,000, against a backdrop of weak U.S. output and employment; the allowance and phaseout threshold were for inflation in 2004 and 2005, and both amounts were scheduled to reset at their pre-JGTRRA levels ($25,000 for the allowance and $200,00 for the phaseout threshold) in 2006.

A new study by Thomas Brosy and Lucas Goodman that examined use of the IRC Section 179 and IRC Section 168(k) expensing allowances from 2001 to 2019 found that the rate at which a business uses (or takes up) the IRC Section 179 allowance was higher for C corporations than for pass-through firms.[13] The study also found that the percentage of pass-through firms that took up this allowance was greater than the percentage of eligible pass-through investment for which firms claimed the allowance. According to the authors, this finding "is consistent with" a scenario in which small firms invest a lot, even though they have little or no profits—and thus receive little immediate benefit from the IRC Section 179 expensing allowance.

[12] See Jane G. Gravelle, "Effects of the 1981 Depreciation Revisions on the Taxation of Income From Business Capital," *National Tax Journal*, vol. 35, no. 1, March 1982, pp. 2-6. In effect, under expensing, the after-tax rate of return on an investment becomes equal to the pretax rate of return. This happens because expensing reduces costs and after-tax returns by the same proportion, which is determined by the tax rate.

[13] Thomas Brosy and Lucas Goodman, "Business Uptake of Investment Expensing," *Tax Notes*, October 3, 2022, p. 27.

Amortization of Business Start-Up Costs

A key concept underlying the federal income tax is that business taxable income should exclude all reasonable costs incurred in earning it. This concept underlies IRC Section 162(a), which generally allows companies to deduct the full amount of ordinary and necessary costs paid or incurred in conducting a trade or business. The concept also implies that costs paid or incurred in starting or organizing a business should not be treated as current expenses, as they are not directly related to the conduct of a trade or business. Instead, because start-up expenses represent an attempt to create a capital asset (in this case a business) with a useful life likely to extend beyond the year when it begins to operate, they should be capitalized, added to the owner's basis in the business, and recovered when the business is sold or shuttered.

IRC Section 195 (as amended by the American Jobs Creation Act of 2004 or AJCA, P.L. 108-357) deviates from this concept by permitting individuals who incur business start-up and organizational costs after October 22, 2004, to deduct up to $5,000 of those costs in the year a new trade or business begins to operate. This deduction is reduced, dollar for dollar (but not below zero), by the amount by which eligible expenditures exceed $50,000. Expenditures that cannot be deducted may be amortized over 15 years, beginning in the first month the new trade or business earns income. To benefit from the $5,000 deduction, a taxpayer must have an equity interest in the trade or business and actively participate in running it.

The Small Business Job Creation Act of 2010 (P.L. 111-240) raised the deduction to $10,000 and the phaseout threshold to $60,000 for qualified expenses incurred or paid in 2010 only. These higher amounts have not been reinstated.

To qualify for the deduction, start-up and organizational costs must meet two requirements. First, they must be paid or incurred as part of an investigation into creating or acquiring an active trade or business, starting a new trade or business, or an effort to produce income or profit before starting a trade or business with the aim of eventually converting the activity into an active trade or business. Second, the costs must be similar in kind to costs that would be deductible if they were paid or incurred in connection with the expansion of an active trade or business.

Taxpayers with start-up and organizational expenses that entered a trade or business on or before October 22, 2004 (the day the $5,000 deduction first became available) were allowed to amortize those expenditures over a minimum of five years, beginning in the month the new trade or business began to operate.

The option to deduct as much as $5,000 in start-up and organizational costs in the first year of operation permits the owner of a new firm to reduce taxable income in the year when the business begins. Without such a provision, the expenses could not be recovered in full until the owner sells his or her interest in the business, or in part until five years after the business started, when the expenses could be amortized. As a result, the option accelerates the recovery of certain business expenses and may boost the cash flow of small start-up firms when their access to funds may be limited. For firms that lose money in their first year of operation, the deduction, if used, simply adds to their net operating losses, which may be carried forward up to 20 years to lower future taxes.[14]

[14] Under the American Recovery and Reinvestment Act of 2009 (P.L. 111-5), eligible firms with net operating losses in the 2008 tax year could carry them back up to five years. Only firms with average annual gross receipts in the past three tax years of less than $15 million were allowed to take advantage of this expanded carryback.

Cash-Basis Accounting

IRC Section 446 requires firms to compute their taxable income using the same method of accounting they regularly employ in keeping their books, provided that method clearly reflects income for tax purposes. A taxpayer's method of accounting clearly reflects income if it treats items of income and deductions consistently from one tax year to the next. Permissible methods of accounting include the cash-receipts method, the accrual method, the installment method, the long-term-contract method, the crop method, the special methods for research and development expenditures, and the method for soil and water conservation expenditures.

Two accounting methods are widely used in the private sector: cash-basis and accrual-basis. Under the former, income generally 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 or the expenses are actually incurred.

Under accrual-basis accounting, income and expenses generally 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. A firm using accrual-basis accounting records income when its right to receive it is established and records expenses when the amounts are fixed and its liability for them is established.

Each accounting method has its advantages. Cash-basis accounting is much simpler to administer and allows firms greater control over when items of income or deduction are recognized for tax purposes. In contrast, accrual-basis accounting generally yields a more accurate measure of a firm's economic income because it matches income with expenses with greater precision and rigor.

Under certain circumstances, the accrual method must be used for tax purposes. For instance, when keeping an inventory is necessary to the operation of a business, a taxpayer must use the accrual method in computing taxable income—unless the IRS determines that another method clearly reflects income and may be used instead. Inventories are considered necessary if a firm earns income from the production, purchase, or sale of merchandise. Subchapter C corporations, partnerships with C corporations as partners, trusts that earn unrelated business income, and authorized tax shelters generally are required to use the accrual method of accounting.

But there are some exceptions to these rules. Starting in 2018, any partnership or C corporation with average annual gross receipts of $25 million or less in the three previous tax years may use the cash method of accounting, regardless of whether they keep an inventory. This amount has been indexed for inflation since 2019; the receipt threshold is set at $26 million in 2021. Self-employed persons, S corporations, and qualifying partnerships and personal service corporations also have the option of using the method. As these exceptions suggest, many eligible firms are relatively small in receipt size.

In effect, the cash method has the potential to extend the same benefit to small firms as the IRC Section 179 expensing allowance does: deferral of income tax payments. The federal tax code generally operates on the principle that a firm receives income when it gains the legal right to be paid for something it provides. But under the cash method, firms have the option of deferring the payment of taxes, or taking advantage of lower tax rates, by shifting deductions and income from one tax year to the next.

Despite the cash method's potential benefits, it may not always be in the interest of eligible firms to use it. For example, a small business might be better off using accrual-basis accounting if it needs to periodically issue accurate and reliable financial reports. Cash-basis accounting can distort a firm's financial position in at least two ways.[15] First, because it records transactions involving only cash or its equivalent, the method excludes transactions involving exchanges of assets or liabilities. Second, the determination of net income under cash-basis accounting can be manipulated by recording revenues or expenses before or after goods and services are produced or sold.

Exemption from Limitation on the Deduction for Business Interest Expenses

Before the enactment of the 2017 TCJA, the federal tax code generally allowed firms to deduct interest and other borrowing expenses incurred in the pursuit of a trade or business without limit in the year they were paid or incurred, under IRC Section 163. There were a few exceptions. No deduction was allowed for interest paid on tax-exempt bonds, interest from unregistered obligations, interest paid on insurance contracts, and interest paid on original discount, high-yield obligations.

The TCJA modified this treatment by limiting the amount of interest and other borrowing costs a company was allowed to deduct. IRC Section 163(j), as amended by the 2017 act, caps the amount of qualified interest expenses (including floor-plan financing interest payments) it may deduct at 30% of its adjusted taxable income.[16] Interest that cannot be deducted in the current tax year may be carried forward indefinitely, subject to certain restrictions for partnerships and S corporations.

Many small firms are not affected by the limitation on the interest deduction. Specifically, firms with average annual gross receipts during the previous three tax years (2018-2020) of $26 million or less are exempt from this limitation.

Tax Incentives for Equity Investment in Small firms

Several small business tax preferences encourage equity investment in qualified small firms that otherwise may have trouble raising needed funds. The preferences, which are described below, do so by increasing potential after-tax returns or reducing potential after-tax losses on such investment, relative to other investment options. The same tax benefits are not available to individuals investing in large firms.

Full Exclusion of Capital Gains on Eligible Small Business Stock

Two key considerations in determining the income tax liability for many individuals are the recognition of income as ordinary or capital gain, and the difference between long-term and short-term capital gains or losses.

A capital gain or loss arises when a capital asset such as a stock or bond is sold or exchanged. If the selling price is greater than the acquisition or purchase price, the transaction produces a capital gain. Conversely, a capital loss results when the reverse is true.

[15] See Robert Libby, Patricia A. Libby, and Daniel G. Short, *Financial Accounting* (Chicago: Irwin, 1996), p. 111.

[16] Adjusted taxable income is a company's regular taxable income calculated without (1) items of income, gain, deduction, or loss not allocated to a trade or business, (2) business interest income, (3) net operating losses, (4) the IRC Section 199A deduction for qualified pass-through business income, and (5) deductions for depreciation, depletion, or amortization in the years before 2022. Floor-plan financing interest is the interest paid or accrued on debt used to finance the acquisition of motor vehicles held for sale or lease to customers and secured by a seller's inventory.

Capital assets held longer than 12 months and then sold or exchanged give rise to long-term capital gains or losses; sales or exchanges of capital assets held one year or less generate short-term capital gains or losses. Short-term capital gains are considered ordinary income and taxed at regular income tax rates. By contrast, long-term capital gains are considered capital income and taxed in 2021 at 20% for single filers with taxable income of $445,850 or more and joint filers with taxable income of $501,600 or more; 15% for single filers with taxable income between $40,400 and $445,850 and joint filers with taxable incomes between $80,800 and $501,600, and 0% for single filers with taxable incomes below $40,400 and joint filers with taxable incomes below $80,800.

IRC Section 1202 allows noncorporate taxpayers (including partnerships, LLCs, and S corporations) to permanently exclude from gross income the entire gain from the sale or exchange of qualified small business stock (QSBS) held for a five or more years. The exclusion is 100% for QSBS acquired after September 27, 2010. For QSBS acquired between August 11, 1993, and February 17, 2009, 50% of any gain on its sale or exchange was excludable. The exclusion was 75% for QSBS acquired between February 18, 2009, and September 27, 2010.

There is a limit on the gain that a taxpayer may exclude. In any tax year, the gain cannot exceed the greater of 10 times the taxpayer's adjusted basis in all QSBS issued by that firm and sold or exchanged by the taxpayer during that year, or $10 million—reduced by any excluded gains from sales of the same stock in previous years. This means that the amount a taxpayer may exclude over time from the sale of a single firm's QSBS cannot exceed $10 million. Any remaining gain is taxed at the long-term capital gains rates under current law.

To qualify for the partial exclusion, small business stock must satisfy several requirements. First, the stock must be issued after August 10, 1993, and acquired by the taxpayer at its original issue, either directly or through an underwriter, in exchange for money or property, or as compensation for services rendered to the issuing corporation. Second, the stock must be issued by a domestic C corporation whose gross assets do not exceed $50 million when the stock is issued. Third, at least 80% of an eligible corporation's assets must be deployed in the active conduct of one or more qualified trades or businesses during "substantially all" of the requisite five-year holding period for QSBS. Assets used for working capital, start-up activities, and research and development meet the active business test, even if they are intended to develop future lines of business. Specialized small business investment companies licensed under the Small Business Investment Act of 1958 also meet the active business test, making their stock eligible for the gain exclusion.

All trades and lines of business are eligible for the IRC Section 1202 gain exclusion except health, law, engineering, architecture, hospitality, farming, insurance, finance, and mineral extraction. Stock issued by the following small C corporations is also ineligible for the exclusion: current or former domestic international sales corporations (DISCs), regulated investment companies (RICs), real estate investment trusts (REITs), real estate mortgage investment conduits (REMICs), financial asset securitization investment trusts (FASITs), cooperatives, or C corporations that have claimed the possessions tax credit under IRC Section 936.

The gain exclusion for QSBS is intended to improve the access of qualified start-up firms to what some would call "patient" equity capital. It attempts to do this by increasing the potential after-tax returns an investor can earn on QSBS, relative to the potential after-tax returns on other investment opportunities, over a minimum of five years. Under current law, the maximum capital gains rate is 20% and the exclusion is 100% of realized gains from the sale or exchange of QSBS acquired after September 27, 2010. A full exclusion yields an effective capital gains tax rate of 0% for QSBS. Proponents of the 100% exclusion say it is needed to compensate for the uncertainty and asymmetric information that can make it difficult for new start-up firms to obtain needed funding for activities critical to their survival and growth.

Little research has been done on the gain exclusion's effects on QSBS issuers. There is some evidence that the exclusion reduces the cost of capital for C corporations issuing QSBS. In a 1999 study of IRC Section 1202, David Guenther and Michael Willenborg found that the prices of QSBS issued by a sample of firms after the enactment of the tax provision were "significantly higher than the issue prices before the change."[17] At the same time, there were no significant differences in the issue prices for a sample of firms that were ineligible to issue QSBS. The authors concluded that at least some of the future benefits from the capital gains rate reduction were captured by issuing corporations in the form of higher stock prices, instead of those benefits going to investors.

Still, some are critical of the gains exclusion. Alan Viard of the American Enterprise Institute, while recognizing the efficiency gains from using equity instead of debt to finance new investments, has argued that the IRC Section 1202 gain exclusion distorts the allocation of investment capital within the U.S. economy. As he noted in a 2012 article, the tax preference encourages equity investment in very small companies in certain industries only and may be claimed by certain investors only, not by all investors.[18] In his view, the rules governing the exclusion diminish its potential economic effects.

Losses on Small Business Investment Company Stock Treated as Ordinary Losses without Limitation

Generally, losses on stock investments are treated as capital losses for tax purposes. They may be used to offset any capital gains a taxpayer has in the same tax year. Individuals may also use any combination of short-term and long-term capital losses to offset up to $3,000 in ordinary income in a tax year.

Under IRC Section 1242, however, individuals who invest in small business investment companies (SBICs) are permitted to deduct from their ordinary income all losses from the sale or exchange or worthlessness of their stock. This exception from the general rule is intended to encourage equity investment in SBICs by lowering the potential after-tax loss on such an investment, relative to potential after-tax losses on other investments.

SBICs are privately owned, regulated investment corporations that are licensed by the Small Business Administration to provide equity capital, long-term loans, and managerial guidance to firms with a net worth of less than $19.5 million and an average net income of less than $6.5 million in the previous two years.[19] SBICs use their own capital and funds borrowed at favorable rates made possible by SBA loan guarantees to invest in qualified firms. For tax purposes, most SBICs are treated as C corporations.

Ordinary Income Treatment of Losses on Sales of Small Business Stock

IRC Section 1244 allows taxpayers to treat a loss from the sale, exchange, or worthlessness of eligible small business stock as an ordinary loss rather than a capital loss. For taxpayers, ordinary losses are treated as business losses in computing a net operating loss.

---

[17] David A. Guenther and Michael Willenborg, "Capital Gains Tax Rates and the Cost of Capital for Small Business: Evidence from the IPO Market," *Journal of Financial Economics*, vol. 53, no. 3 (1999), p. 401.

[18] Alan D. Viard, "The Misdirected Debate and the Small Business Stock Exclusion," *Tax Notes*, February 6, 2012, p. 741.

[19] For more information on SBICs, see CRS Report R41456, *SBA Small Business Investment Company Program*, by Robert Jay Dilger.

To qualify for this treatment, a stock must meet four requirements. First, it must be issued by a small business corporation after November 6, 1978. A small business corporation is a domestic C corporation whose cash and property received as a contribution to capital and paid-in surplus total less than $1 million when the stock is issued. Second, an individual or partnership must acquire the stock in exchange for cash or other property (but not stock and securities). Third, during the five tax years before a loss on a qualified stock is recognized, the small business corporation must obtain more than 50% of its gross receipts from sources other than passive income such as royalties, rents, dividends, interest, annuities, and stock or security transactions. The amount that may be deducted as an ordinary loss in a tax year is capped at $50,000 for single filers and $100,000 for joint filers.

Uniform Capitalization of Inventory Costs

Firms that earn income from the production, purchase, or sale of merchandise are required to keep inventories to account for the cost of goods sold in a tax year. This cost is subtracted from gross receipts in the computation of taxable income. In most cases, the cost of goods sold is determined by adding the value of a firm's inventory at the beginning of the year to purchases of inventory items made during the year and subtracting that amount from the value of a firm's inventory at the end of the year.

IRC Section 263A requires business taxpayers that produce real or tangible property or buy such property for resale to "capitalize" (or include in the value of their inventories) both the direct and indirect costs of the property included in inventory. This provision, known as the uniform capitalization rule, was added to the federal tax code by the Tax Reform Act of 1986. In general, direct costs are considered to be the material and labor costs related to the production or acquisition of goods; indirect costs refer to all other costs incurred through the production or acquisition of goods (e.g., repair and maintenance of equipment and facilities; utilities; insurance; rental of equipment, land, or facilities; and some administrative costs). Taxpayers have some discretion in assigning indirect costs to property from production or purchase, but the cost allocation methods should yield results that make sense for particular trades or businesses.

Some small firms are exempt from the uniform capitalization rule. Specifically, it does not apply to firms with average annual gross receipts of $25 million or less in the last three tax years that acquire tangible or intangible property for resale. This exemption is beneficial because eligible firms have lower administrative costs, face less complexity in complying with income tax laws, and can exercise more control over the timing of business expense deductions, opening up opportunities for tax deferral.[20]

Refundable Research Tax Credit for Small Firms

IRC Section 41 allows firms to claim a tax credit for qualified research expenses (QREs) above a base amount, which is intended to approximate how much a firm would invest in qualified research in the absence of the credit. There are three components to the credit: (1) an incremental credit equal to 20% or 14%/6% of a firm's current-year QREs in excess of its base amount; (2) an incremental university basic research credit equal to 20% of a firm's payments for basic research conducted by a university above a base amount; and (3) a flat credit equal to 20% of a firm's payments for research conducted by qualified energy research consortia. While in a tax year a

[20] See Paul G. Schloemer, "Simplifying the Uniform Inventory Capitalization Rules," *Tax Notes*, vol. 53, no. 9, December 2, 1991, pp. 1065-1069.

firm may claim all three components of the IRC Section 41 credit, the vast share of claims for the credit are for the incremental credit only.

The research tax credit is nonrefundable (with one exception) and is part of the IRC Section 38 general business credit (GBC), and thus subject to the GBC's limitations. Unused amounts of the research credit may be carried back one year and forward up to 20 years. The longer it takes a firm to fully use the research credit it claims for a specific tax year, the lower the credit's net present value as an offset to tax liability. This can be an issue for small young firms investing in research that qualifies for the credit that incur net operating losses.

For certain small firms, however, the research credit is effectively refundable, depending on the size of their payroll. For tax years beginning after December 31, 2022, businesses with less than $5 million in gross receipts in the current tax year and no receipts in tax years preceding the previous five years may offset up to $500,000 in unused research tax credits against their current-year payroll tax liability. The maximum offset had been $250,000 through 2022 but was doubled by the law commonly known as the Inflation Reduction Act (P.L. 117-169).

Simplified Dollar-Value LIFO Accounting Method for Small Firms

As noted earlier, businesses that keep inventories to account for the cost of goods sold are required to determine the value of their inventories at the beginning and at the end of each tax year. Doing this item by item is time-consuming and costly; so many taxpayers use estimation methods based on certain item or cost flows.

One such method is known as "last-in-first-out" (or LIFO). LIFO assumes that a firm's most recently acquired goods are sold before all other goods. Consequently, LIFO assigns the most recent unit costs to the cost of goods sold and the oldest unit costs to the remaining inventory at the end of the year. The method is likely to be advantageous when the cost of many inventory items is rising, because it yields a lower taxable income and inventory valuation than other methods. There are various ways to use LIFO. One widely used application is known as the dollar-value method. Under it, a taxpayer accounts for the value of its inventory according to a pool of dollars rather than a pool of inventory items. Each dollar pool includes the value of a variety of inventory items and is measured by the dollar value of the items in the year when they were first added to the inventory. The dollar-value method is complicated and costly, putting it beyond the reach of many small firms.[21]

IRC Section 474, which was added to the tax code by the Tax Reform Act of 1986, allows qualified small firms to use a simplified dollar-value LIFO method. It differs from the regular method in the pooling of inventory items and the estimation of the base-year value of pooled items. Firms with average annual gross receipts of $5 million or less in the three previous tax years may use the simplified LIFO method.

Nonrefundable Tax Credit for Pension Plan Start-Up Costs of Small Firms

Under IRC Section 45E, certain small firms may claim a nonrefundable tax credit for a portion of the start-up costs incurred in setting up new retirement plans for employees. The credit, which was enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001, originally was scheduled to expire at the end of 2010. But the Pension Protection Act of 2006

---

[21] For more details on this method, see U.S. Congress, Joint Committee on Taxation, *Impact on Small Business of Replacing the Federal Income Tax*, JCS-3-96, April 23, 1996, pp. 18-19.

permanently extended it. It is a component of the general business credit under IRC Section 38 and thus subject to its dollar limitations and rules for carryover.

The credit is equal to 50% of qualified plan start-up expenses paid or incurred in each of the first three years a qualified pension plan is available. There is a dollar limit on the annual amount of the credit. Specifically, the credit is the greater of $500 or the lesser of $5,000 or $250 for each employee who is eligible to participate in a plan. This means the credit can be expected to range from $500 to $5,000, depending on the number of eligible employees. The Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019 (P.L. 116-94) increased the maximum credit from $500 a year to $5,000.

The credit applies to the ordinary and necessary expenses of administering a plan and informing employees about its benefits and requirements. These include the costs of setting up a plan and operating it from day to day; operational expenses include recordkeeping and accounting, legal, and trustee services.[22] Any new 401(k) plan, 403(a) annuity plan, savings incentive match plan for employees (SIMPLE IRA), or simplified employee pension plan qualifies for the credit. Only firms with fewer than 100 employees, each of whom received at least $5,000 in compensation in the previous year, may claim the credit.

In effect, the credit gives qualified small firms an incentive to establish pension plans for employees by lowering the after-tax cost of setting up and administering these plans over the first three years they are available. As a 2010 SBA report pointed out, start-up costs can be considerable on a per-employee basis for companies with relatively few employees.[23] Available data on pension benefits by employer size provide no clear evidence that the credit has increased the share of small employers offering pension plans. According to the Employee Benefit Research Institute (EBRI), the percentage of firms with fewer than 100 employees sponsoring pension plans was lower in 2013 than it was in 2002, the first year the credit was available.[24]

Nonrefundable Tax Credit for Automatic Employee Enrollment in Small Employer Retirement Plans

The SECURE Act added a second tax credit for qualified small employer retirement plans: IRC Section 45T. The credit is identical to the IRC Section 45E credit, except for the amount of the credit and its purpose.

An eligible employer may claim an IRC Section 45T credit of $500 for each of the first three years it adds automatic enrollment to current or new employee retirement plans. It applies to the same plans as the IRC Section 45E credit does. Thus, an eligible employer could receive a total tax credit of $16,500 during the first three years it offers a qualified employee pension plan with

[22] Yusi Lou and Anthony P. Curatola, "Taxes: Tax Credits for Pension Plan Start-Up Costs," *Strategic Finance Magazine*, June 1, 2020.

[23] See Kathryn Kobe, *Small Business Retirement Plan Availability and Worker Participation* SBA Office of Advocacy, contract no. SBA-HQ-06M0477 (Washington: March 2010), p. 22.

[24] In 2013, according to an EBRI report, 10.3% of firms with fewer than 10 employees sponsored pension plans; the share in 2002 was 16.5%; for firms with 10 to 49 employees, the 2013 share was 24.0%, and the 2002 share 31.4%; and for firms with 50 to 99 employees, the 2013 share was 36.1%, and the 2002 share 46.9%. See Employee Benefit research Institute, "Employment-Based Retirement Plan Participation: Geographic Differences and Trends, 2013," *Issue Brief*, no. 405 (Washington, Oct., 2014), Figure 2, p. 11; and "Employment-Based Retirement and Pension Plan Participation: Declining Levels and Geographic Differences," *Issue Brief*, no. 262 (Washington: October 2003), Figure 2, p. 7.

automatic enrollment: three years of the maximum IRC Section 45E credit comes to $15,000 (3 x $5,000 per year) plus three years of the IRC Section 45T credit (3 x $500 per year).

Employers with fewer than 100 employees, each of whom received at least $5,000 in compensation during the previous year, are eligible for the IRC Section 45T credit. Automatic enrollment leads to greater employee participation in employer plans.[25]

Nonrefundable Tax Credit for Expenses Paid or Incurred in Improving Business Access for Disabled Persons

Under IRC Section 44, an eligible small firm may claim a nonrefundable tax credit for expenses incurred in making its facilities more accessible for disabled employees. The credit is equal to 50% of eligible expenditures in a tax year above $250 but not greater than $10,250. A firm may claim no more than $5,000 of the credit in a tax year. In the case of a partnership and S corporation, this ceiling applies separately at the entity level, and at the partner or shareholder level. The disabled-access credit is a component of the general business credit under IRC Section 38 and thus subject to its dollar limitations and rules for carrying the credit back and forward.

A firm may claim the IRC Section 44 credit if, during its previous tax year, its gross receipts (less returns and allowances) totaled no more than $1 million, or its full-time workforce did not exceed 30 persons.

An eligible firm may also deduct (under IRC Section 190) up to $15,000 a year for qualified expenses for the removal of architectural or transportation barriers to accessing its facilities by elderly or handicapped persons. The deduction has to be reduced by the amount of any IRC Section 44 credit a taxpayer claims.

Virtually any amount an eligible firm spends to bring its business into compliance with the Americans with Disabilities Act of 1990 (P.L. 101-336, ADA) qualifies for the credit. The expenses must be reasonable in amount and required by law. Eligible expenses include the cost of removing architectural, communication, transportation, or physical barriers to making a business more accessible to or usable by disabled individuals; providing interpreters or other effective methods of making materials understandable to hearing-impaired individuals; and supplying qualified readers, taped texts, and other effective methods of making materials understandable to visually impaired individuals.

The credit is intended to lower the net cost to small firms of complying with ADA mandates, and to encourage them to hire more disabled persons. Although the credit has been available since 1990, it remains unclear how effective it has been in achieving its intended goals of stimulating increased investment in making workplaces more accommodative to the special needs of disabled persons seeking employment.[26] In a 2002 report, the then-named General Accounting Office (GAO) noted that it could find no studies of the effectiveness of the credit and that few businesses were even aware of it.[27] It appears that no such studies have been done since 2002.

---

[25] Linda J. Blumberg, John Holahan, and Jason Levitis, *How Auto-Enrollment Can Achieve Near-Universal Coverage: Policy and Implementation Issues*, Urban Institute Issue Brief, June, 10 2021, https://www.urban.org/sites/default/files/publication/26326/412723-Automatic-Enrollment-Employee-Compensation-and-Retirement-Security.PDF.

[26] The credit was a component of the Omnibus Reconciliation Act of 1990 (P.L. 101-508).

[27] U.S. General Accounting Office, *Incentives to Employ Workers with Disabilities Receive Limited Use and Have an Uncertain Impact*, GAO-03-39 (Washington: December 2002), p. 19.

Nonrefundable Tax Credit for Employee Health Insurance Expenses

The Patient Protection and Affordable Care Act (ACA, P.L. 111-148) added a tax credit (IRC Section 45R) for small employers that make nonelective contributions to employee health plans. An employer's contribution is nonelective if it does not lower participating employees' salaries or wages.

Eligible for-profit employers have been able to take the credit since 2010. From 2010 through 2013, the maximum credit was equal to 35% of the *lesser* of the total amount of an employer's nonelective payments during a tax year to a qualified employee health insurance plan through a "contribution arrangement," or the total amount of nonelective contributions that would have been made if each employee had enrolled in a qualified health plan with a premium equal to the average premium for the small-group market in the state where an employer is located. The credit does not apply to employer-paid premiums above the average premium for a state's small-group market; it applies only to the average premium.

Starting in 2014, an eligible for-profit employer may claim the credit for no more than two consecutive tax years (e.g., 2016 and 2017) if it offers one or more qualified health plans through a state-based health insurance exchange. Each state was required to establish such an exchange by 2014. The maximum credit in 2014 and thereafter is equal to 50% of the lesser of

- the total amount of employer contributions for qualified health plans offered through a health insurance exchange, or
- the total amount of employer contributions that would have been made if each employee had enrolled in a qualified health plan with a premium equal to the average premium for the small-group market in the rating area where the employees receive coverage.

In 2023, employers with 25 or fewer full-time employees who earn an average annual compensation of $55,600 or less can benefit in varying amounts from the credit; the full credit may be claimed only by employers with 10 or fewer full-time employees whose average annual compensation is $30,700 or less.

The credit a firm may claim is phased out by the sum of the following two amounts:

- amount of the credit multiplied by a fraction equal to the number of full-time employees above 10 divided by 15, and
- amount of the credit multiplied by a fraction equal to a firm's average annual wages above $27,800 (2021 only) divided by $27,800 (2021 only).

Several rules governing use of the credit affect its effective rate. The credit is a component of the general business credit (GBC), and thus subject to its limitations. Unused GBCs may be carried back one year or forward up to 20 years. Any credit not used by the end of the 20-year carry-forward period may be deducted in its entirety in the next tax year. Since 2011, employers have been able to take the credit against both the regular income and alternative minimum taxes. But to prevent employers from deriving two tax benefits from the same expenditures, any employer taking the credit must reduce its deduction for employer-paid health insurance premiums by the amount of the credit.

The credit is intended to increase the number of small employers with low-to-medium wage employees that offer employee health insurance. Congress added the credit to the ACA in part to address long-standing concerns about gaps in domestic employer-provided health insurance coverage. While most large employers have offered health benefits to employees, a much smaller share of small employers have done so, and that share is even smaller for small employers with mostly low-wage workers. In 2020, for example, 99% of firms with 200 or more employees offered health insurance to employees, compared to 55% of firms with 3 to 199 employees.[28]

Available evidence suggests that the IRC Section 45R credit's impact has fallen short of initial expectations. According to the 2020 survey of U.S. employer health benefits by the Kaiser Family Foundation, 59% of firms with three to nine employees offered employee health benefits in 2010, the first year that the credit was available; that share had dropped to 48% by 2020.[29] According to a 2016 GAO report, relatively few firms used the credit between 2010 and 2014, compared with its potential usage. GAO noted that initial estimates of the number of eligible firms ranged from 1.4 million to 4 million, but total claims for the credit averaged only 183,200 between 2010 and 2014.[30]

GAO concluded that the credit was not large enough to convince large numbers of small employers to offer or maintain employee health benefits. It cited several reasons for this outcome.[31] Relatively few employers qualify for the full credit. The credit phases out if a firm employs more than 25 people, or if its average annual wage exceeds an inflation-adjusted cap ($55,600 in 2021). The credit covers the average premium in the small business market in the state where the firm is located; if a firm pays a premium above that amount, the credit does not apply to the excess. The credit is temporary: since 2014, it can be used only in two consecutive years. Some eligible firms may be deterred from claiming the credit because of its complexity and the recordkeeping required to compute it.

Author Information

Gary Guenther
Analyst in Public Finance

[28] See KFF, *Employer Health Benefits: 2020 Annual Survey*, p. 47, https://www.kff.org/report-section/ehbs-2020-section-2-health-benefits-offer-rates/.

[29] Ibid.

[30] U.S. Government Accountability Office, *Small Employer Health Tax Credit: Limited Use Continues Due to Multiple Reasons*, GAO-16-491T, March 22, 2016, pp. 4-6, https://www.gao.gov/assets/gao-16-491t-highlights.pdf.

[31] Ibid., pp. 5-10.

Disclaimer