FEDERAL TAX TREATMENT OF SMALL BUSINESS: HOW FAVORABLE? HOW JUSTIFIED?*

Jane G. Gravelle, Congressional Research Service

CERTAIN POLICY TOPICS IN CONGRESS SEEM particularly surrounded by myth and endowed with an icon-like aspect; among these are small and family businesses. Like the family farm, they are seen as the embodiment of the American pioneering and entrepreneurial spirit. To question benefits provided to small businesses, especially tax benefits, is as much on the forbidden list as tackling the home mortgage interest deduction.

Perhaps no example better portrays the ability of arguments relating to small business to exercise an excessive (and unjustified) role in public policy than the debate over ending the estate tax. This role is documented in the book by Graetz and Shapiro, *Death by a Thousand Cuts* (2005), where they suggest that anecdotes about family businesses and the estate tax trumped more carefully gathered evidence. Even though only a negligible share of small businesses would ever face the estate tax, and despite the existence of a number of benefits for these businesses including a specific exemption for family-owned businesses, the estate tax was heralded not only as a destroyer of small business, but of minority-owned small business.

Moreover, evaluating the desirability of small business tax benefits or even defining those benefits is complicated by an uncertain definition of small business. The references to small business as commonly used can range from a local Mom-and-Pop business that may have no employees outside of the family to venture capitalist firms on the verge of a public offering.

The first section of this paper discusses favorable tax treatment of small business, the second, trends over time, and the third justifications. A final section discusses an often overlooked issue, the difficulty of monitoring small businesses for compliance and the subsequent higher noncompliance rates for unincorporated business income.

*The views in this paper do not represent the views of the Congressional Research Service.

HOW FAVORABLY ARE SMALL BUSINESSES TREATED?

The federal income tax code contains both implicit and explicit small business income tax subsidies. There are numerous provisions that explicitly target small business in some fashion, either by being available only to businesses of certain receipt, asset, or income sizes or organizational forms or by having dollar caps and sometimes phase-outs that deny or make unimportant the benefits to large firms. Implicit subsidies arise not because of specific benefits but because small businesses are less likely to be subject to the corporate income tax. Although small firms can be incorporated and large firms can operate as partnerships, there is a powerful correlation between business size and corporate versus noncorporate status. Indeed this correlation stimulated an alternative model of the corporate income tax that was largely driven by economies of scale in the corporate sector and entrepreneurial talent in the noncorporate sector (Gravelle and Kotlikoff, 1989). In addition, because small businesses are exposed to less regulation and are more costly to monitor per dollar of potential revenues, tax compliance is significantly lower in the unincorporated business sector.

While this paper focuses on income tax issues, it also addresses issues relating to estate and gift taxes and payroll taxes, where there are also small business issues.

Targeted Small Business Subsidies

Table 1 shows the provisions that are reported in either the Joint Committee on Taxation's or the administration's list of tax expenditures, that might be construed as favoring small business. Note that some items are included in the tax expenditure list of one organization and not the other, and also that there may be some dispute about whether the provisions should be considered a small business provision. For example, the largest provision in terms of revenue effect is an exemption of a limited amount of losses from the passive income restriction in the case of real estate. Whether passive

Table 1
Revenue Costs of Tax Expenditures Associated with Small Business, FY 2008 ($billions)

Provision	*Corporations (JCT)*	*Individuals (JCT)*	*Corporations (OMB)*	*Individuals (OMB)*
$25,000 passive loss exemption (rents)				7.52
Reduced rates on corporate income	3.5		4.27	
Section 170 expensing	0.3	2.2	1.07	4.26
Percentage depletion (oil and gas)	1.2	[1]	0.7[2]	0.08[2]
Cash accounting	[1]	0.8		
Amortization of business start-up costs	[1]	0.8		
Exemptions from imputed interest rules	[1]	0.4		0.05
Completed contract rules	0.4	[1]		
Expensing of timber growing costs	0.2	[1]	0.23	0.100
Capital gains exclusion small business stock				0.320
Expensing of agricultural costs[3]	[1]	0.2	0.03	0.180
Small life insurance company	0.1		0.06	
Special tax for small property and casualty			.05	
Ordinary loss for small business stock				0.05
Tax benefits for small refiners	[1]			
Tax credit for refueling property	[1]	[1]		
Tax credit for disabled access	[1]	[1]	0.10	0.20
Geographic incentives[4]				

Sources: Joint Committee on Taxation (2007), Office of Management and Budget (2007).

[1]Less than $50 million.

[2]Not separately stated for oil and gas; total 0.8 which is likely to be largely oil and gas.

[3]These provisions are estimated separately for types of expensing, but the divisions differ between JCT and OMB. According to JCT estimates, only the individual costs for expensing of fertilizer and soil conditioner costs and expensing of dairy and breeding cattle are in excess of $50 million. Corporate costs, and individual costs for expensing soil and water conservation are less than $50 million.

[4]Tax provisions directed at lower income areas (empowerment zones, renal communities, and new markets tax credits) and to Indian reservations contain some investment subsidies that are capped per firm, but they are not separately estimated. The total corporate and individual costs according to the JCT estimates are $1.2 billion and 1.0 billion respectively. OMB estimates set them at $0.62 billion and $1.85 billion, and do not include Indian Reservations (which are the smallest component in the JCT estimates).

investors in real estate are considered to be small businesses is not straightforward.

Even the graduated corporate tax rate provision may function more to provide a shelter from the individual income for wealthy individuals than to encourage small businesses. The provision allowing expensing of equipment investment, which is limited and phased out, clearly is a subsidy to small business activity.

There are some other provisions that are not listed in Table 1 that also benefit small business, although their size may be relatively small (Guenther, 2007). They include a provision exempting small corporations from the alternative minimum tax (AMT), adopted in 1997; the cost of this provision began at over $100 million but is currently projected at $20 million. Another provision likely to be small in cost is allowing ordinary losses on small business investment company stock. Two provisions that could be more significant are the exemption from the uniform capitalization rules and simplified dollar value LIFO.

Implicit Subsidies: Pass-through Treatment

How valuable is pass-through treatment compared to the explicit provisions included in Table 1? The maximum value of the provisions in Table 1, using the highest estimates provided by either organization is about $22 billion. Moreover, a good case could be made for excluding the passive loss provisions (which is not even included in the JCT list); in that case, the total is about $15 billion. The benefits of not being taxed at the higher corporate tax rate appear to be much larger. According to a recent study released by the U.S. Department of Treasury (2007), hereafter the Treasury Study, the effective tax rate in the corporate sector is approximately 40 percent on equity and -2 percent on debt, taking into account all levels of tax (individual and corporate). The rate for unincorporated business was 20 percent. These tax rates measured the expected tax on new investment. However, if they continue, they can be translated into dollar amounts. For 2007, unincorporated business income was $938 billion. An additional 20 percent on this income would have resulted in an additional tax of $188 billion! There would be some offset because debt is favored for the corporate sectors, but debt plays a much less important role in the cost of capital, both because it tends to be a small share of assets (typical rules of thumb are about a third) and has a much lower real return than on equity. Overall, the Treasury Study estimated overall tax rate in the corporate sector was about 30 percent, averaging in the debt subsidy.

Some of this tax benefit accrues to firms that might not be truly considered small, including limited liability partnerships, and Subchapter S partnerships. As the rules allowing many partners and many shareholders have evolved, the share of incorporated businesses has grown dramatically. According to the Treasury study S corporations' (corporations that elect to be taxed as partnerships) share of total business income have increased from 1 percent in 1980 to 15 percent in 2004 and the share of partnerships from 3 percent to 21 percent, while sole proprietorships have decreased from 17 percent to 14 percent. Overall, unincorporated business shares increased from 21 percent to half of business income.

The Subchapter S share has grown consistently, likely reflecting a dramatic increase in the number of shareholders allowed for the election (the limit of 10 was raised to 35 in 1982, to 75 in 1996, and to 100 in 2004). Partnership income did not rise until the 1990s, increasing to 11 percent in 1995 and 18 percent in 2000. While Subchapter S firms are constrained by the shareholder limit, partnerships are not. This growth reflects in part the growth of limited liability corporations established under state law (the first state adopted such a provision in 1982), which qualify as unincorporated business for corporate tax purposes. Indeed, partnerships as a share of returns has changed little, initially falling slightly from 11 percent in 1980 to 7 percent in 1995, and then rising to 9 percent in 2004. Proprietorship income has not shown a specific trend, first rising (to 26 percent in 1995) and then falling. The share of total business net income received by unincorporated businesses has increased since 1980, from 21 percent of total net income to 60 percent. While the share of proprietorships (which have no limited liability) has declined slightly, from 17 percent to 14 percent, the share of Subchapter S firms (firms that are incorporated but are allowed to elect taxation as an unincorporated business) rose from 1 percent to 15 percent. Partnerships (including limited liability corporations and limited liability partnerships) increased from 3 percent to 21 percent with most of the increase occurring after 1990.

These larger unincorporated businesses may or may not be viewed as "small businesses." Treasury data indicate that flow-throughs with receipts over $50 million accounted for 16 percent of net income. But even if we restrict our definition of small businesses to the firms taxed as unincorporated businesses in 1980, the value of not taxing equity income at the corporate rate is still $77 billion.

An argument could be made that some of the tax subsidies in Table 1, primarily the expensing provision, understate the value of the subsidy because they reflect timing. The tax rates that examine the return for prospective investment indicate that on average, the expensing provision, where effective, lowers the tax rate for new investment by about 2 percentage points (Gravelle, 2006); and since many smaller businesses are not affected at the margin, this comparison also suggests that the capped expenditure provision for small business

Table 2

Distribution of Taxpayers and Income by Marginal Tax Rate and Subchapter S Share

Category	*Percent of All Taxpayers*	*Percent of All Net Income*
Share top 2 brackets	8	72
Share top 2 brackets, positive and active	7	57
Share Subchapter S	13	30

Source: U.S. Department of Treasury, 2007.

is not nearly as important as the benefits of being unincorporated. This limited effect occurs because only a small part of the reproducible assets of small businesses are equipment; more of the investment tends to be in structures and inventories.

Estate Tax Issues

As noted in the introduction, small and family businesses were featured heavily in the political debate about the estate and gift tax, and this political role is discussed in detail by Graetz and Shapiro (2005). Gravelle and Maguire (2007) indicate that only about 3 percent of small and family-owned businesses were subject to the tax and that less than one-half of 1 percent of family-owned businesses would have faced a liquidity problem. In 1997, small businesses were made eligible for a qualified family-owned business interest (QFOBI) deduction for estates where more than half of the estate is a family business. This provision was capped and in the 2001 tax revision, the larger estate tax deductions exceeded the cap, but the exemption will become relevant again. Ironically, Graetz and Shapiro themselves may be charged with using anecdotal evidence when they claim that this exemption was so complicated virtually no one used it; according to data presented in a CBO study, Gravelle and Maguire conclude that one-third to one-half of estates with family businesses used the exemption.

Payroll Tax Issues

While the income tax generally favors small businesses returns to capital income, the payroll tax produces a penalty because, for the self-employed, all earnings (including those attributable to capital investment) are subject to the payroll tax. The Social Security part of the payroll tax, at a rate of 12.4 percent is subject to a cap, so it does not affect wealthy self-employed businesses whose tax rates would be higher and who benefit from not being taxed at the corporate rate lower. In 2007, the cap on Social Security wages was $97,500. The taxable income of the top 15 percent bracket, even if the standard deduction were taken, is $81,200 for joint returns and $40,600 for single returns; the top of the 25 percent bracket is $146,000 and $85,800, respectively, and probably considerably more since these returns likely benefit from itemized deductions. While some fraction of those in the 25 percent brackets (and possibly the 28 percent bracket for two-earner families with high incomes) would be subject to the 12.4 percent tax, the majority of tax would likely apply to lower brackets.

Also, additional benefits from the 12.4 percent tax are associated with additional payments which offset, in part, the tax payment. The Medicare tax of 2.9 percent has no ceiling and no connection to additional benefits after the individual qualifies for Medicare, and thus should be viewed as an additional tax. Self-employed individuals are allowed to deduct half of these taxes in determining income for individual income tax purposes so that the tax is reduced by 17.5 percent at the top rate of 35 percent and 7.5 percent at the 15 percent bracket.

Sole proprietors and partnerships engaged in a trade or business are subject to the tax. There are some exceptions for other types of business organizations. Subchapter S corporations are not subject to these taxes on earnings, but the individual must be paid a fair compensation for services performed, which are subject to the tax. This treatment might also allow investments to reduce the exposure of labor income to payroll taxes, through understating their compensation. (Interestingly, the recent reform proposal advance by Chairman Charles B. Rangel of the Ways and Means Committee would eliminate the exclusion from this treatment by Subchapter S firms.) Small businesses can avoid the tax on capital income by incorporating or by picking the option to be taxed as a corporation under the Limited Liability Company rules.

Because of the payroll tax, an additional tax is imposed on small businesses of certain types and is imposed on the margin. This payroll tax effect offsets in part the benefit of pass-through treatment for some small businesses.

Overall Treatment

The overall stance of the federal tax system towards small business is not entirely clear, although in general small business appears to be favored. While labor income is treated in the same fashion in both sectors, tax burdens differ for capital income. The income tax provides benefits to smaller businesses largely by not subjecting them to the corporate tax. On average the differential tax on equity income is 20 percentage points. Corporate businesses and their higher tax rates do, however, result in a favorable treatment of corporate debt, and overall Treasury estimates indicate that the differential is narrowed by half due to that rate. Smaller businesses also benefit from some more targeted tax preferences, including the ability to expense investment. They also have some favorable treatment because of the estate tax.

The payroll tax imposes additional taxes. Nevertheless, these taxes are likely to be unimportant at the margin and on average compared to the benefits. Table 2 presents data from U.S. Department of Treasury (2007) indicating the fraction of returns that are in the top two brackets. While the number of returns with income falling in the top two brackets is small, 72 percent of net income falls into the top two brackets and would not be subject to payroll taxes, other than Medicare, at the margin. A somewhat smaller share, 57 percent, of positive active business income falls into these brackets. This share understates the number not affected at the margin because lower tax rates also would not be affected. From another perspective, 13 percent of taxpayers and 30 percent of income fall into the Subchapter S category, where only income relevant to earnings is taxed under payroll taxes. Overall, the combination of Subchapter S, high marginal tax rates, and the benefits attached to payroll taxes suggest that the penalty from the payroll tax application is relatively small and probably significantly less than income tax subsidies.

Thus, a dramatic change has occurred in the economy between the truly small businesses and the large corporate firms. At the same time "large" small businesses, whether through more liberal Subchapter S rules, or through considerable more generous rules for large partnerships, have had their relative tax treatment eliminated and, thus, the smaller of small businesses have lost ground on two levels: relative to large corporations and relative to larger small firms. The larger small businesses, which in the past would have been subject to the corporate tax have had their situation improve both relative to large corporations and smaller businesses. All firms have had their tax burden lowered relative to tax burdens on investments in owner-occupied housing, however. At the same time, the growth in payroll taxes and introduction of Medicare have imposed taxes on capital incomes of small businesses.

Many of these changes have probably been made without necessarily recognizing them as harmful to small firms, but have simply been the consequence of enacting other programs (such as Social Security) or pursuing lower taxes on capital income in general and particularly of the most heavily taxed sectors.

DEVELOPMENTS OVER TIME

The ability to be taxed as a flow-through corporation is an enormously larger tax benefit than targeted small business tax subsidies that tend to be the subject of most discussion of small business tax treatment. However, that relative benefit has been changing over time. For firms that were traditionally treated as pass-throughs and remain so—the smaller of the small businesses—that relative benefit has been falling. Gravelle (2004) documents the falling differentials in tax rates between the corporate and noncorporate sector. In 1953 the effective corporate tax rate on new investment, taking into account debt and personal level taxes, was estimated at 70 percent and the noncorporate rate at 37 percent—an over 30 percentage point differential. The depreciation revision in 1954 lowered the rates to 57 percent and 23 percent, respectively—lower rates but a similar rate spread. The differential fell with rate reductions and further depreciation revisions beginning in the late 1970s, and eventually with the more recent favorable treatment of capital gains and dividends. The differential is only about 10 percentage points today.

JUSTIFICATIONS FOR TAX TREATMENT

The standard view in the economics literature is that the favorable treatment of unincorporated businesses, arising from the corporate income tax, results in undesirable economic distortions. Most economists in assessing tax policy would applaud, at least on efficiency grounds, these reductions in differential marginal tax rates. The imposition of the corporate tax is heavily correlated with size. Indeed, it is virtually impossible to raise the large amount of capital needed for most modern corporate business without turning to equity markets and attracting the corporate tax.

But, are there justifications for favoring small businesses? We exclude from this discussion issues of vertical and horizontal equity. There is no evidence that owners of small businesses have lower incomes than large businesses, and indeed, the U.S. Department of Treasury (2007) documents the concentration of ownership of unincorporated businesses in the higher income brackets. As for horizontal equity, presumably market forces equate the net-of-risk returns from alternative deployments of labor and capital.

What about reasons associated with economic efficiency? A perusal of general discussions of small business and potential justifications for favoring these firms, at least in the political debate, suggest the following arguments that are often made for favoring small businesses: small businesses create most of the jobs in the economy, small businesses are important in economic innovation and technological advance, small businesses undertake greater risks, small businesses have more difficulty raising capital, and small businesses bear a heavier burden in complying with the tax law because they cannot spread the fixed costs of compliance over a large income stream.

On closer examination, these arguments all appear to be relatively weak as a justification for favorable tax treatment of small businesses. While there is evidence that smaller businesses create more net new jobs, their role in this process is not clear because of migration across size classifications; moreover, although this sector of the economy may offer more opportunities to women and minorities, they pay less, they are less stable, and they have fewer fringe benefits (Edmiston, 2007). Hence, it is not clear that generation of jobs among small businesses is desirable. But, more importantly, there is not an obvious market failure. The economy is capable of creating jobs without the intervention (at least in the long run) of government, and there is no indication that there is a distortion in the mix of jobs developed.

While there is general agreement that innovation is probably under supplied in a capitalist economy. While theoretically there can be too little innovation, because innovators cannot capture all of the social returns from their development, there can also be too much as firms compete with each other and duplicate efforts in a race to find innovations. Empirical evidence, however, suggests that the average return on innovations is high. However, the evidence of the relative role of small and large businesses in the innovation process does not clearly indicate that small businesses are more important. Edmiston (2007) surveys the evidence and concludes that it is not clear. Moreover, the rate of innovation varies across industry and across size in the small business sector. Allowing tax benefits to all small businesses, the vast majority of whom do virtually no research and development, is an exceedingly blunt instrument for pursuing this objective.

By the nature of investing assets in a single business, investment presents greater risks for small business owners who, unlike individuals investing in the stock market, cannot diversify their assets. Moreover, for a variety of reasons, the tax law does not allow perfect loss offset. While this argument may have some merits, it also presents some limitations. First, as discussed by Holtz-Eakin (1995), the relationship between taxes and risk-taking is not entirely clear. A more general question is whether there is inadequate risk-taking in the small business sector—or possibly too much? The rate of failure among small businesses is quite high (Edmiston 2007), and many start-up businesses may be ill prepared for the challenges of competition. Whether it is desirable to increase the rate of small business formation given small business failure also seems unclear. Risk per se is not desirable; the question is rather whether individuals are undertaking the optional amounts of risk given expected returns. While there may be some merit in this argument, it is a weak one for granting broad-based tax benefits.

A similar argument may be applied to claims that small businesses should be favored because they have difficulty in raising capital. The reluctance of lenders and investors to finance smaller businesses may reflect not excessive, but accurate, perceptions of risk. In any case, the better tool for intervening is likely to be through providing government loan assistance.

Smaller businesses also have higher costs of compliance than do larger businesses. The fixed costs of learning the tax law, higher professional help and keeping records must be spread over smaller amounts of income than in the case of larger corporate firms. The magnitude of this effect is difficult to determine, in part because record keeping is a joint cost with other business purposes. This compliance cost could also justify certain types of benefits such as cash accounting, exemption from uniform capitalization rules, simplified inventory accounting, and the expensing provision that allows a certain amount of equipment investment to be deducted when purchased. As noted in the following section, however, smallness can be a benefit as well, through the greater ability to evade taxes.

TAX EVASION

As noted above, smaller businesses likely have greater compliance costs per dollar of income than do large ones. There is, however, another side of this coin. Small businesses also have greater abilities to evade taxes than do large businesses. It is more costly, per dollar of revenue, for the Internal Revenue Service to monitor small businesses, and there is less regulation and third party reporting than for other uses of capital and labor. That is, the cost of evasion (penalties times the probability of detection) is much smaller for smaller businesses. And projections of evasion suggest that small businesses have much higher evasion rates. According to tax gap measures, the underreporting rate for proprietorship income is 57 percent, contrasted with a rate of less than 20 percent for large and medium-sized corporate businesses. The compliance rate for wages and salaries is 99 percent (Internal Revenue Service, postings at U.S. Department of Treasury, Internal Revenue Service, 2006 and Plumley, 2004). A recent study by the U.S. Government Accountability Office (2007) found noncompliance among small firms to be common—61 percent understated net income —although the bulk of the underpaid taxes was concentrated in a small fraction of firms.

CONCLUSION

The analysis in this paper suggests that small businesses have significant tax benefits, in part through targeted preferences, but largely through not being subject to the corporate income tax. These benefits appear to more than offset additional taxes on capital income from self employment through the payroll tax. Over time this benefit has been falling for the smaller of the small businesses, and rising for the larger of them. In general, however, there seems little justification for tax subsidies for small business, either explicit ones or implicit ones.

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