

## **DOES THE FEDERAL INCOME TAX FAVOR SMALL BUSINESS?**

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This paper will appear in National Tax Association, *Proceedings of the 100<sup>th</sup> Annual Conference, 2007*. The paper represents the views of the author alone and not necessarily those of the Urban Institute, its Board and its Sponsors or the Brookings Institution. The author thanks Len Burman for helpful comments and Carol Rosenberg for research assistance.

## INTRODUCTION

“To make our economy stronger and more competitive, America must reward, not punish, the efforts and dreams of entrepreneurs. Small business is the path of advancement, especially for women and minorities.”

- George W. Bush, State of the Union Speech, February 2, 2005.

"The entrepreneurial spirit burns brightly as the creativity and productivity of America's small businesses make our Nation's business community the envy of the world."

– Bill Clinton, State of Small Business Report, May 5, 1998.

As these quotes suggest, everyone loves small business. Small business is the source of our entrepreneurial genius, creativity, and productivity. Small business opens up opportunities for all Americans, especially women and minorities. Small business is the great engine of American prosperity and job creation. The vision of individual risk-takers pursuing their dreams, free of the security blanket and limitations that corporate and government employers impose, is deeply imbedded in our national self-image.

Nonetheless, a substantial portion of our economic activity occurs within large corporations, non-profits and public enterprises. Of the U.S. GDP of \$12.5 trillion in 2005, \$6.4 trillion of gross value added originated in the corporate sector (51 percent), \$3.2 trillion in other businesses (26 percent), \$1.4 trillion in the government sector (11 percent) and another 1.4 trillion in the household and non-profit sector (11 percent).<sup>i</sup> If all corporations were large businesses and all non-corporate enterprises were small businesses, this would imply that small business accounts for about a quarter of GDP. Even though many corporations are small businesses and many non-corporate enterprises are large businesses, calculations from business tax return data suggest this estimate of the relative contribution of small business is roughly correct.<sup>ii</sup>

Research showing that small business is the principal engine of new job creation (Birch, 1979) has been challenged by others. Armington and Odle (1982) found that large businesses generate most new jobs, while Davis, Haltiwanger and Schuh (1993) also refute the finding that small businesses generate more jobs than large businesses.

The supposed benefits of small business are sometimes used to justify tax incentives and other government benefits that favor smaller over larger businesses. Economic theory suggests that tax incentives for small businesses would cause a change in the size distribution of business organizations, resulting in an increased share of economic activity within smaller as opposed to larger business organizations. This would occur both through a shift in the composition of firms within industries and through a shift in the composition of economic activity among industries toward those sectors in which natural economic forces (absence of economies of scale, higher than average costs of within-firm coordination) are relatively more favorable to smaller than to larger firms.

This paper discusses how the federal income tax treats firms of different sizes. It reviews specific provisions favoring small businesses and more general aspects of the federal income tax that may differentially affect firms of different sizes and also discusses how opportunities for tax avoidance and costs of complying with the tax law affect businesses of different size.

## OVERVIEW OF RELATIVE TAXATION OF SMALL AND LARGE BUSINESSES

There are many ways to define a small as opposed to a large business. The IRS includes as taxpayers “served” by its Small Business and Self-Employed (SBSE) division businesses with assets less than \$10 million. In addition to assets, businesses may be classified as large or small by gross receipts, gross business receipts (excluding net

receipts from passive investments), and number of employees. Some tables in this paper report statistics on businesses with greater or less than \$50 million of business receipts (the largest receipts category displayed in published SOI data), but this definition of small business certainly includes companies that many would label “mid-sized”.

The vast majority of small businesses, accounting for most receipts of small businesses, are not subject to entity-level income taxation. Instead, they allocate their net profits to their owners, who include this source of income on their individual income tax returns.<sup>iii</sup> To compare tax burdens between flow-through businesses and businesses that pay corporate income tax, one must examine how all taxes on the companies, their employees, and their owners affect how much they can charge their customers, while still earning a normal profit rate.

A few provisions of the federal income tax explicitly favor smaller over larger firms. More important are more general provisions that disproportionately favor smaller over larger business. These include the separate corporate income tax (because large businesses are more likely than small businesses to be organized as taxpaying corporations) and rules for deducting business expenses (which allow certain deductions for the self-employed and closely-held businesses that are not available to employees of large corporations).

Beyond the effects of specific tax law provisions, the technology of tax administration and compliance affect small and large businesses differently. Small businesses, especially those that are paid in cash instead of by check or credit card, have much greater opportunities to avoid tax by underreporting income than larger businesses,

but the fixed costs of complying with the income tax law are a much larger percentage of business receipts for smaller than for larger business.

## PROVISIONS THAT EXPLICITLY FAVOR SMALL BUSINESS

### *Expensing under Section 179 of the Internal Revenue Code (IRC)*

Under Section 179 of the IRC, businesses in any year may immediately deduct from income the first \$25,000 of qualifying investments. The amount of investment spending available for the section 179 deduction decreases dollar for dollar for investments in excess of \$200,000, so that if a business spends \$225,000 on qualifying investments, the section 179 deduction phases out completely. The Jobs and Growth Tax Relief Reconciliation Act (JCTRRRA) of 2003 increased the amount that could be expensed in any year from \$25,000 to \$100,000, raised the dollar amount of investment at which the phase out of expensing begins from \$200,000 to \$400,000, and made computer software eligible for section 179 expensing, all through 2009, while indexing dollar limits to changes in the consumer price index.

Section 179 reduces the cost of capital for small businesses that use qualifying machinery and equipment, but produces little benefit for those whose capital consists principally of structures or inventory and no benefit for firms that spend \$25,000 (\$100,000 through 2009) more than the limit on qualifying equipment. The incremental benefit varies depending on the alternative depreciation rules for the type of machinery eligible for expensing and the taxpayer's discount rate. For example, at a 10 percent discount rate, the present value of depreciation of equipment that can be written off using double declining balance over 7 years is 79.4 cents per dollar of investment. Therefore, at a 34 percent tax rate, expensing for this type of equipment saves the taxpayer 7 cents

(.34 times 20.6 cents) per dollar of investment. The benefit of expensing is larger for longer-lived equipment, but less for shorter lived equipment, such as computers. Section 179 also reduces compliance costs for taxpayers who would otherwise have to apply tax depreciation rules and keep track of the basis of qualifying assets.

#### *Graduated Corporate Tax Rates*

Under current law, the corporate tax rate is 15 percent on the first \$50,000 of taxable income, 25 percent on the next \$25,000 of income, and 34 percent on the next \$9.925 million. The benefit of the rates below 34 percent is recaptured by a 5 percent additional tax on corporate income between \$100,000 and \$335,000, so that for income between \$335,000 and \$10 million the average tax rate is 34 percent. For income over \$10 million, the corporate tax rate is 35 percent. The benefit of the 34 percent rate (compared with 35 percent) is recaptured by a 3 percent additional tax on corporate income between \$15 million and \$18.33 million.

Graduated tax rates provide a substantial benefit to small, closely held corporations with low taxable profits that can avoid the corporate double tax on distributed income by paying wages and bonuses instead of dividends to owners and can reduce the tax rates they pay on retained profits to 15 and 25 percent, compared with rates of up to 35 percent (39.6 percent if the 2001 tax cuts expire as scheduled after 2010) if the profits were taxed to owners as ordinary income. Most economic activity of very small businesses, however, takes place in firms organized as flow-through enterprises. For example, according to IRS data, flow-through businesses in 2002 accounted for 94.5 percent of receipts from firms with gross business receipts less than \$100,000 and 81.2 percent of receipts for firms with business receipts between \$100,000 and \$500,000.

### *Other Provisions and Revenue Losses*

Other provisions that specifically favor small over larger businesses are a 50 percent exclusion of capital gains on qualified small business stock held by individuals for more than 5 years, ordinary income treatment of losses of up to \$100,000 for the sale of small business stock, and a 50 percent credit (limited to \$5,000) for small business for expenditures in excess of \$250 to remove access barriers for disable persons. Table 1 displays revenue losses estimated by JCT and Treasury of these provisions.

Table 1: Tax expenditure estimates for 2007-2011 (billions of dollars)

	Treasury	JCT
Expensing of certain small investments	14.4	9.5
Graduated corporate income tax	21.8	17.3
Capital gains exclusion of small corporation stock	1.8	N/A
Ordinary income treatment of loss from small business corporation stock sale	0.3	N/A
Credit for disabled access expenditures	0.2	N/A

Sources: "Estimates of Federal Tax Expenditures for Fiscal Years 2007-2011," Joint Committee on Taxation, September 24, 2007, JCS-3-07; "Analytical Perspectives: Budget of the United States Government, Fiscal Year 2008," Office of Management and Budget, February 5, 2007.

### PROVISIONS THAT MORE OFTEN THAN NOT FAVOR SMALL BUSINESS

The corporate form of business organization offers business owners the advantages of limited liability and, for publicly-traded companies, wide access to capital markets. Over the past several decades, however, it has become easier for businesses to gain the advantage of limited liability without paying corporate income tax. Corporations with between 1 and 100 shareholders and meeting other tests can elect to be taxed as flow-through entities under Subchapter S of the Internal Revenue Code. Partnerships can

be organized as limited liability companies and choosing the partnership form has become easier since Treasury instituted “check the box” regulations in the 1990s. Toder and Koch (2007) report that over the past decade the share of businesses organized as partnerships and S corporations and the share of business receipts of these companies has increased steadily, although C corporations still account for the majority of receipts of large companies.

#### *Taxation of Flow-Through Entities Compared with Subchapter C Corporations*

For businesses that are equivalent in other respects, non-corporate enterprises are taxed more favorably than C corporations. Equity returns to C corporations bear a tax at the entity level (the corporate income tax) and then are taxed again when the profits are paid out as dividends and when shareholders realize capital gains attributable to corporate retained earnings. In contrast, returns to equity in flow-through enterprises bear only the individual income tax. Preferential treatment of investments (such as accelerated depreciation or expensing) that reduces the effective tax rate on business income benefits both corporations (through a lower effective tax rate at the corporate level) and flow-through enterprises (through a lower effective tax rate on the profits of their owners).

Table 2 displays results of illustrative calculations of relative required pretax returns on capital invested in C corporations and flow-through entities under five alternative sets of assumptions. The calculations all assume that investors require the same after-tax returns on equity and debt in both corporate and flow-through investments. Returns net of corporate tax, but before individual income tax, on corporate equity, and the world interest rate are assumed to be set in international markets. Under these assumptions, the corporate income tax raises the required pretax return to corporate

capital, but does not affect the after-tax return to holders of corporate equity.<sup>iv</sup> Individual level taxation of corporate equity income (taxation of dividends and capital gains) does not affect the cost of corporate capital, but reduces the after-tax return to investors in corporate equity. Taxation of corporate dividends and capital gains do, however, affect

Table 2. Illustrative Calculations of Required Real Pre-tax Returns on Corporate and Non-Corporate Capital\*

	Corporate Debt	Corporate Equity	All Corporate Capital	Non-corporate Debt	Non-corporate Equity	All Non-Corporate Capital
Case 1	3.30%	11.51%	8.14%	3.30%	8.73%	6.50%
Case 2	3.30%	11.51%	8.14%	3.30%	7.72%	5.91%
Case 3	1.17%	6.50%	4.31%	1.17%	5.75%	3.87%
Case 4	1.17%	6.50%	4.31%	0.88%	4.96%	3.29%
Case 5	3.30%	11.51%	8.88%	3.30%	8.73%	6.99%

\*Non-corporate capital includes subchapter S corporations

Case 1: 2001 and 2003 individual income tax cuts extended, debt-capital ratio = .41, all capital income included in business tax base (economic depreciation of investments).

Case 2: 2001 and 2003 individual income tax cuts expire, debt-capital ratio = .41, all capital income included in business tax base (economic depreciation of investments).

Case 3: 2001 individual income tax cuts extended, debt-capital ratio = .41, full exemption of capital income from business tax base (expensing of investments)

Case 4: 2001 individual income tax cuts expire, debt-capital ratio = .41, full exemption of capital income from business tax base (expensing of investments)

Case 5: 2001 and 2003 individual income tax cuts extended, debt-capital ratio = .32, all capital income included in business tax base (economic depreciation of investments).

#### Other Assumptions:

Real return on equity net of corporate tax = 6.5%, Inflation rate = 2.8 percent, Real interest rate = 3.3 percent, Ratio of dividends to real after-tax corporate profits = .571, Ratio of realized to accrual capital gains = 0.5, Corporate tax rate = 35%, Marginal tax rate on income = 35% if tax cuts extended, 39.6% if tax cuts expire, Marginal tax rate on dividends = 15% if tax cuts extended, 39.6% if tax cuts expire, Marginal tax rate on capital gains = 15% if tax cuts extended, 20% if tax cuts expire

the cost of capital to flow-through enterprises because changes in after-tax returns on corporate equity change the returns required to attract capital to them.

All the calculations use assumptions from previous studies (Gravelle, 1994; Congressional Budget Office, 2005; Smith *et. al*, 2007) about the real interest rate, the real yield net of corporate tax on corporate equity, the inflation rate, the debt-equity ratio, the dividend payout rate, and the ratio of realized to accrued capital gains, and all assume the marginal investor is in the top individual income rate bracket. Cases 1, 2 and 5 assume capital income is included in the tax base (economic depreciation of investments), while cases 3 and 4 assume a zero effective tax rate on new investments (expensing). Cases 1, 2 and 5 use the 2007 maximum federal income tax rates on ordinary income, dividends and realized capital gains, while cases 3 and 4 assume the 2001 tax cuts expire, with top marginal income tax rates rising to 39.6 percent for ordinary income (now including dividends) and 20 percent for capital gains. Finally, cases 1 through 4 assume the average debt-equity ratio of corporations, while case 5 is otherwise the same as Case 1, but with a lower debt-capital ratio representing the average debt-capital ratio of flow-through enterprises (see Congressional Budget Office, 2005).

In all cases, the required pretax returns are higher for C corporations than for flow-through enterprises, but absolute and relative required returns vary among cases. Required returns for both C corporations and flow-through enterprises are lower with less taxability of business income and higher debt-capital ratios (because the cost of debt is lower than the cost of equity for both types of enterprises). The expiration of the Bush individual income tax cuts lowers the cost of non-corporate capital (by reducing after-tax returns to investors in corporate equity), thereby increasing the relative preference to

flow-through enterprises. Overall, the relative cost advantage to flow through enterprises varies from around 10 percent (with extension of the Bush tax rates and expensing of business investments) to about 27 percent (with expiration of the Bush tax rates and economic depreciation of business investments).

The percentage of business receipts from businesses organized as a C corporation increases with business size (Table 3). C corporations account for less than 6 percent of receipts for very small businesses with annual receipts less than \$100,000, 39 percent of receipts for mid-sized business with receipts between \$1 million and \$50 million, and 81 percent of receipts for businesses with annual receipts of \$50 million or more. While flow-through enterprises account for only 19 percent of receipts of all large businesses, they account for more significant shares of receipts of large businesses in some sectors (Table 4) - 60 percent in arts, entertainment and recreation; 48 percent in construction; 45 percent in agriculture, forestry, fishery and hunting; and 42 percent in professional, technical and scientific services.

To sum up, the current rules for business taxation generally favor smaller over larger businesses because the tax law favors flow-through organizations over businesses subject to the corporate tax and the relative share of economic activity by business subject to the corporate tax increases with business size. The degree of tax advantage conveyed by flow-through relative to C corporation status, however, varies greatly among businesses subject to varying taxation of returns to investment and, although corporations dominate the largest business size class (by receipts), flow-through enterprises comprise a large share of receipts of big businesses in some industries.

Table 3. Percentage Distribution of Business Receipts by Type of Business and Size of Business Receipts, 2002

Type of Business	All Receipt Groups	Size of Business Receipts				
		<\$100,000	\$100,000-\$500,000	\$500,000-\$1million	\$1-50 million	\$50 million and over
All Businesses	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Sub C Corporations	64.9%	5.5%	18.8%	28.1%	38.8%	80.9%
Sub S Corporations	18.5%	9.7%	29.2%	40.6%	41.7%	8.2%
Partnerships	11.6%	3.2%	7.7%	9.4%	15.5%	10.7%
Non-farm small proprietorships	5.0%	81.7%	44.3%	22.0%	3.9%	0.2%
All Flow-Through Bus.	35.1%	94.5%	81.2%	71.9%	61.2%	19.1%

Note: Detail may not add to total because of rounding

Source: IRS Statistics of Income, SOI Integrated Business Dataset, at <http://www.irs.gov/pub/irs-soi/02ot2busbr.xls>

Table 4. Share of Business Receipts Accounted for by Flow-Through Enterprises by Industry and Firm Size – Selected Industries

Industry	Business Receipts		
	< \$1 million	\$1-50 million	\$50 million +
All Industries	80.6%	61.2%	19.1%
Arts, entertainment and recreation	84.2%	77.9%	60.1%
Construction	84.7%	64.6%	47.6%
Agriculture, forestry and fisheries	70.1%	63.5%	45.2%
Professional, scientific and technical services	83.9%	61.7%	42.0%

Source: IRS Statistics of Income, SOI Integrated Business Dataset, at <http://www.irs.gov/pub/irs-soi/02ot2busbr.xls>

### *Deductible Expenses*

Small businesses also benefit by more favorable taxation of labor services compared with large businesses when the labor they use is supplied by owner-managers or active business partners. Owner-managers or partnerships can effectively deduct all their employee business expenses from the business or partnership income they report, while employees may deduct only amounts in excess of 2 percent of adjusted gross income (or none if they are subject to the individual alternative minimum tax.) Owner-managers may also represent some personal expenses (such as home office expenses or automobile use) as business expenses because it is difficult to monitor or even to determine the proper boundary between the two.<sup>v</sup>

### DIFFERENTIAL NON-COMPLIANCE – WHO BENEFITS AND HOW MUCH?

The preceding sections discussed provisions of the tax law that affect business differently depending on their size, assuming that businesses, their employees and their owners pay all taxes they owe. But IRS estimates of non-compliance suggest that evasion on income originating in small businesses is a much larger percentage of tax owed than evasion on income in large businesses. Individuals have more opportunity to underreport gross receipts from businesses and self-employment, especially for receipts received in cash, than for income they receive as employees and passive investors because the latter is subject to either withholding, information reporting, or both.

### *IRS Data on Compliance from National Research Program*

Under the National Research Program (NRP), IRS selected a stratified random sample of 46,000 tax year 2001 individual income tax returns to estimate underreporting of individual income tax liability.<sup>vi</sup> IRS (2006) reports an estimated net misreporting

percentage (NMP) for all business income tax liability of 43 percent; the breakdowns for sub-categories of income are 57 percent for taxes on non-farm proprietor income, 72 percent for taxes on farm income, 51 percent for taxes on rents and royalties and 18 percent for taxes on income from partnerships, S-corporations, estates and trusts (Table 5). The estimate for flow-through entities measures tax that individual taxpayers underreport, but does not fully capture underreporting of income at the business level.<sup>vii</sup>

Table 5. Income Tax Underreporting Estimates for Different Income Sources

	Tax Gap (in billions of dollars)	Net Misreporting Percentage
<u>Business Income</u>		
Non-farm proprietor income	68	57%
Farm Income	6	72%
Rents and Royalties	13	51%
Partnerships, S corps., estates and trusts	22	18%
<u>Non-Business Income</u>		
Wages, salaries and tips	10	1%
Interest income	2	4%
Dividend income	1	4%
Capital gains	11	11%

Source: Internal Revenue Service (2006)

In contrast, underreporting rates are very low for income sources subject to both withholding and information reporting (1 percent for wages), information reporting only (4 percent for dividends and interest) and partial information reporting (11 percent for capital gains, which is subject to information reporting for gross receipts, but not basis).

IRS estimates of the corporate tax gap are based on random audit studies (for small corporations) and operational audit studies (for the largest corporations, for which audit coverage was then almost universal) from the 1980s, with the estimates extrapolated to more recent years in proportion to the growth in corporate tax liability.

IRS has not recently released estimates of the corporate misreporting percentage, so one has to guess the approximate magnitude. For tax year 2001, IRS estimates a \$30 billion underreporting gap for corporations - \$25 billion for large corporations and \$5 billion for small corporations. For tax year 2001, the SOI Division of IRS reported corporate income tax liability (after credits) of \$166.7 billion. A \$30 billion tax gap implies a net misreporting percentage of 15.2 percent ( $166.7/166.7+30$ ). For the same year, SOI reported tax liability of about \$12.4 billion for corporations with assets under \$10 million (the IRS definition of small business) and \$155.5 billion for large corporations. These figures imply net misreporting percentages of 13.9 percent for large corporations and 28.7 percent for small corporations.<sup>viii</sup>

The figures imply substantially higher non-compliance rates for small businesses, especially for sole proprietors than for large businesses. IRS appears to find higher non-compliance rates for small than for large corporations and clearly finds much higher non-compliance rates for business income on individual tax returns than for corporate income. Note also that the difference is even higher than these figures imply if one is comparing a closely held small business with a large enterprise. For the former, business income includes returns to both labor services and capital and the higher non-compliance rate applies to both components of income generated in the business. For large enterprises, however, the tax on labor services is paid by employees who, due to withholding and information reporting, have an estimated non-compliance rate of only 1 percent. The corporate tax gap applies only to the taxable profits of the enterprise, not to the value added generated by labor services and the portion of capital returns paid to creditors.

*Who Benefits From Tax Evasion by Small Businesses?*

IRS compliance estimates do not imply that all or even the majority of small business persons are substantial tax evaders; the propensity to underreport income varies greatly due to variations in personal integrity, tastes for risk, and opportunities to conceal income. Nor do small business owners who underreport income necessarily reap all the rewards of non-compliance; some of the benefits are passed on to consumers of selected goods and services in the form of lower prices (Bankman, 2007). In some businesses where non-compliance is prevalent, more compliant business owners may receive lower profits to the extent competition from the less compliant drives prices down.

Thus, greater non-compliance opportunities do not produce an unambiguous benefit for all small business persons. The benefits of the reduced tax liability are certainly highly uneven among industries and among individuals within an industry and are shared between business owners and consumers. The increased opportunity to evade tax, however, provides on average an apparently much larger benefit for self-employment and small business activity than any benefit from explicit preferences in the tax law.

#### DIFFERENTIAL COMPLIANCE COSTS – A BURDEN FOR SMALL BUSINESS

Any estimate of how the tax system burdens people must take account of not only tax payments, but also the costs people incur to comply with the tax system. Compliance costs include time spent and out of pocket expenses in preparing tax returns and time and money costs in response to IRS audits or other taxpayer contacts.

#### *Summary of Recent Research*

IRS and IBM consulting recently completed a study of compliance burdens by small business taxpayers (DeLuca *et al*, 2007). IBM consulting surveyed a representative sample of small business (firms with assets less than \$10 million)

taxpayers, including C corporations, S corporations, and partnerships. IRS estimates that small business taxpayers spent between 1.709 and 1.844 million hours and between \$14.977 billion and \$16.411 billion in out of pocket expenses in preparing and filing tax returns. If one values the time of small business employees engaged in tax preparation activities at \$45.40 per hour (about \$90,800 per year), the total compliance burden is between \$92.5 billion and \$100.1 billion per year, about as large as the estimated compliance burden for all individual taxpayers (Guyton *et al*, 2005).<sup>ix</sup>

Slemrod and Venkatesh (2004) surveyed LMSB taxpayers to estimate compliance costs for mid-sized businesses and found their compliance costs are larger relative to size than costs for the largest corporations in the United States. Earlier research on compliance costs of large corporations by Slemrod and Blumenthal (1996) also found that compliance costs as a percentage of asset value decreased as asset size increased.

Further evidence of economies of scale in compliance burdens are shown in the latest IRS small business survey data. DeLuca *et al* report (2007) estimated compliance burdens as a percentage of gross receipts for firms of different sizes, measured by receipts. Assuming a time value of \$45.40 per hour, they report that the ratio of compliance costs to gross receipts declines monotonically with the level of gross receipts, falling from between 239.3 and 242.3 percent for firms with gross receipts less than \$10,000 to between 15.1 and 17.7 percent for firms with receipts between \$50,000 and \$100,000, between 5.1 and 5.4 percent for firms with receipts between \$100,000 and \$500,000 and only 0.5 percent for firms with receipts over \$1 million. Compliance burdens add significantly to the costs of doing business for very small firms, but are a very small percentage of revenue for the larger group of “small” businesses. The authors

show similar dramatic scale economy effects for firms ranked by number of employees and by asset size.

For the entire group of small business taxpayers, DeLuca *et. al* find that compliance costs (at a time value of \$45.40 per hour) are at most 1.6 percent of receipts, but are between 2.6 and 2.9 percent of asset value. At a 10 percent pretax yield on assets, this would be equivalent to a 26 to 29 percent additional tax rate on capital income. Thus, although compliance burdens on average do not add much to the price small businesses must charge their customers, they represent a significant additional “tax” on investment income. Moreover, there is significant variation within firms, with the very smallest firms bearing disproportionately higher burdens as a share of gross receipts.

## CONCLUSIONS

The federal income tax generally favors smaller over larger businesses. Some tax incentives in the law directly subsidize smaller firms, most notably expensing up to a fixed dollar amount of qualifying investment under Section 179 of the Internal Revenue Code and graduated tax rates for corporations. Other more general features of the tax law create on average more favorable treatment of small than of larger businesses, including the separate corporation income tax, limits on the deductibility of employee business expenses by wage earners and the ability of self-employed individuals and active partners of businesses to deduct from income a broader range of expenditures than can employees.

The technology of tax administration creates both relative advantages and disadvantages for small businesses. Individuals can more easily evade taxes on income originating in small than in larger enterprises and IRS tax gap estimates find that underreporting of tax liability is proportionately much larger in small businesses than in

large corporations. This provides a competitive advantage to small businesses and misallocates resources towards sectors of the economy in which small businesses using cash transactions are more prevalent. But research sponsored by IRS and others also shows that costs of complying with the income tax decline as a share of receipts as the size of a business (measured either in receipts, assets, or employees) increases. Compliance costs per unit of sales are especially high for very small firms.

This paper has provided some indication of the magnitude of these effects, but has not combined them into an overall measure of the net benefit the tax system provides to small business. The estimates of non-compliance and compliance costs are imprecise and both the potential gains from evasion and the potential additional costs of complying with the tax law associated with size vary greatly among industries and among firms within industries. The magnitude of both the gains and the losses to small businesses from features associated with how the tax law is administered, however, may swamp any benefits to small business from tax law provisions that explicitly favor them.

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<sup>i</sup> Calculations are based on data from U.S. Council of Economic Advisors (2007), tables B-10 and B-14.

<sup>ii</sup> Data from the IRS Statistics of Income Division reveal that businesses with gross business receipts of \$50 million or more account for 34 percent of gross business receipts by all businesses. Defining a small business as any business with gross receipts over \$50 million, assuming the distribution by size of business gross receipts is close to the distribution by size of business value added, and applying the 34 percent figure to the \$9.6 trillion of gross value added in the business sector produces the same estimate of a 26 percent share of GDP originating in small businesses. This calculation uses a fairly expansive definition of a small business, however, so by some measures the share of GDP originating in small businesses could be less. See SOI Tax Stats, Integrated Business Data, Table 2 at <http://www.irs.gov/pub/irs-soi/02ot2busbr.xls>

<sup>iii</sup> In practice, many closely-held businesses that are taxed as corporations also pay very little direct business income tax because they can plan their activities so as to pay out their returns in the form of deductible wages or bonuses to employees.

<sup>iv</sup> This assumption about the incidence of the corporate tax may be controversial, but does not affect the calculation of *relative* required returns on corporations and flow-through enterprises. The key assumption affecting the relative returns is the assumption that investors require the same after-tax returns in both corporate and non-corporate investments.

<sup>v</sup> There are other tax benefits that can more easily be used by the self-employed than by employees. For example, employer payments for medical insurance and medical expenses are tax-free to employees, but the share of health insurance premiums paid by employees and all premiums paid by employees not covered by their employers come from after-tax dollars. In contrast, self-employed persons may deduct

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100 percent of their health insurance premiums from their income tax, although unlike employees receiving employer-provided insurance, they cannot exclude premiums from earnings subject to payroll taxes.

<sup>vi</sup> IRS defines the tax gap as the difference between tax liability owed and taxes paid on time in a given year. The tax gap consists of three components – non-filing (tax liability on returns not filed on time by taxpayers with a requirement to file), underreporting (the difference between reported tax liability and tax owed on returns filed on time), and underpayment (taxes reported on timely filed returns, but not paid on time). Underreporting accounts for 83 percent of the tax gap. The discussion in this section refers to underreporting only.

<sup>vii</sup> The 2001 NRP study systematically examined income reported on individual income tax returns, but did not conduct random audits of the business entities that report shares of partnership and S-corporation income to individuals. (In some cases where there were reasons for suspicion, the auditor did examine the underlying entity, but this was not typically part of the audit.) NRP is currently completing a random audit study of S-corporation returns and will use the findings to adjust the individual income tax gap estimates.

<sup>viii</sup> Because of rounding issues with the data IRS reports, these estimates are very imprecise. Another way to guess at the estimated corporate non-compliance rate is from past IRS reports because the method of tax gap extrapolation maintains the ratio of non-compliance to reported tax liability. Internal Revenue Service (1990) reported a non-compliance rate (including both underreporting and non-filing) of corporations of between 12 and 19 percent, but did not break this estimate down by firm size.

<sup>ix</sup> The \$45.40 figure is used in DeLuca *et. al* (2007). In these calculations, the time cost borne by the businesses themselves is around five times larger than out of pocket costs, although most businesses use paid preparers. The vast majority of time costs are accounted for by recordkeeping costs. Recordkeeping expenses required for tax preparation, of course, also contribute to internal business management, so it is challenging to estimate the *incremental* recordkeeping attributable to the tax system, although the survey questionnaire attempted to do so. If, for example, only half the time costs of internal employees reported by businesses in the survey were really incremental to tax preparation, then at \$45.40 per hour, the estimated compliance burdens would drop to between \$53.8 billion and \$58.3 billion.

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