

Revised February 2, 2009

## BIG MISCONCEPTIONS ABOUT SMALL BUSINESS AND TAXES

By Chye-Ching Huang and James Horney

Supporters of various tax benefits for high-income households often claim that failure to maintain them would have an undue effect on many small businesses. But even assuming a broad definition of “small business,” such claims are often exaggerated or false. This paper examines three such claims.

First, critics charge that allowing the 2001 tax cut’s reduction in the top two marginal income tax rates for individual taxpayers to expire as scheduled would affect a large proportion of small-business owners. In fact, *only 1.9 percent of filers* with any small-business income are projected to face either of the top two income tax rates in 2009.<sup>1</sup> By contrast, more than 14 percent of filers with small-business income claim the Earned Income Tax Credit (EITC) for low-income workers. Thus, strengthening the EITC could help *more than seven times* as many small businesses as reducing the top income tax rates.

Second, critics often greatly exaggerate the burden of the estate tax on small businesses. Only a tiny proportion of the few estates that owe any estate tax have significant small business or farm assets. Furthermore, the small businesses and farm estates that do owe estate

### KEY FINDINGS

- Supporters of various tax benefits for high-income households often claim that failure to maintain them would have an undue effect on many small businesses. But even assuming a broad definition of “small business,” these claims are very often exaggerated or false.
- Only 1.9 percent of taxpayers with small-business income face either of the top two income tax rates. Thus, allowing the 2001 reductions in these rates to expire as scheduled in 2010 would not affect most small-business owners. Strengthening the Earned Income Tax Credit could help more than seven times as many small businesses as extending the reductions in the top rates.
- Claims that the estate tax must be largely or entirely eliminated to protect small businesses are misleading as well. According to the Tax Policy Center, in 2009 only 0.003 percent of all estates – that is, the estates of three out of every 100,000 people who die this year – will be small business estates that owe *any* estate tax.
- The typical small business is not a wealthy hedge fund. Closing a lucrative tax loophole used by hedge fund managers would have no effect on “mom and pop” businesses.

<sup>1</sup> Urban Institute and Brookings Institution Tax Policy Center estimates, with a small business defined as any tax unit that receives *any* income (or loss) from a sole proprietorship, farm proprietorship, partnership, S corporation, or rental income.

tax benefit from special provisions designed to help them reduce their estate tax liability.<sup>2</sup>

Third, critics often falsely claim that proposals to eliminate tax breaks for hedge fund managers would harm “mom and pop” businesses. Even the most expansive definition of a small-business owner does not fit the typical hedge fund executive.

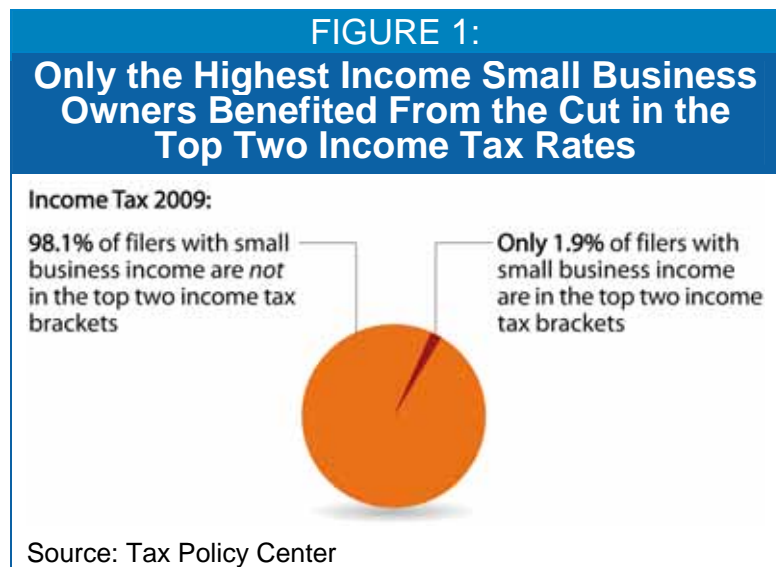
This paper analyzes these claims. It likely overestimates the number of small businesses adversely affected by changes to the top two marginal tax rates, the estate tax, and loopholes available to hedge-fund managers because it: (1) adopts an extremely generous definition of “small business” (see Appendix 1) and (2) does not consider many valuable tax breaks that small businesses and small-business owners enjoy (see Appendix 2). Yet it still finds that the claims typically made about small businesses and taxes are highly exaggerated, misleading, or false.

**“Claims that changing the top income tax rates, maintaining a viable estate tax, or eliminating the carried interest tax loophole would harm small businesses are either exaggerated or empty.”**

### **Only a Tiny Share of Small-Business Owners Face Top Two Income Tax Rates**

Despite clear data to the contrary, it is often claimed that changes to the top two income tax rates affect large numbers of small-business owners.<sup>3</sup> In particular, some have argued that extending *all* of the 2001 tax cuts — including the reductions in the top rate (from 39.6 percent to 35 percent) and the next-to-top rate (from 36 percent to 33 percent) — beyond 2010 is vital for small businesses<sup>4</sup> because many small-business owners are in the top two tax brackets.<sup>5</sup> This claim is false.

Estimates by the Urban Institute-Brookings Institution Tax Policy Center show that just 1.9 percent of filers with any small-business income (roughly 650,000 filers) will be



<sup>2</sup> Urban Institute and Brookings Institution Tax Policy Center estimates, with a small-business estate defined as one with more than half its value in a farm or business and with the farm or business assets valued at less than \$5 million.

<sup>3</sup> See, for example, “Remarks by the President During Meeting with Small Business Owners,” The White House, March 16, 2001.

<sup>4</sup> See, for example, “President Bush Addresses Small Business Week Conference,” Ronald Reagan Building and International Trade Center, April 13, 2006.

<sup>5</sup> See, for example “Treasury Releases Latest Number of Income Tax Returns Filed by Small Business Owners and Entrepreneurs,” U.S. Department of Treasury, March 16, 2001.

subject to either of the top two income tax rates in 2009. In other words, 98.1 percent of small-business filers have income too low to be subject to either of the top two tax rates (Figure 1).

By contrast, a substantial percentage of filers with small-business income are in the *lowest*

tax brackets. According to Tax Policy Center data, 34 percent of filers with small-business income either are in the 10 percent bracket or are not subject to income taxes because their incomes are too low. And 14.5 percent of filers with business income — *about 5 million filers* — claim the Earned Income Tax Credit, a refundable income tax credit for low-income working people.<sup>6</sup>

Percent of filers with any small business income who:	
▪ Face either of the top two marginal tax rates:	<b>1.9%</b>
▪ Have incomes too low to pay any income tax, or are in the bottom (10 percent) bracket:	<b>33.7%</b>
▪ Claim the Earned Income Tax Credit for low-income workers:	<b>14.5%</b>

Moreover, many of the roughly 650,000 filers with small-business income who face one of the top two tax rates are merely passive investors who have nothing to do with running the business. This is because the Tax Policy Center data cited above use the Treasury Department's relatively broad definition of "small business." Under the Treasury definition, for example, the \$84 of income President Bush received in 2001 from a passive investment in an oil and gas company<sup>7</sup> made him a "small-business owner." About 35 percent of "small-business owners" with incomes above \$200,000, and about 58 percent of "small-business owners" with incomes over \$1 million, received some or all of their business income in the form of passive investments. The Treasury definition also counts as "small-business income" the fees that CEOs are paid for sitting on corporate boards.

In short, few small businesses see any benefit from reductions in the top two income tax rates. The imagined impact on small businesses is a poor justification for extending the current top two rates, which would increase the deficit by \$450 billion over the next ten years.

## Estate Tax Has No Impact on Vast Majority of Small Businesses

Similarly, supporters of permanently eliminating most or all of the estate tax argue that the tax hurts many small businesses, asserting, for example, that "[o]ften [small] businesses, after being owned and operated by the same family for multiple generations, have to be sold in order to pay the tax generated by the transfer of ownership."<sup>8</sup> In fact, the estate tax has *no impact* on the vast majority of small businesses, and the very few small businesses that owe any estate tax pay on average *just 14 percent of the value of the estate* in tax.

<sup>6</sup> Tax Policy Center estimate, as of August 1, 2008.

<sup>7</sup> Tax Analysts, Tax History Project, "2001 Federal Individual Income Tax Return of President George W. Bush," [http://www.taxhistory.org/thp/presreturns.nsf>Returns/968A0298DD56761B85256E4400790D0E/\\$file/GW\\_Bush\\_2001.pdf](http://www.taxhistory.org/thp/presreturns.nsf>Returns/968A0298DD56761B85256E4400790D0E/$file/GW_Bush_2001.pdf).

<sup>8</sup> Senator Pat Roberts, Issue Statement on <http://roberts.senate.gov>, retrieved August 05, 2008.

Only 0.2 percent of all estates from deaths in 2009 (i.e., two out of every 1,000) are expected to owe any estate tax, according to Tax Policy Center estimates.<sup>9</sup> And only about 1.3 percent of those taxable estates are small-business estates (Figure 2).<sup>10</sup> The Tax Policy Center has estimated that in 2009, only *0.003 percent of all estates* — that is, the estates of three out of every 100,000 people who die this year — will owe *any* estate tax.

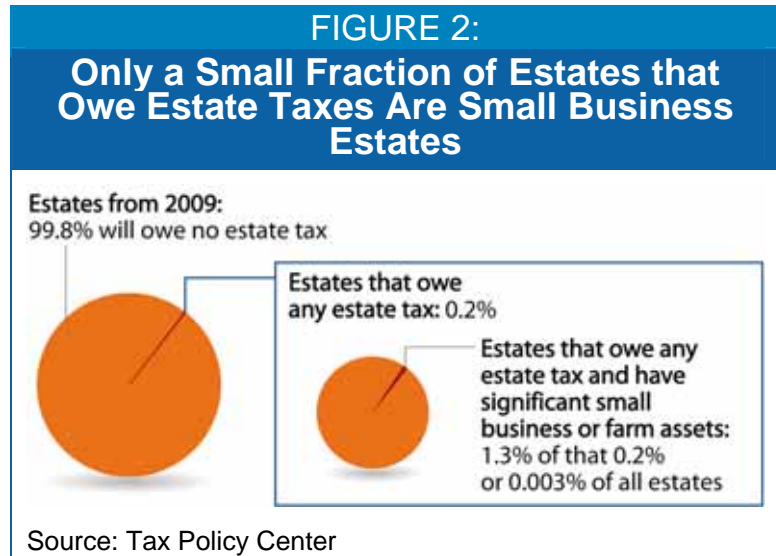
Furthermore, the small-business estates that do owe estate tax generally pay a very small percentage of their value in tax. The tiny number of small-business estates that will owe any estate tax from deaths in 2009 will owe an average rate of just 8 percent, which is significantly less than the 19.4 percent average rate that taxable estates overall will owe in 2009.<sup>11</sup>

There are two main reasons why. First, since small-business estates tend to have a smaller gross value than other estates,<sup>12</sup> the fact that the first \$3.5 million of any estate is entirely exempt from estate tax (\$7 million for a couple) generally protects a greater percentage of the value of small-business estates than it does for other estates.<sup>13</sup> Second, a number of special estate tax provisions targeted to small-business estates allow them to reduce significantly the amount of tax they owe.<sup>14</sup>

As in the debate about the top marginal income tax rates, concerns about small businesses under the estate tax are unwarranted.

## Eliminating Tax Breaks for Hedge-Fund Managers Would Not Harm Small Businesses

Finally, critics have charged that a proposal the House passed this summer to no longer allow private equity fund managers with multi-million-dollar incomes to pay tax at lower marginal rates than most middle-income Americans would “hurt small businesses.” This claim, too, is incorrect.



<sup>9</sup> Leonard E. Burman, Katherine Lim, and Jeffrey Rohaly, “Back from the Grave: Revenue and Distributional Effects of Reforming the Federal Estate Tax,” Urban Brookings Tax Policy Center, October 20, 2008.

<sup>10</sup> A small-business estate is one with more than half its value in a farm or business and with the farm or business assets valued at less than \$5 million.

<sup>11</sup> Urban Institute and Brookings Institution Tax Policy Center estimates. The average rate falls far below the 45 percent top marginal estate tax rate primarily because of the tax’s \$2 million exemption.

<sup>12</sup> Urban Institute and Brookings Institution Tax Policy Center

<sup>13</sup> Urban Institute and Brookings Institution Tax Policy Center. In 2009 the exemption level will increase to \$3.5 million (\$7 million per couple).

<sup>14</sup> The provisions targeted to small business and farm estates include the qualified family-owned business-interest deduction, valuation of assets based on current use, minority discounts, and the payment of estate taxes owed over 15 years.

Currently, executives who manage investment funds are able to receive a portion of their compensation in the form of “carried interest” (i.e., a share of the profits of the investment fund) and pay tax on it at the capital gains tax rate, which is typically much lower than their marginal income tax rate. Such preferential treatment for carried interest compensation is difficult to justify. While these executives’ compensation is calculated as a percentage of profits, they cannot accurately be viewed as earning shares of the profit of the investment fund, since they have not contributed any capital to the fund.

The House proposal would require carried interest compensation to be taxed at the recipient’s marginal individual income tax rate. This is a reasonable proposal to eliminate an inefficient and inequitable loophole.<sup>15</sup> Furthermore, the proposal would use the \$31 billion that closing this loophole would save over the next decade to help prevent millions more taxpayers from becoming subject to the Alternative Minimum Tax.

One response to this proposal has been the familiar but baseless refrain that the proposal “could affect countless ‘mom and pop’ businesses along Main Street, U.S.A.”<sup>16</sup> However, taxing carried interest in the same way as ordinary income would only affect individuals who provide investment management services and are paid in the form of carried interest. It would have *no effect* on small-business proprietors or individuals starting up small businesses, except for people who set up and run investment management firms. Indeed, when the director of Congress’s Joint Committee on Taxation was asked about the provision’s impact on “mom and pop” operations, he jokingly replied, “mom and pop private equity firms?”

## Conclusion

Claims that changing the top income tax rates, maintaining a viable estate tax, or eliminating the carried interest tax loophole would harm small businesses are either exaggerated or empty. The data clearly show that only a very small proportion of small businesses are affected by these tax policies. (The carried interest rules may not affect any small businesses at all.) This is true even when one uses an overly broad definition of “small business” that classifies substantial numbers of high-income taxpayers as “small-business owners” because they receive some income from passive business investments.

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<sup>15</sup> For a detailed discussion of the proposal to tax carried interest compensation at regular income tax rates, see Aviva Aron-Dine, “An Analysis of the ‘Carried Interest’ Controversy”, Center on Budget and Policy Priorities, revised August 1, 2007, <http://www.cbpp.org/7-31-07tax.pdf>

<sup>16</sup> Dissenting Views in “H. Rept. 11-728 accompanying H.R. 6275, the Alternative Minimum Tax Relief Act of 2008,” House Ways and Means Committee, June 20, 2008.

## Appendix 1: Statistics Overstate the Number of “Small Businesses”

The power of the term “small business” lies in the image it evokes in the public imagination. Typically, it brings to mind risk-taking entrepreneurs who are involved in the hands-on management of their small firms. To some people, it calls to mind the corner grocery store owner or the local auto mechanic. To others, it suggests a start-up firm, such as a new business developing a new type of software.

Yet when referring to “small businesses,” policymakers are often referring to firms and owners that bear little resemblance to these typical images. There is no uniformly recognized definition of a small business (the Internal Revenue Code contains at least 24 different definitions of a small business)<sup>17</sup> and, as the Congressional Research Service has noted, this makes firm size “a flexible concept that lawmakers can reshape almost without limit to suit their legislative aims.”<sup>18</sup>

The body of this analysis cites Tax Policy Center estimates of how many small businesses are affected by the top two income tax rates. However, the Tax Policy Center statistics use (for the sake of consistency) the Administration’s extremely broad definition of “small businesses,” a definition that bears little relation to the typical image of a small business. Therefore, it is likely that the number of entities typically thought of as small businesses that are affected by the estate tax and the top two income tax rates is likely to be *significantly smaller* than the Tax Policy Center statistics cited here indicate.

### Administration Definition of “Small-Business Owner” Inflates Estimates of Tax-Cut Benefits Going to Small-Business Owners

The definition of “small-business owner” used by the Administration in its estimates deviates wildly from the typical image of a “small business”. The Administration’s estimates count as a small-business owner any tax unit that receives *any* income (or loss) from a sole proprietorship, farm proprietorship, partnership, S corporation, or rental income. This expansive definition suffers from two problems. First, it counts as tax cuts for small businesses billions of dollars in tax benefits that go to individuals whose businesses are not small in any sense. Second, it counts as tax cuts for small businesses tax benefits that go to wealthy individuals who are passive investors and have nothing to do with operating the business in question (and may never have set foot in it).

#### *What Does “Small” Mean?*

As the Joint Committee on Taxation has noted, “while many small businesses are arranged as a sole proprietorship, a partnership, or an S corporation, not all of the businesses organized in these forms are small...”<sup>19</sup> Using IRS data from 2003, the Joint Tax Committee showed that the Treasury definition of “small business” included 770,000 businesses with gross receipts of over \$1 million and 86,000 companies with gross receipts of over \$10 million. Businesses with gross receipts of more than \$10 million accounted for about two thirds of the gross receipts of all partnerships and S corporations.

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<sup>17</sup> Gary Geunther, “Small Business Tax Benefits: Overview and Economic Rationales”, Congressional Research Service, revised September 18, 2007, p. 29.

<sup>18</sup> Gary Geunther, “Small Business Tax Benefits: Overview and Economic Rationales”, Congressional Research Service, revised September 18, 2007, p. 29.

<sup>19</sup> Joint Committee on Taxation, “Present Law and Background Relating to Selected Business Tax Issues,” JCX-41-06, September 19, 2003.

### *What Makes Someone a “Small-Business Owner”?*

The Treasury definition of a “small business” includes many wealthy individuals who are passive investors, not small-business proprietors. According to the Tax Policy Center, passive income from partnerships and S corporations accounted for some or all of the small-business income of 2.9 million tax filers who were termed “small-business owners” under the Treasury definition in 2004. For 850,000 of these filers, *all* of their “business income” came in this passive form.

It is of particular note that the prevalence of passive business income increases at higher income levels. Passive investment income constituted all or part of the business income of about 9 percent of all households counted as small-business owners under the Treasury definition. But about 35 percent of “small-business owners” with incomes above \$200,000 — and about 58 percent of “small-business owners” with incomes over \$1 million — received some or all of their “business income” in this form.

The Treasury definition also counts as “small-business income” the fees that CEOs are paid for sitting on corporate boards, as well as the honoraria that journalists receive for giving speeches. This turns a number of corporate CEOs and journalists employed by large media corporations into “small-business owners.” Doctors and lawyers who organize their practices as sole proprietorships, partnerships, or S corporations are considered small-business owners, as well, under this definition, as are people receiving book royalties.

Under the expansive Treasury definition of small-business owner, even President Bush and Vice President Cheney would have been considered “small-business owners” during at least part of their terms as President and Vice-President. For example, in 2001 President Bush received \$84 of income from a passive investment in an oil and gas production concern;<sup>20</sup> this would have made him a “small-business owner” under the Treasury definition. Vice-President Cheney and his wife Lynne received royalty income (paid to Lynne) in 2003; this would have made them small-business owners, as well, under the Treasury definition.<sup>21</sup>

### Conclusion

The analysis in the body of this paper uses the Administration’s overly broad definition of “small businesses,” a definition that captures entities bearing little resemblance to what is typically thought of as a small business. As a result, the analysis significantly overstates the number of small businesses that are, in fact, affected by the top two income tax rates (and the estate tax). Yet the analysis still finds that the vast majority — 98.1 percent — of small-business owners do not face the top two income tax rates.

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<sup>20</sup> Tax Analysts, Tax History Project, 2001 Federal Individual Income Tax Return of President George W. Bush, [http://www.taxhistory.org/thp/presreturns.nsf>Returns/968A0298DD56761B85256E4400790D0E/\\$file/GW\\_Bush\\_2001.pdf](http://www.taxhistory.org/thp/presreturns.nsf>Returns/968A0298DD56761B85256E4400790D0E/$file/GW_Bush_2001.pdf)

<sup>21</sup> Tax Analysts, Tax History Project, 2003 Federal Individual Income Tax Return of Vice-President Richard Cheney, [http://www.taxhistory.org/thp/presreturns.nsf>Returns/FE7DE8307A712BF585256FE4007705B9/\\$file/R\\_Cheney\\_2003.pdf](http://www.taxhistory.org/thp/presreturns.nsf>Returns/FE7DE8307A712BF585256FE4007705B9/$file/R_Cheney_2003.pdf)

## Appendix 2: Small Businesses Benefit from Large Tax Subsidies

A valuable array of tax subsidies is available to small businesses. In a survey of the tax treatment of small businesses, the Congressional Research Service found that “current federal tax law contains a number of provisions bestowing preferential treatment on small firms.”<sup>22</sup> For example, the federal small business tax preferences with the broadest reach include: “the taxation of small firms as passthrough entities, the graduated rates structure for the corporate income tax, the expensing allowance for equipment..., the exemption of some small corporations from the corporate alternative minimum tax, cash basis accounting, and the exclusion from taxation of capital gains on the sale or disposition of certain small business stock”.<sup>23</sup>

Estimates by the Joint Committee on Taxation and the Treasury Department indicate that the value of these tax subsidies for small businesses was more than \$11 billion in 2007.<sup>24</sup> The presence of these tax benefits makes even more dubious any argument that allowing the reduction in the two top tax rates to expire, making permanent the 2008 or 2009 estate tax rules, and closing the carried interest loophole would place small businesses at a significant tax disadvantage compared to large corporations.

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<sup>22</sup> Gary Geunther, “Small Business Tax Benefits: Overview and Economic Rationales”, Congressional Research Service, revised September 18, 2007, p. 3

<sup>23</sup> Gary Geunther, “Small Business Tax Benefits: Overview and Economic Rationales”, Congressional Research Service, revised September 18, 2007, p. (i).

<sup>24</sup> Gary Geunther, “Small Business Tax Benefits: Overview and Economic Rationales”, Congressional Research Service, revised September 18, 2007, p. 4