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The Impact of Tax Expenditure Policies on Incorporated Small Business

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The U.S. Internal Revenue Code contains numerous tax and tax credit provisions affecting the operation and after-tax profitability of large and small businesses. The implementation of these policies and they way in which the effects are distributed between large and small firms has not yet been well investigated. This study examines the effects of various tax expenditure programs that would allow large and small firms the opportunity to reduce their tax liability. It primarily uses corporate data for 1998 to 2000 collected from the Internal Revenue Service's Statistics of Income (SoI) Division.

This report identifies ten programs that the Joint Committee on Taxation (JCT) and Treasury classify as tax expenditures to analyze in detail. In addition, while not "true" tax expenditures, the foreign tax credit and deduction for travel and entertainment expenses are also analyzed since they provide businesses with tax benefits. All of these programs account for at least 70 percent of the total tax expenditures provided to corporate taxpayers in the United States over the past few years.

Overall Findings

Small firms benefit from certain tax expenditure programs, although as a general matter, by a smaller amount than larger firms. Large firms with more extensive operations are better able to realize advantages from certain tax expenditure programs. The one tax expenditure program that clearly benefits small businesses more than large firms by a sizeable margin is the partial deduction for travel and entertainment expenses. Small firms realized an average reduction of 0.86 percent in their effective tax rate from this program, compared with large firms that witnessed a 0.11 percent reduction.

Highlights

• Currently, businesses are able to deduct half of their travel and entertainment (T&E) expenses. Small firms receive an effective tax reduction of 0.75 percent more than their larger counterparts. In addition, small firms would receive an increased reduction in their effective tax rate of 1.04 percent if T&E expenses were fully deductible. Large firms, however, would receive an additional reduction in the effective tax rate of only 0.11 percent. While small firms would benefit more, both large and small businesses would prefer a 100 percent deduction for their T&E expenses.

• Small businesses in the educational services (NAICS Code 61), professional, scientific, and technical services (NAICS Code 54), and the administrative and support, waste management and recreation service sectors (NAICS Code 62) received the largest impact from the T&E deduction, realizing a

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reduction in their effective tax rates between 1.5 and nearly 5 percentage points.

• The Section 179 deduction permits the depreciation of relatively small amounts of business property to be "super accelerated." The professional, scientific, and technical service industry (NAICS Code 54) utilized this benefit the most - over 35 percent of the industry's accelerated depreciation impact came from their Section 179 deductions. Other small industries to benefit from this program include wholesale and retail trade (NAICS Codes 42, 44-45), finance and insurance (NAICS Code 52), and health care and social assistance (NAICS Code 62).

• Large firms utilized the foreign tax credit more extensively than small firms, as might be expected. For large firms, the manufacturing (NAICS Codes 31-33) and mining (NAICS Code 21) sectors are able to reduce their effective tax rates by between 3 and 4.5 percent with the foreign tax credit, more than any other industry.

• The manufacturing (NAICS Codes 31-33) and professional, scientific and technical service (NAICS Code 54) sectors realized the greatest positive impacts of the research and development (R&D) credit program. However, small firms did not benefit to the degree of large firms. Small businesses in these two industries reduced their effective tax rates between 0.14 and 0.39 percent, whereas larger businesses experienced between 0.89 and 1.50 percent reductions.

• The impact of the R&D credit for both large and small firms declined in each of the three years from 1998 to 2000, possibly the result of many firms choosing to expense rather than credit their research costs.

• Small construction and utility companies (NAICS Codes 23, 22) experienced twice the impact of accelerated depreciation of large firms. The industry sector in which both large and small firms received the largest benefit, though, was in the management of companies and enterprises (NAICS Code 55).

• A series of case studies in Chapter IV provide further evidence of the importance of accelerated depreciation and other tax expenditure programs. For instance, the large firms in the wired telecommunications industry (NAICS Code 51331) that were evaluated would see greater effective tax rate reductions than the smaller firms in the same industry. In addition, the computer systems design industry (NAICS Code 541512) would benefit from increasing the travel T&E deduction from partial to full deductibility, with smaller firms benefiting more than large.

Scope and Methodology

Data collected and maintained by the Treasury and the IRS' Statistics of Income Division (SoI) permit estimation of effective tax rates, the rate at which taxes are actually paid after credits, deferrals, deductions, and exemptions. SoI provided data tabulations for estimating effective tax rates. They also provided data on several of the specific programs to permit isolation of the impact of these tax expenditure programs on the effective tax rate. These data were provided on the basis of firm size groupings to compute differential effective rates by business size category as well as by general industry category. This enabled the researchers to quantify the impact of various programs in terms of both the total dollar value of each program as well as the impact on the effective tax rate, and to measure the differential impact between large and small business. Appendix C provides more detail on the effective tax rate methodology used in this study.

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