Tax Policy and Small Business

Donald B. Marron*
Director,
Urban-Brookings Tax Policy Center
www.taxpolicycenter.org

Testimony before the Subcommittee on Select Revenue Measures,
Committee on Ways and Means,
United States House of Representatives
March 3, 2011

Chairman Tiberi, Ranking Member Neal, and Members of the Subcommittee, thank you for inviting me to appear today to discuss the tax system and small business.

America's tax system is needlessly complex, economically harmful, and often unfair. Because of a plethora of temporary tax cuts, it's increasingly unpredictable. And it fails at its most basic task, raising enough money to pay our government's bills. For these reasons, the time has come for fundamental tax reform.

Such reform could have far-reaching effects on every participant in the economy, including small businesses. To provide a foundation for thinking about these effects, my testimony discusses basic facts about the relationship between tax policy and small business. I make six main points:

- Today's tax code generally favors small businesses over larger ones. Provisions such as Section 179 expensing, graduated corporate tax rates, and special, low capital gains taxes benefit businesses that are small in terms of investment, income, or assets.

- Many small businesses also benefit from the opportunity to organize as pass-through entities. S corporations, limited liability companies, partnerships, and sole proprietorships all avoid the double taxation that applies to income earned by C corporations.

---

* The views expressed here are my own; they do not necessarily reflect the views of the Urban Institute, its funders, or its trustees. Joe Rosenberg, Eric Toder, and Roberton Williams provided helpful comments, but all errors are my own.

- However, the benefits of organizing as a pass through are not limited to small businesses. Some large businesses adopt these forms as well. Although these large firms account for a tiny share of pass-through entities, they represent a substantial fraction of pass-through economic activity. For example, only 0.2 percent of partnerships had revenues above $50 million in 2005, but they accounted for 57 percent of partnership income. For that reason, lawmakers should take care not to assume that all pass throughs are small businesses.

- Small businesses face disproportionately high costs in complying with the tax code. They are also more likely to understate their income and underpay their taxes. High compliance costs thus disadvantage responsible small businesses, while the greater opportunity to evade taxes can advantage less responsible ones.

- An ideal tax system would collect enough revenue to pay for government services while minimizing distortions to economic activity. To the extent possible, economic fundamentals, not tax considerations, should drive business decisions about organizational structure. By treating pass throughs and C corporations differently, our current tax system deviates from that ideal.

- Many tax reform proposals would reduce business tax preferences and use the resulting revenue to cut corporate income tax rates. Such revenue-neutral reforms could lessen the disparity in tax treatment between pass throughs and C corporations. Pass throughs would see their tax burden increase (since they would lose tax preferences but not benefit from the rate reduction), while C corporations would, on average, see their taxes decline.

I elaborate on these points in the remainder of my testimony.

1. The tax code generally favors small businesses over larger ones.

The tax code favors businesses that are small in terms of investment, income, or assets. The most important such preferences include Section 179 expensing, graduated corporate tax rates, and low capital gains taxes.

Section 179 expensing

Under Section 179, businesses can deduct from their taxable income the full cost of qualifying investments (machinery and equipment) up to a specified limit; those investments would otherwise need to be capitalized and written off over time. Such expensing benefits firms by reducing their tax liabilities immediately and eliminating the record-keeping burden of tracking capitalization and depreciation.

Under permanent law, firms can immediately expense their first $25,000 in qualifying investments; this benefit is then taken back dollar for dollar for investments in excess of $200,000. Thus, only firms that make less than $225,000 in qualifying investments benefit.

Since 2003, however, Congress has repeatedly extended Section 179 expensing on a temporary basis. Most recently, the Small Business Jobs Act of 2010 and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 set the maximum amount for expensing at $500,000 and the start of the phase-out at $2 million.[1] For taxable years starting in 2012, those amounts are scheduled to decline to $125,000 and $500,000, respectively. In 2013, they are scheduled to return to permanent law levels of $25,000 and $200,000.

Graduated corporate tax rates

Corporate income tax rates are 15 percent on the first $50,000 of taxable income, 25 percent on the next $25,000, and 34 percent up to $10 million.[2] These rates are lower than the 35 percent that applies to larger, profitable corporations. The tax code thus favors corporations with small profits over those with higher profits.

Lower capital gains taxes

The tax code also offers favorable treatment to some capital gains from individual investments in small businesses. For investments made in 2011, for example, capital gains (up to the larger of $10 million or ten times the taxpayer’s basis in the stock) resulting from new equity investments in qualifying small businesses (C corporations with less than $50 million in assets) will be exempt from income taxes

---

[1] The 2010 tax act also extended and expanded certain bonus depreciation provisions for all businesses. As a result, businesses can fully expense the cost of qualified investments through the end of 2011. Leaving aside some differences in the investments covered, this provision means that small and large businesses have the same opportunity to expense investments in 2011. The relative preference for small businesses will reemerge in 2012 and beyond.

[2] A 5 percent additional tax between $100,000 and $335,000 recaptures the benefits of the 15 and 25 percent brackets. A 3 percent additional tax between $15 million and $18.3 million recaptures the benefits of the 34 percent bracket.

if the stock is held for more than five years. In his recent budget, President Obama proposed to extend this provision permanently, while tightening reporting requirements to avoid misuse.

2. The tax system favors pass-through entities over C corporations.

The tax system also distinguishes among businesses based on how they are organized. Businesses that organize as S corporations, partnerships, limited liability companies (LLC), and sole proprietorships do not pay the corporate income tax. Instead, their profits are reported and taxed on the returns of their owners. The earnings from pass-through entities thus escape the double taxation that otherwise can apply to the income of C corporations.

To illustrate, consider a small business owner in the top personal income tax bracket, currently 35 percent. If she structures her business as an LLC, she will pay 35 cents in personal taxes on each additional dollar that her business earns.

If she structures her business as a C corporation, however, the income will face two layers of tax. The business will pay a 35 percent corporate income tax on each additional dollar of earnings. The 65 cents in after-tax income is then subject to personal income taxes when it gets distributed to the owner. Any earnings distributed as dividends, for example, would be taxed at a top personal rate of 15 percent. If the company paid out all 65 cents in after-corporate-tax income as dividends, the resulting personal taxes would be about 10 cents. The owner's after-tax income would thus be only 55 cents from a C corporation versus 65 cents from an LLC. The difference between a 45 percent effective tax rate and a 35 percent rate is a powerful incentive to structure as a pass through.[3]

3. The benefits of organizing as a pass through are not limited to small businesses; in fact, much pass-through activity happens in large enterprises.

Most small businesses organize themselves as pass throughs. For example, the Census Bureau reports that in 2008 more than three-quarters of small businesses were pass throughs.[4] But that doesn't mean that all pass throughs are small

---

[3] The owner might keep some of her earnings in the company rather than paying them out as dividends. That would reduce, but not eliminate, the difference in effective tax rates.

[4] This is true for businesses with fewer than 100 employees and for businesses with fewer than 500 (http://www2.census.gov/econ/susb/data/2008/us_naicssector_lfo_2008.xls).

businesses. Some large, closely held businesses also organize themselves as partnerships, S corporations, LLCs, and even sole proprietorships.

Those large pass throughs are few in number but account for a large fraction of the economic activity pass throughs undertake. Data from the Joint Committee on Taxation (Table 1) show that in 2005 less than 1 percent of S corporations and partnerships[5] had more than $50 million in assets.[6] Large partnerships and S corporations were thus extremely rare. But they accounted for the majority of partnership assets (76 percent) and a substantial share of S corporation assets (37 percent).

Table 1. Distribution of S Corporations and Partnerships by Assets, 2005

	Total Assets		
	< $50 million	**$50 million +**	**Total**
S Corporations			
Returns	99.8%	0.2%	100%
Assets	62.7%	37.3%	100%
Partnerships			
Returns	99.2%	0.8%	100%
Assets	24.1%	75.9%	100%
S Corporations + Partnerships			
Returns	99.6%	0.4%	100%
Assets	30.6%	69.4%	100%

Source: Author's calculations based on Joint Committee on Taxation (2008)

A similar pattern emerges when we look at receipts. Among all partnerships, S corporations, and sole proprietorships, only 0.1 percent had receipts greater than $50 million and only 0.4 percent had receipts greater than $10 million (Table 2).[7] But those large firms account for a disproportionate share of pass-through revenues. Firms with receipts over $50 million accounted for more than 40 percent

[5] Almost all LLCs choose to be treated as partnerships for tax purposes; they are included in the partnership data.

[6] I use $50 million as the cutoff because that's the asset level the tax law uses to distinguish small C corporations that qualify for favorable capital gains rates.

[7] The Small Business Administration uses a range of revenue cutoffs to identify small businesses; they generally fall in the $7 million to $35.5 million range, but some are smaller (http://www.sba.gov/sites/default/files/Size_Standards_Table.pdf). The closest divisions in the JCT data are at $10 million and $50 million.

of pass-through revenues, and those with receipts over $10 million accounted for almost 60 percent of pass-through revenues.

Table 2. Distribution of Pass-Through Entities and Net Income by Receipts, 2005

	Total Receipts			
	< $10 million	$10-50 million	$50 million +	Total
S Corporations				
Returns	97.9%	1.7%	0.3%	100%
Receipts	41.0%	25.0%	34.0%	100%
Net Income	51.0%	22.2%	26.8%	100%
Partnerships				
Returns	99.0%	0.8%	0.2%	100%
Receipts	19.4%	13.9%	66.7%	100%
Net Income	28.7%	14.0%	57.4%	100%
Nonfarm Sole Proprietorships				
Returns	100.0%	0.0%	0.0%	100%
Receipts	94.2%	3.6%	2.2%	100%
Net Income	98.9%	0.8%	0.3%	100%
Total				
Returns	99.6%	0.3%	0.1%	100%
Receipts	40.2%	18.5%	41.3%	100%
Net Income	58.0%	12.5%	29.5%	100%

Source: Author's calculations based on Joint Committee on Taxation (2008)

Large pass throughs also accounted for a disproportionate share of net profits. Firms with revenues of $50 million or more accounted for nearly 30 percent of pass-through net income, and firms larger than $10 million accounted for 42 percent of net income (Table 2).

Large businesses thus account for a large share of the economic activity pass-through entities undertake. Policymakers should therefore take care not to equate pass throughs with small business.

4. **Small businesses face relatively high costs in complying with the tax system; they are also more likely to underpay their taxes.**

Although the tax law often favors small businesses over large ones, complying with that law can be disproportionately burdensome. A few years ago, researchers at the Internal Revenue Service (DeLuca et al. 2007) estimated the total costs of complying with the income tax, including out-of-pocket expenses and the estimated value of employee and management time devoted to compliance. They found that there are substantial economies of scale in tax compliance. The cost of compliance amounted to 15 to 18 percent of revenues for very small businesses—those with receipts of $50,000 to $100,000. For businesses with receipts between $100,000 and $500,000, that ratio fell to about 5 percent. For businesses with receipts between $500,000 and $1 million, it was about 2 percent. And for businesses with receipts greater than $1 million, it was only 0.5 percent.[8] Tax compliance thus imposes much less relative burden on larger organizations.

On the other hand, smaller firms are more likely to underreport their income and thus underpay their taxes. Some small businesses, for example, rely heavily on cash transactions, which are relatively difficult for the tax authorities to monitor. Small businesses willing to engage in tax evasion may thus have an advantage over larger firms that have more transparent systems for monitoring and reporting income. As Toder (2008, p. 6) notes,

> The IRS reports that large percentages of income not subject to withholding or document matching go unreported—57 percent for nonfarm proprietor income, 72 percent for farm income, and 51 percent for rents and royalties. In contrast, income sources that make up a majority of income originating in large corporate businesses have very low underreporting rates—1 percent for wages and 4 percent for dividends and interest. IRS estimates of underreporting of corporate profits tax by large and small corporations are based on extrapolations from earlier studies and are less reliable, but the order of magnitude estimates reinforce the conclusion that large businesses are more compliant.

5. An ideal tax system would neither favor nor disfavor particular organizational choices.

In a world without taxes, businesses would choose their organizational structures based solely on economic fundamentals. Partnerships and corporations, both small and large, would compete on a level playing field, and an efficient mix of organizations would tend to emerge over time.

---

[8] These estimates rely on several important assumptions, including (a) an average cost of $45.40 per employee hour devoted to tax compliance and (b) tax record-keeping costs would not otherwise have been incurred for internal management purposes. Alternative assumptions would affect the estimated compliance burden, but would not change the qualitative result that smaller businesses bear a larger burden, as a share of receipts.

Taxes can interfere with that process. An ideal system would raise enough revenue to pay for government services but not distort business decisions, including those about organizational form and size. By treating pass throughs and C corporations differently, our current system deviates from that ideal. As a result, some businesses may choose less efficient organizational forms to reduce their tax burdens.

6. Tax reform could change the relative attractiveness of pass throughs and C corporations.

Both the corporate and personal income taxes are riddled with tax preferences (Marron 2011). These preferences narrow the tax base, reduce revenues, distort economic activity, complicate the tax system, force rates higher than they would otherwise be, and are often unfair. Many analysts and policymakers thus believe that reducing tax preferences should be the core of any new tax reform. Doing so could make the system simpler, fairer, and more conducive to America's future prosperity and raise revenues to finance a combination of tax rate cuts and deficit reduction.

Recently, several policymakers—including President Obama—have proposed narrow tax reforms that would reduce business tax preferences and use the resulting revenue to lower corporate tax rates. Such revenue-neutral reforms could increase the tax burden on pass throughs, since they would lose the tax preferences, but not benefit from the rate reduction. On the other hand, such reforms would reduce the tax burden on corporations, since the benefit of the rate reduction would be larger than the loss of corporate tax preferences. Such changes raise important questions about the distribution of the tax burden among different types of businesses. One potential benefit of such reform is that it would reduce the disparity in tax treatment between pass throughs and C corporations.

Thank you again for inviting me to appear today. I look forward to your questions.

References

DeLuca, Donald, John Guyton, Wu-Lang Lee, John O'Hare, and Scott Stilmar. 2007. "Estimates of U.S. Federal Income Tax Compliance for Small Businesses." Presented at the 2007 National Tax Association meetings, Columbus, OH.

Joint Committee on Taxation. 2008. *Tax Reform: Selected Federal Issues Relating to Small Business and Choice of Entity*. JCX-48-08. Washington, DC: Joint Committee on Taxation.

Marron, Donald B. 2011. "Cutting Tax Preferences Is Key to Tax Reform and Deficit Reduction." Testimony before the Senate Committee on the Budget, February 2.

Toder, Eric J. 2008. "Tax Reform and Taxation of Small Business." Testimony before the Senate Committee on Finance, June 5.