



Distribution of Small Business Ownership and Income by Individual Tax Rates and Selected Policy Issues

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Summary

Some lawmakers have expressed concern over several proposals being considered in the current Congress to raise the tax burden on high-income individuals. Of particular concern are a proposal by the Obama Administration to allow the top two individual marginal tax rates (currently 33% and 35%) to return to their pre-2001 levels of 36% and 39.6%, starting in 2011, and a provision in the health care reform bill passed by the House (H.R. 3962) to impose a 5.4% surtax on the modified adjusted gross incomes (MAGIs) of single filers above \$500,000 and the MAGIs of joint filers above \$1 million, also starting in 2011. Critics claim the proposed tax hikes would undermine the economic incentives for small business formation and investment.

By contrast, backers of the Administration's proposal say it is needed to raise revenue during a time of large budget deficits, inject greater progressivity into the federal income tax in the wake of the sweeping tax cuts enacted during the Bush Administration, and promote a fairer distribution by income level of the cost of government services. A similar argument underlies support for the surtax in H.R. 3962.

One approach to evaluating the contention that the proposed tax hikes would harm small business investment, formation, and growth is to examine the distribution of small business income and the tax returns of small business owners by tax bracket. Two critical considerations in undertaking such an evaluation are the definition of small business income and ownership and its compatibility with available federal income tax data.

An analysis by the Urban Institute-Brookings Institution Tax Policy Center (TPC) of the distribution of small business income and tax filers reporting such income by tax bracket in 2007 and 2009 defines a small business owner as anyone who reports income or loss on Schedule C (self-employment income), Schedule E (income from rents, royalties, partnerships, limited liability companies, and S corporations), and Schedule F (income from farming). Such a broad definition arguably has more disadvantages than advantages, calling into question its usefulness for policy analysis. So any results based on such a definition should be seen as illustrative or suggestive rather than definitive or conclusive.

The TPC analysis found that a small share of small business owners would likely be affected by the proposed tax hikes: an average of less than 2% of such individuals were subject to the 33% or 35% marginal tax rates in 2007 and 2009. At the same time, the results suggested that a significant share of small business income could be subject to the higher rates. In 2007 and 2009, small business income represented an average of 30% of adjusted gross income (AGI) for filers in the 33% tax bracket, and an average of 35% of AGI for filers in the 35% bracket; the average for all filers was 14%.

Raising the marginal tax rates facing high-income individuals without changing the top corporate or capital gains tax rates in theory could increase the share of firms organized as C corporations rather than passthrough entities. A shift in the distribution of taxable income among the main forms of business organization might have a significant impact on business tax revenue.

A rate hike also has the potential to harm the domestic climate for small business formation and investment. But current business tax benefits, if retained beyond 2010, would lessen a rate hike's dampening effect on investment, and its impact on the creation of new firms may be difficult to determine.

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Introduction

Some lawmakers have expressed concern over the impact on small business of several proposed increases in the income tax rates for high-income individuals being considered in the current Congress.

In his budget request for FY2011, President Obama is proposing to extend permanently most of the individual income tax cuts that were enacted in 2001 and 2003 and are due to expire at the end of 2010. But the request also called for restoring the top two tax brackets (currently 35% and 33%) to their levels prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; P.L. 107-16): 39.6% and 36%; the higher rates would become effective in 2011. Under the proposal, the 39.6% rate would apply that year to all filers with adjusted gross incomes (AGIs) above \$373,650, and the 36% rate would affect single filers with AGIs from \$200,000 to \$373,650 and joint filers with AGIs from \$250,00 to \$373,650.

Upper-income individuals would also face higher marginal tax rates under the versions of health care reform legislation passed by the House (H.R. 3962) and the Senate (S.Amdt. 2786 to H.R. 3590). The House measure would impose a surtax equal to 5.4% of modified adjusted gross income (MAGI) in excess of \$500,000 for single filers and in excess of \$1 million for joint filers. Though the Senate bill does not include the surtax, it would impose an added payroll tax of 0.5% on the wage income of single filers above \$200,000 and on the wage income of joint filers above \$250,000; the tax would also apply to self-employed workers with business incomes above those thresholds.

Proponents of the proposed rate hikes say they are needed to raise revenue for a variety of crucial budgetary purposes (including reducing projected federal budget deficits). In their view, the hikes would also reverse the decline in the progressivity of the individual income tax ushered in by the sweeping tax cuts enacted during the Bush Administration.

Critics, by contrast, argue the rate increases would ultimately shrink the economy's long-term growth potential through their impact on savings, investment, and wages.¹ One of their main concerns is the effect that higher rates would have on small business formation, growth, and investment. Citing recent research findings, critics maintain that firms with fewer than 500 employees historically have accounted for a substantial share of business investment and made important contributions to the commercial development of new technologies.² In their view, the proposed higher marginal tax rates would boost the tax burden for many small business owners, reducing their incentives to open new lines of business, expand current operations, or invest in the development of new products and processes.

This report seeks to shed some light on the validity of such an argument by exploring what is known about the share of small business owners and of small business income that is subject to the top two marginal income tax rates.

¹ See, for example, Alan D. Viard, "The Case Against the Millionaire Surtax," *Tax Notes*, Dec. 21, 2009, pp. 1355-1362.

² See CHI Research, Inc., *Small Serial Innovators: The Small Firm Contribution to Technical Change*, funded by Small Business Administration, Office of Advocacy (Washington: Feb. 2003); and Kathryn Kobe, *The Small Business Share of GDP, 1998-2004*, funded by Small Business Administration, Office of Advocacy (Washington: April 2007).

Available Tax Data on Small Business Income

The analysis at the heart of this report is built around the distribution of small business income by marginal individual tax rates. While the Internal Revenue Service (IRS) does not release to the general public the data needed to compute such a distribution, the figures can be extracted from the vast store of individual tax data collected by the agency. Using a micro-simulation model, economists at the Tax Policy Center (TPC) jointly managed by the Urban Institute and the Brookings Institution have generated a distribution of small business income and filers with such income by tax bracket for 2007 and 2009.³

Before discussing the results, however, it is useful to know what is meant by a small business owner and small business income in this context. Providing such an explanation is not as simple or straightforward an exercise as it may appear. This is because a small business can be defined in several ways, and there is no consensus among analysts on the proper or correct definition. Still, a line must be drawn between small business income and all other sources of income in order to determine the share of small business owners and small business income that could be affected by an increase in the marginal tax rates affecting upper-income individuals.

In estimating the distribution of small business income by tax bracket, TPC uses the same definition of a small business owner that the Treasury Department has employed in several recent studies. In both cases, such an owner is anyone who reports any income or loss on Schedule C (self-employment income), Schedule E (income from rents, royalties, partnerships, limited liability companies, and S corporations), and Schedule F (farm income). Such a definition seems to have little in common with the popular image of a small business as a start-up firm owned by risk-taking entrepreneurs bent on commercializing some new technology, or a one-of-a-kind family-owned firm serving mostly local customers.

There are advantages and disadvantages to using such a definition as a basis for estimating the distribution of small business income by tax bracket. On the one hand, it covers all income earned in a tax year by what are referred to as passthrough entities, many of which could be considered small on the basis of the size of their workforces, revenue, or assets. The definition also makes it possible to separate small business income from all other sources of income using available tax data.

On the other hand, the definition has several limitations that call into question its usefulness for policy analysis. First, it excludes income earned by small C corporations and passed on to owners as compensation, dividends, or capital gains.⁴ There is no clear economic justification for omitting income from small C corporations when estimating the distribution of small business income by tax bracket. Second, the TPC/Treasury definition allows some firms that could be considered medium-sized or large using different criteria to be counted as small. For example, in

³ The results are presented in tables. See <http://www.taxpolicycenter.org/numbers/displayatab.cfm?Simid=237>.

⁴ Basically, there are three kinds of passthrough entities: S corporations, partnerships, and sole proprietorships. The income they earn is taxed not at the entity level but at the individual level, as the income flows through to the tax returns of their owners. Passthrough entities are to be distinguished for tax purposes from C corporations, whose earnings are taxed both at the entity level and at the individual level when shareholders receive dividend payments or realize a gain on the sale of corporate stock. For more information on the taxation of different business entities, see CRS Report R40748, *Business Organizational Choices: Taxation and Responses to Legislative Changes*, by Mark P. Keightley.

2005, 620,682 S corporations (or 17% of all S corporation tax returns) and 197,404 partnerships (7% of all partnership tax returns) reported receipts of \$1 million or more on their federal tax returns; the same firms accounted for 91% of the combined receipts for S corporations and partnerships that year.⁵ Third, under the TPC/Treasury definition, it is likely that many upper-income individuals who are what the IRS views as passive investors in partnerships and S corporations are counted as small business owners. In 2004, for example, passive investment income from those entities made up some or all the business income reported by 9% of households, and 58% of all individuals with adjusted gross incomes (AGIs) above \$1 million reported receiving some or all of their small business income as passive investment income.⁶ Yet another limitation with the TPC definition is that it treats certain kinds of miscellaneous income unrelated to investment or wages as small business income, even though the miscellaneous income has no clear-cut relationship to the ownership and management of a business; noteworthy examples include the fees given to CEOs for sitting on corporate boards, proceeds from sales on eBay, the honoraria received by journalists, and the royalties paid to book authors.

It is not known to what extent these limitations might distort a distribution of small business owners or income by tax bracket based on what many would regard as a more plausible definition of a small business owner.⁷ The linkages between the individual and business tax data collected by the IRS needed to generate such a distribution simply do not exist.

So given the limitations of any distribution of small business owners and income by tax bracket that relies on the TPC/Treasury definition, its results should be viewed as illustrative or suggestive rather than definitive or conclusive.

Distribution of Small Business Owners and Income by Tax Bracket

Table 1 shows the key results of the estimated distribution of small business income in 2007 and 2009 generated by TPC's microsimulation model. At least four conclusions relevant to the argument that the growth of small firms would be stunted by a rise in the top two individual tax rates can be drawn from the figures in the table.

First, the results indicate that few small business owners face the current top two marginal tax rates of 33% and 35%. Less than 2% of tax filers in those brackets in both 2007 and 2009 reported any small business income. At the same time, a majority of small business owners are subject to marginal tax rates ranging from 0% to 15%: in 2007, 68% of tax filers with small business income were in that position; the share rose to 72% in 2009. Thus, it seems reasonable to conclude that even after allowing for the limitations to the measurement of small business income in the TPC analysis, a tiny share of individual taxpayers who own and are actively involved in the

⁵ U.S. Congress, Joint Committee on Taxation, *Tax Reform: Selected Federal Tax Issues Relating to Small Business and Choice of Entity*, JCX-48-08, June 4, 2008, pp. 15-16.

⁶ Chye-Ching Huang and James Horney, *Big Misconceptions About Small Business and Taxes*, Center on Budget and Policy Priorities, Dec. 5, 2008, p. 7.

⁷ Such a definition would be based solely on some measure of the size of a firm only (e.g., firms with 200 or fewer employees or firms with \$500,000 or less in assets or receipts).

management of firms that many would regard as small on the basis of their employment, revenue, or asset size would be affected by an increase in the top two individual tax rates.

Second, small business income is not the dominant form of income in any tax bracket above zero. In 2009, such income totaled anywhere from 6.0% of AGI in the 15% bracket to 39.6% in the 35% bracket. (The high shares shown in the table for the 0% bracket stem from substantial business losses and the use of the absolute value of those losses to compute the ratio of small business income to AGI.)

Third, while most filers in the top two brackets report some small business income, a majority derive less than half of their AGIs from small business. In 2009, small business income accounted for over 50% of AGI for 40% of filers in the top bracket and for 33% of filers in the second bracket.

Finally, the results suggest that the proposed tax hikes for upper-income individuals would affect a greater share of small business income than small business owners. In 2007 and 2009, small business income represented an average of 30% of AGI for filers in the 33% tax bracket, and an average of 35% of AGI for filers in the 35% bracket; by contrast, the average for all taxpayers (including non-filers) was 14%. While it is unclear what proportion of small business income fell into each bracket shown in the table, there is evidence that taxpayers subject to the top two marginal rates earn a major share of that income. According to IRS individual income tax data (which can be accessed through the agency's website: <http://www.irs.gov>), small business income (as defined in the TPC analysis) accounted for 61% of the aggregate AGI for all filers with AGIs of \$200,000 or more in 2006 and 62% of the aggregate AGI for the same set of filers in 2007.

Table I. Distribution of Small Business Income by Tax Bracket in 2007 and 2009

Tax Bracket	Percentage of Tax Filers		Percentage of Tax Filers with Small Business Income ^a		Percentage of Tax Filers with Small Business Income Greater than 50% of Adjusted Gross Income (AGI)		Small Business Income as a Percentage of AGI	
	2007	2009	2007	2009	2007	2009	2007	2009
Non-filers	15.1%	8.3%	3.2%	1.4%	3.4%	2.9%	14.2%	18.6%
0%	15.6	20.3	26.8	24.6	21.8	20.2	67.0	59.4
10	14.7	16.2	13.3	14.0	7.7	7.2	10.8	10.9
15	30.2	35.4	28.0	33.0	3.8	3.5	6.3	6.0
25	9.4	15.5	8.6	17.4	3.4	4.0	5.3	6.7
26 (AMT ^b)	12.2	1.2	19.3	2.6	5.5	10.0	9.0	14.3
28 (Regular)	0.9	1.5	1.1	2.6	8.5	10.1	10.7	13.2
28 (AMT ^b)	1.5	1.1	4.1	3.2	19.5	22.1	21.7	24.3
33	0.0	0.1	0.1	0.4	28.1	33.2	26.4	33.6
35	0.4	0.3	1.4	0.9	39.1	39.9	37.3	39.6
All	100.0	100.0	100.0	100.0	7.7	8.1	14.1	13.8

Source: Urban-Brookings Tax Policy Center

Notes:

- a. Small business income is composed of income or losses reported on Schedule C (self-employment income), Schedule E (income from rents, royalties, partnerships, limited liability companies, and S corporations), and Schedule F (farm income).
- b. AMT refers to the individual alternative minimum tax. Individuals whose adjusted gross incomes exceed an exemption amount must compute their income tax liability under the regular tax and the AMT and pay the greater tax. In 2009, the exemption amount was \$46,700 for single filers and \$70,950 for joint filers.

Policy Issues Related to the Impact on Small Business of a Rise in the Marginal Tax Rates for Upper-Income Taxpayers

Proposals to increase the marginal tax rates facing upper-income individuals raise several policy issues related to small business. One concerns the legal form of organization in which small firms operate. The enactment of a rate increase could modify the tax incentives to operate as a corporation. Another issue is the effect of rate increases on small business formation and investment. The results of the TPC analysis suggest that a major share of small business income could be affected by a rise in the marginal tax rates facing upper-income individuals. Some are concerned that a larger tax burden on small business income could lead to reduced rates of small business formation and investment. Both issues are explored below.

Legal Form of Business Organization

Under current federal tax law, the owner(s) of a business can choose to operate either as a C corporation or some kind of passthrough entity (i.e., partnership, limited liability company, sole proprietorship, or S corporation). The decision hinges on a variety of tax and non-tax considerations. Foremost among the tax considerations are the rates at which individual and corporate income are taxed, tax rates for dividends and long-term capital gains, and the length of the investment horizon.⁸ In combination, they determine the expected after-tax rate of return on investment in or by any business entity.

In general, non-tax considerations appear to be of greater importance to large firms that wish to raise capital globally from a variety of investors and lenders than they are to smaller firms. The former are organized largely as C corporations to allow them to take advantage of the benefits of operating in that legal form. Unlike other forms of organization, a C corporation faces no limits on the number of shareholders it may have, the kinds of stock it may issue, or the nationality of its shareholders. In addition, the shares of C corporations generally are traded in established exchanges, making it possible for ownership interests to be transferred readily at relatively low transactions costs.⁹

⁸ For more details on the taxation of these business entities, see CRS Report R40748, *Business Organizational Choices: Taxation and Responses to Legislative Changes*, by Mark P. Keightley.

⁹ *Ibid.*, p. 6.

The earnings of C corporations are taxed twice: first at the corporate level and a second time at the individual level when the earnings are distributed—or passed through—to shareholders as compensation, dividends, or capital gains. By contrast, the earnings of passthrough entities are taxed only once: at the individual level of the owners as part of their taxable income from all sources, whether they are distributed or not. Given that a major proportion of small business income is taxed at the top two marginal tax rates, a rise in those rates, coupled with no change in the top rates for corporate income, dividends, and capital gains, could trigger an increase in the fraction of small firms organized as C corporations.¹⁰ In this case, the magnitude of the difference between the maximum individual and corporate rates could prove decisive in determining whether such a rise occurs and its extent.

Both the individual and corporate rate structures are progressive. In 2010, for taxpayers with sufficient taxable income, the former ranges from 10% to 35%, while the latter has a minimum rate of 15% and a maximum rate of 35%. Qualified dividends and long-term capital gains are either not taxed or taxed at a rate of 15% in the same year. Under the Obama Administration's budget request, the top individual rate would rise to 39.6% starting in 2011, leaving it nearly five percentage points above the top corporate rate. The Administration's FY2011 budget request also calls for re-setting the top tax rate for long-term capital gains and dividends at 20% for single filers with AGIs of more than \$200,000 and joint filers with AGIs in excess of \$250,000, beginning in 2011.¹¹ If enacted, these changes are likely to alter the tax incentives for operating as a C corporation. For lawmakers, an interesting question is whether the alteration would be sufficient to usher in a significant rise in the fraction of small firms operating as corporations.

One way to address this question is to construct a series of simplified investment scenarios involving a partnership and a corporation and compare their after-tax profitability. In essence, the scenarios would reflect the interaction of current top individual, corporate, and capital gains tax rates, as well as proposed changes in them, over a variety of investment horizons.

The results of such an exercise are summarized in **Table 2** below. Three sets of four scenarios are analyzed, using a simple model for determining after-tax rates of return for investing in a passthrough entity like a partnership or a C corporation.¹² Each set is built around a different investment horizon: one year, five years, and 10 years. The first scenario reflects current law in that it sets the individual tax rate at 35%, the corporate rate at 35%, and the long-term capital gains rate at 15%. In the second scenario, the individual rate rises to 39.6% (as proposed by the Obama Administration for 2011 and thereafter), while the corporate rate and the capital gains rate remain at 35% and 15%, respectively. For the third scenario, the individual rate stays at 39.6% and the corporate rate at 35%, but the capital gains rate rises to 20% (as proposed by the Obama Administration for 2011 and beyond). The fourth scenario combines an individual rate of 39.6%

¹⁰ According to IRS data on business taxation, about 6% of firms submitting tax returns were organized as C corporations in 2007, down from a share of about 17% in 1980.

¹¹ Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals* (Washington: Feb. 2010), p. 131.

¹² For a passthrough entity, the after-tax rate of return on investing one dollar is derived from the following formula: $\$1[1 + R(1 - t_p)]^n$, where R is the desired pre-tax rate of return, t_p is the top individual tax rate, and n is the length of an investment in years. For a corporation, the after-tax rate of return on investing one dollar comes from the following formula: $\$1[1 + R(1 - t_c)]^n \times (1 - t_{cg}) + \$1(t_{cg})$, where t_c is the top corporate tax rate and t_{cg} is the top long-term capital gains tax rate for individuals. For more details on the formulas and their underlying assumptions, see Myron S. Scholes, et al., *Taxes and Business Strategy: A Planning Approach*, 3rd edition (Upper Saddle River, NJ: Pearson Prentice Hall, 2005), pp. 85-87.

and a capital gains rate of 20% with a reduction in the corporate rate to 30.5%, as proposed by House Ways and Means Committee Chair Charles B. Rangel in a tax reform bill (H.R. 3970) he introduced in 2007.

Several simplifying assumptions undergird each scenario. First, an investor can expect to earn a constant pre-tax rate of return of 20%, regardless of whether she invests in a partnership or a corporation. Second, all after-tax income generated during the life of an investment that is not distributed is reinvested in the business. In the case of a partnership, each partner receives an annual distribution equal to 7% of partnership earnings to pay her federal tax on her share of the earnings. In the case of a corporation, shareholders receive no dividends. Third, the business is liquidated after five years. In the case of a partnership, there is no capital gain or loss at the time of the liquidation, and all partners receive a liquidating distribution of the remaining after-tax income, plus their initial investments. In the case of a corporation, the shareholders pay a capital gains tax at the top rate when they sell their shares or when the business is liquidated. Finally, the earnings of both the corporation and the partners are taxed at the top rates.

As the figures in **Table 2** suggest, small business owners subject to the top individual and capital gains tax rates appear to be better off operating as a partnership rather than a C corporation under both current law and the proposed changes in the maximum individual, corporate, and long-term capital gains tax rates examined here. In the scenario reflecting current law, a partnership would earn an after-tax rate of return that is 2.0 percentage points greater over one year, 1.5 percentage points greater over five years, and 1.1 percentage points greater over 10 years. Boosting the top individual rate to 39.6% while holding the other two rates constant narrows the gap significantly, but the partnership still comes out ahead over one year and 10 years. A partnership would realize a greater after-tax rate of return in all three periods when the top individual rate is 39.6%, the top capital gains rate is 20%, and the top corporate rate is 35%. And a reduction in the corporate rate to 30.5%, coupled with no change in the other two rates, results in a greater after-tax rate of return over one year and five years for a partnership, although a corporation would gain a slight edge over 10 years.

Table 2. After-Tax Rates of Return for a Corporation and a Partnership Under Four Investment Scenarios

Investment Horizon	Scenario I: Top individual rate: 35%; top corporate rate: 35%; top capital gains rate: 15%		Scenario II: Top individual rate: 39.6%; top corporate rate: 35%; top capital gains rate: 15%		Scenario III: Top individual rate: 39.6%; top corporate rate: 35%; top capital gains rate: 20%		Scenario IV: Top individual rate: 39.6%; top corporate rate: 30.5%; top capital gains rate: 20%	
	Partnership ^a	Corporation ^b	Partnership	Corporation	Partnership	Corporation	Partnership	Corporation
One year	13.0%	11.0%	12.0%	11.0%	12.0%	10.0%	12.0%	11.0%
Five years	13.0	11.5	12.0	12.0	12.0	10.8	12.0	11.7
10 years	13.0	11.9	12.0	11.7	12.0	11.3	12.0	12.2

Source: Congressional Research Service and *Taxes and Business Strategy: A Planning Approach*, 3rd ed., by Scholes, Wolfson, Erickson, Maydew, and Shevlin

Notes:

- a. The after-tax rate of return on investing another dollar in an investment project for a partnership is derived from the following formula: $\$I[1 + R(1 - t_i)]^n$, where R is the assumed pre-tax rate of return, t_i is the top individual tax rate, and n is the length of an investment in years.
- b. The after-tax rate of return on investing another dollar in a corporate investment project is derived from the following formula: $\$I[1 + R(1 - t_c)]^n \times (1 - t_{cg}) + \$I(t_{cg})$, where t_c is the top corporate tax rate and t_{cg} is the top long-term capital gains rate for individuals.

The distribution of taxable income among the main forms of business organization can affect the amount of revenue flowing into the U.S. Treasury. Evidence substantiating such a link can be found in a recent report released by the Small Business Administration's Office of Advocacy that addressed average effective tax rates for the various forms of business organization. A firm's average effective tax rate is the ratio of taxes paid to gross receipts; as such, the rate reflects both the appropriate statutory tax rate and the reduction in that rate owing to any tax benefits a firm can claim, such as credits, exemptions, exclusions, and special deductions. Using IRS tax return data for individuals and corporations, the report estimated an average effective tax rate in 2004 of 26.9% for S corporations, 17.5% for C corporations, 13.3% for sole proprietorships, and 23.6% for partnerships (including limited liability companies); the rate for all small businesses was 19.8%.¹³ These findings indicate that everything else being equal, more revenue would have been raised that year if a larger amount of small business taxable income had been attributable to S corporations or partnerships than to C corporations.

Small Business Formation and Investment

Federal tax policy has the potential to affect the performance of small firms through its impact on the incentives for savings, investment, and entry into self-employment. Decisions about critical matters such as whether or not to launch a new business, how a firm should be organized, how much it should invest in a certain period, and how to finance that investment can be swayed by the taxation of business income. The extent to which taxes influence the decisions of small business owners is no trivial issue, as those decisions, collectively, have important implications for the performance of the U.S. economy.

Critics of the proposed increases in the marginal tax rates for high-income taxpayers claim they would harm the domestic climate for small business formation and investment. More specifically, in their view, upper-income households earn the major share of capital income, and boosting their tax burden would end up shrinking their incentives to save, form a new business, or invest in an existing small business by giving the federal government a larger share of the returns from those activities. For critics, the data in **Table 1** suggesting that individuals in the top two tax brackets receive a large share of small business income validate this concern.

In making such a claim, critics draw in part on some of the findings from recent research into the effect of tax policy on entrepreneurial firms, which typically are equated with the self-employed population, owing to a lack of consensus over the definition of such firms. Of particular significance is a 2001 study by economists Douglas Holtz-Eakin and Harvey S. Rosen of the impact of the individual income tax on entrepreneurial activities. They found that a rise in individual marginal tax rates contributed to lower investment spending by profitable sole proprietors, reduced growth in their workforces and payrolls, and slower expansion of their businesses (as measured by business receipts) from 1985 to 1988, relative to a scenario based on no change in those rates.¹⁴

¹³ Quantrria Strategies, LLC, *Effective Federal Income Tax Rates Faced by Small Businesses in the United States*, report for the Small Business Administration (contract no. SBAHQ-07-Q-0012), April 2009, pp. 53-59.

¹⁴ See, for example, Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey S. Rosen, *Personal Income Taxes and the Growth of Small Firms*, NBER Working Paper No. 7980 (Cambridge, MA: National Bureau of Economic Research, 2000).

Given that small firms (as defined by the Small Business Administration) are thought to account for about half of gross domestic product and non-agricultural employment in the private sector, on average, and to play critical roles in the commercial development of many new technologies, the concerns raised by critics warrant serious consideration. Yet neither the literature on taxation and entrepreneurship nor the current tax treatment of small business offers robust, unqualified support for those concerns. Instead, both this literature and current tax policy sketch a more complicated and less clear-cut picture of the relationship between income taxes and entrepreneurial activity.

Creation of New Firms

On the issue of the formation of new firms (which tend to be small in employment size), there is general agreement among economists that tax policy has the potential to make entering self-employment more or less attractive than working for a wage or salary. What is more open to question (and controversy) is the role taxes play in the creation of new firms. This issue is explored in depth in a 2004 review of the theoretical and empirical literature on taxation and self-employment by Herbert J. Schuetze and Donald Bruce.¹⁵ Their findings reveal a lack of consensus among economists on the relationship between the two.

The theoretical literature suggests that taxation has a complex and ultimately ambiguous effect on the decision to become self-employed. In theory, several tax considerations are thought to influence this decision. Those discussed in the literature include differences between the tax treatment of business income and wage or salary income, the extent to which the government shares the risks associated with becoming self-employed through the offset of net operating losses against other sources of taxable income, the progressivity of the individual and corporate income tax systems, and opportunities to avoid or evade the taxation of business income. Models of the decision to enter into self-employment derived from these considerations have yielded inconclusive or contradictory results, implying that taxes have no clear-cut impact on the formation of entrepreneurial firms.

A similar conclusion evidently applies to the findings of the empirical literature. Some studies discussed in the review have found that higher rates fostered increased “rates of entrepreneurial activity,” while other, more recent ones have challenged that finding.¹⁶ The former support the popular notion that individuals become self-employed to avoid paying higher taxes on their wage or salary income. But the latter generally have detected no more than a weak link between tax rates or opportunities for tax avoidance or evasion, on the one hand, and entry into self-employment, on the other hand. For instance, in a 2006 study, Donald Bruce and Mohammed Mohsin estimated that a 50 percentage point cut in the top marginal tax rate would be required to engender a 1% gain in “entrepreneurial activity.”¹⁷ Schuetze and Bruce attributed this weak link to the opposing effects of higher tax rates on the decision to become self-employed: a higher top rate reduces the expected returns from self-employment but increases the sharing of risk associated with starting a new business.

¹⁵ See Herbert J. Schuetze and Donald Bruce, *Tax Policy and Entrepreneurship*, prepared for the Conference on Self-Employment held in Stockholm, Sweden on Mar. 22, 2004, see <http://web.uvic.ca/~hschuetz/setax.final.pdf>.

¹⁶ *Ibid.*, p. 8.

¹⁷ Donald Bruce and Mohammed Mohsin, “Tax Policy and Entrepreneurship,” *Small Business Economics*, vol. 26, Spring 2006, p. 415.

In the view of Schuetze and Bruce, more research needs to be done on the relative importance of risk-sharing and opportunities for tax evasion in the decision to become self-employed. They contend that the development of a theoretical model incorporating both factors would make it possible for lawmakers to make more informed decisions about tax legislation affecting the incentives for small business formation, increasing the chances of achieving the intended objectives.¹⁸

Investment by Small Firms

On the issue of investment by small firms, a rise in the top two individual tax rates may not be as damaging as some have argued. In fact, a careful consideration of the major forces driving small business investment casts some doubt on the notion a rate increase would reflexively cause a drop in small business investment.

In theory, if most small business income is subject to those rates, then an increase in both might result in less investment by small firms than otherwise would be the case, all other things being equal.¹⁹ There are two possible explanations for such an outcome.

One flows from what is known as the neoclassical theory of business investment. According to the theory, the cost of capital is the main driver of this investment; so when it rises in a way that affects most firms, business investment declines, and the opposite occurs when the cost falls. For any firm, the cost of capital combines the opportunity cost of making an investment, economic depreciation for the acquired asset, and the tax burden on the returns the investment generates. By itself, an increase in a business taxpayer's marginal tax rate has the effect of boosting its cost of capital. If the neoclassical model is accurate, the taxpayer will respond by cutting back its investment spending. In the face of a higher cost of capital, the number of projects a firm can undertake profitably decreases, as does its desired capital stock. Plenty of studies indicate that business investment is responsive to changes in the cost of capital, but considerable uncertainty still surrounds the degree of responsiveness.²⁰

A second reason why higher tax rates could spark a decline in business investment is tied to what might be called the cash flow theory of business investment. Under the theory, the main driver of business investment is a firm's cash flow or its retained earnings. Whereas the neoclassical model assumes that the opportunity cost of internal and external funds are the same, and that it can borrow as much money as it wants at that cost, the cash flow model proceeds from the supposition that for most firms, the cost of internal funds is lower than that of external funds. So how much a firm invests over time hinges on its cash flow in that period. All other things being equal, a rise in tax rates should lead to reduced business investment, as most firms would have lower retained earnings as a result. At least one study has found a notable correlation between cash flow and business investment, but what this means for the relationship between the two is far

¹⁸ Ibid., p. 31.

¹⁹ See Harvey S. Rosen and Ted Gayer, *Public Finance*, 8th edition (New York: McGraw-Hill Irwin, 2008), pp. 446-448.

²⁰ Numerous studies of the sensitivity of business investment to a shift in the user cost of capital have been done under a variety of assumptions. While no consensus exists, one reasonable option is to assume a range of values for the price elasticity of demand for capital goods from 0.2 to 0.6, with 0.4 as the initial benchmark. A price elasticity of 0.4 means that a 10% increase in the cost of those goods would lead to a 4% drop in business investment. See Robert S. Chirinko, "Corporate Taxation, Capital Formation, and the Substitution Elasticity between Labor and Capital," *National Tax Journal*, vol. 40, no. 2, June 2002, pp. 339-355.

from clear. Do firms invest more because their retained earnings are growing, or is it the case that profitable firms have both relatively high cash flows and levels of investment?²¹

But the story does not end there. There is an alternative theory of business investment that has little to do with the cost of capital or cash flow. According to the theory, the main engine powering expansions or contractions in investment is the level of overall demand in an economy for goods and services. Rises in demand will translate to higher investment spending largely because the ratio of capital and labor to output is fixed in the short run. Under what some call the accelerator model of business investment, changes in the cost of capital generated by changes in tax policy essentially do not matter. While there is no doubt that expected increases in sales play a powerful role in determining how much a firm invests in a given period, there is little doubt that the cost of capital also plays an influential role.

In addition, current federal tax law contains several tax incentives that directly affect business investment, one of which is targeted at small firms. Under Section 179 of the Internal Revenue Code (IRC), small firms have the option to write off (or expense) the cost of qualified assets in the tax year when they are placed in service, within certain limits; an enhanced version of the expensing allowance was available in 2008 and 2009 as a stimulative measure.²² The same firms (as well as all larger firms) were allowed to expense up to 50% of the cost of qualified assets bought and placed in service in 2008 and 2009. (Congressional leaders among the Democrats and Republicans and the Obama Administration have endorsed an extension of both the enhanced expensing allowance and the so-called bonus depreciation allowance through 2010, as a stimulative measure.) It is not known how many small firms took advantage of either or both special deductions, owing to a lack of tax and other data on small business investment. Expensing is the most accelerated form of depreciation and can result in taxing the returns to investment at a marginal effective rate of zero. So business taxpayers facing the top individual and corporate tax rates can lower the tax burden on the returns to qualified investments by claiming current expensing allowances.

A similar outcome can be achieved when a small firm invests in research that qualifies for the research tax credit under IRC Section 41 and has research expenditures that may be expensed under IRS Section 174. In combination, the tax incentives can produce a negative marginal effective tax rate on the returns to investment in research and development.²³

These considerations raise the possibility that those who claim that a rise in the tax rates affecting upper-income individuals would curtail small business investment may not be taking into account all the key forces shaping the domestic climate for that investment. The availability of investment tax incentives and other business tax benefits may lessen or offset the dampening effect of such a rise. And starting in 2011, a sustained upturn in domestic and foreign demand for goods and services produced in the United States could go a step further and overwhelm any such effect.

²¹ Rosen and Gayer, *Public Finance*, p. 448.

²² Under current law, the maximum allowance in 2010 is \$134,000, with a phase-out threshold of \$530,000. In 2008 and 2009, the allowance was capped at \$250,000, and the phase out began at \$800,000. For more details, see CRS Report RL31852, *Small Business Expensing Allowance: Current Status, Legislative Proposals, and Economic Effects*, by Gary Guenther.

²³ See CRS Report RL31181, *Research and Experimentation Tax Credit: Current Status and Selected Issues for Congress*, by Gary Guenther, p. 21.

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