

# CRS Report for Congress

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## **Small Business Tax Benefits: Overview and Economic Rationales**

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Gary Guenther  
Analyst in Business Taxation and Finance  
Government and Finance Division

# Small Business Tax Benefits: Overview and Economic Rationales

## Summary

Congress has long taken an interest in the federal tax burden on small firms and its effect on their performance and rates of formation and growth. This interest has led to the enactment of numerous legislative initiatives over the years to reduce this burden. The 109<sup>th</sup> Congress is considering a variety of proposals to expand current small business tax preferences or create new ones.

This report describes the principal federal tax benefits for small firms and examines possible economic rationales for them. It will be updated when any new benefits are added to the tax code, or current ones are modified or repealed.

While the federal revenue cost of existing small business tax preferences is not known, estimates by the Treasury Department and Joint Committee on Taxation indicate that they may exceed \$8 billion in FY2005. The small business tax benefits outside farming with the broadest impact are the taxation of small firms as passthrough entities, the graduated rate structure for the corporate income tax, the expensing allowance for equipment under section 179 of the Internal Revenue Code, 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.

These benefits raise several interesting and important policy issues. For many public finance economists, a key issue is whether or not they can be justified on economic grounds. It can be argued that in the absence of such a foundation, proposals to enhance small business tax preferences could have adverse efficiency and equity effects.

In general, proponents of targeting tax relief at small firms claim that the special economic role played by small firms, the barriers in financial markets to their formation and growth, the special opportunities for social and economic advancement offered by small firms, and the sensitivity of small business owners to tax rates justify the use of such relief. More specifically, they assert that there are compelling economic reasons to favor or subsidize small firms through the tax code: namely, the income, jobs, technological innovations, and opportunities for economic renewal and structural change generated by small firms; the constraints on their ability to raise capital in debt and equity markets; and the formidable competitive advantages held by large, established firms.

While acknowledging the significant contributions made by small firms to domestic income and employment, critics of small business tax preferences argue that there appears to be no sound economic rationale for them. More specifically, they say that these subsidies mainly have the effect of undercutting the progressivity of the federal tax code and generating efficiency losses. In addition, critics assert that some such preferences are either inappropriate or poorly designed, leading to perverse or counterproductive outcomes.

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# Small Business Tax Benefits: Overview and Economic Rationales

Some policy issues seem to be permanent fixtures on the congressional legislative agenda. One such issue is the federal tax burden on small firms and how it affects their performance and growth prospects. Many lawmakers hold the view that small firms are a vital and indispensable source of job creation, economic opportunity, and technological innovation. Many of the same individuals see the taxation of small firms as both a drag on their growth and a barrier to their formation and a policy instrument for stimulating their rates of formation and growth. Such a dual perspective has made possible the adoption of a variety of small business tax benefits in recent decades. Current federal tax law contains a number of provisions bestowing preferential treatment on small firms. In addition, the 109<sup>th</sup> Congress is considering several proposals to further lessen their tax burden by enhancing some current small business tax preferences, creating new ones, or simplifying tax compliance for small firms.

Existing small business tax benefits and proposals to enhance or expand them raise several important economic policy issues. One is the substantial resources transferred to small firms through such subsidies and their long-term economic consequences. Public statements made by some lawmakers suggest that they firmly believe the long-term economic benefits of small business tax subsidies outweigh their short-term revenue cost, making them a desirable investment of public funds. Another key policy issue concerns whether these preferences can be justified on economic grounds. If such a rationale cannot be found or appears flimsy at best, then small business tax preferences may end up causing more harm than good in the long run.

This report explores these issues by examining the main small business tax preferences and the economic arguments for and against them. It begins with a brief description of current federal tax preferences for small firms, moves on to consider what is known about the economic role of small firms, and concludes with an explanation of the principal economic arguments for and against these subsidies.

## **Firm Size: How Small Is Small?**

Before describing the ways in which the federal tax code favors small firms and elucidating the economic role of small firms, it is useful to understand how small firms are defined for tax purposes. Unfortunately, doing so is anything but a simple and straightforward task. This is because there is no uniform definition of a small firm in the many federal laws granting benefits to small business. Instead, several

criteria are used to sort firms by size, and the rationale for this variation is far from transparent.

This ambiguity may have its roots in the Small Business Act (P.L. 85-536, as amended), which defines a small firm as “one that is independently owned and operated and which is not dominant in its field of operation.”<sup>1</sup> The Act goes on to specify that the definition of a small firm may vary from industry to industry to reflect important structural differences among those industries.<sup>2</sup> Under the Act, the Small Business Administration (SBA) has the authority to establish (and alter, if necessary) the size standards and limits for determining which firms are eligible for federal programs to assist small business, many of which are administered by the SBA. All federal agencies administering programs to set aside a certain proportion of procurement contracts for small firms are required to use SBA size standards and limits. But for other programs lending support to small firms, federal agencies have the choice of using SBA size standards and limits or establishing their own.

In general, three criteria are used to identify small firms eligible for federal support. Each specifies the maximum size a firm (including affiliates) can attain and still qualify for a particular program. For the most part, the SBA uses two criteria to determine eligibility for the programs it administers: number of employees and average annual receipts in the previous three years. The criteria vary by industry. For example, the criterion for most manufacturing and mining firms is employment size, and the upper limit is 500 employees; but for most retail and service firms, the criterion is average annual receipts, and the upper limit is \$6 million. SBA’s current size limits for small firms range from \$0.75 million to \$28.5 million for average annual receipts, and from 100 to 1,500 for number of employees.<sup>3</sup> A third criterion is a firm’s asset size. Under this size standard, eligible small firms own assets up to a certain threshold, such as \$50 million. Among the array of federal programs granting special benefits to small business, use of this criterion appears much more limited than number of employees or average annual receipts.

How does the federal tax code define a small firm? Again, no simple or straightforward answer is possible. A variety of criteria are used to determine eligibility for current small business tax preferences, and it is not clear why the size standard and limit vary from one preference to the next.<sup>4</sup> Some of these preferences rely on asset size, receipt size, or employment size to select eligible firms. Others confer benefits on small firms not because of some size standard but because of the nature of the provisions themselves. (If this distinction seems confusing, the description of the principal small business tax benefits in the following section should clarify its meaning.)

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<sup>1</sup> 15 U.S.C. § 632(a)(1)

<sup>2</sup> Small Business Administration, *Guide to SBA’s Definitions of Small Business*, available at [<http://www.sba.gov/gopher/Financial-Assistance/Defin/defi14.txt>].

<sup>3</sup> *Ibid.*

<sup>4</sup> A recent article claims that the Internal Revenue Code contains at least 24 different definitions of a small business. See Douglas K Barney, Chris Bjornson, and Steve Wells, “Just How Small Is Your Business?,” *National Public Accountant*, Aug. 2003, pp. 4-6.

The lack of a uniform definition of a small firm in the tax code has its advantages and disadvantages. On the one hand, it can lead to the almost perverse situation where a firm is eligible for some small business tax preferences but not others. On the other hand, the absence of a uniform definition gives policymakers some flexibility in targeting tax benefits at small firms. Regardless of the practical implications of this lack, there is little doubt that it creates the impression that what it means to be a small firm is a flexible concept that can be reshaped almost without limit to suit the aims of lawmakers.

## **Main Federal Tax Benefits for Small Business**

In general, all business income is subject to federal taxation. But not all business income is treated equally under the federal tax code. Its tax treatment can differ along numerous lines. For instance, the taxation of business income depends on whether or not a firm is organized for tax purposes as a corporation. Corporate net income is taxed twice, whereas the net income of passthrough entities such as S corporations, sole proprietorships, limited liability companies, or partnerships is taxed once. The taxation of business income also depends on whether or not a corporation or the owners of passthrough entities are subject to the alternative minimum tax (AMT). Corporations or business owners paying the AMT may be taxed at lower marginal rates than their counterparts paying the regular income tax. In addition, the tax burden on business income depends on how investments are financed. For example, the returns to corporate investments financed solely by debt face lower marginal effective tax rates than the returns to investments financed solely by equity, because corporations may deduct interest payments from taxable income but not dividend payments.

The tax treatment of business income also differs to some extent by firm size. Various provisions of the federal tax code confer benefits on smaller firms that are not available or of lesser value to larger firms. The tax code makes no explicit or formal distinction between the taxation of small and large firms in that the code does not have separate sections for small and large firms. Instead, it contains numerous provisions scattered throughout its many chapters which confer preferential treatment on relatively small firms but not on relatively large firms. Most of these provisions come in the form of deductions, exclusions and exemptions, credits, deferrals, and preferential tax rates. In general, tax preferences such as these have the effect of lowering the cost of capital for new investment by eligible firms relative to non-eligible firms. A few other provisions benefit small firms by reducing the cost and or burden of complying with tax laws, or by granting tax relief in exchange for the provision of certain fringe benefits to employees.

The small business tax subsidies with the broadest reach outside agriculture are described below. Excluded from the list are subsidies targeted at small firms in specific industries, such as life insurance, banking, and energy production or distribution. It is unclear what the net budgetary cost is for the subsidies discussed below. Nevertheless, recent estimates by the Joint Committee on Taxation (JCT) and

the Treasury Department indicate that they are likely to lower federal revenue by more than \$8 billion in FY2005.<sup>5</sup>

## Taxation of Passthrough Entities

Business enterprises operate in a variety of legal organizational forms. The business laws of each state determine the range of available choices. For tax purposes, five such forms are widely used: subchapter C corporations, subchapter S corporations, sole proprietorships, partnerships, and limited liability companies (LLCs).

The decision to operate in a particular organizational form has important implications for the tax burden on a firm's return on investment. C corporation earnings are taxed twice: once at the corporate level and again at the individual level when the earnings are distributed to owners either as dividends or realized capital gains. By contrast, the earnings of the other business entities are taxed only once: at the individual level of their owners. For this reason, these entities are often referred to as passthrough entities: their earnings are not taxed at the entity level but pass through to the owners.<sup>6</sup> The entities' profits, losses, and items of income, deduction, exclusion, and credit are attributed to the owners according to their shares of ownership, regardless of whether the profits have been distributed. The vast majority of businesses operate as sole proprietorships: in 2002, they accounted for 72% of federal business tax returns. Next in order of importance were S corporations (12% of business tax returns), followed by C corporations (8% of returns), partnerships (5% of returns), and LLCs (3% of returns).<sup>7</sup>

There is no legal requirement that C corporations be large in income, asset or employment size, and that passthrough firms be small. Yet such a distinction holds in practice. In 2001, for example, the average C corporation's asset size was over five times greater than that of the average partnership and 35 times greater than that of the average S corporation.<sup>8</sup>

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<sup>5</sup> In FY2005, the projected combined revenue loss for seven of the most important small business tax preferences is \$7.960 billion. It covers the following seven small business tax preferences: (1) expensing of depreciable business property; (2) reduced rates on the first \$10 million of corporate taxable income; (3) cash accounting outside agriculture; (4) the partial exclusion of capital gains on the sale of certain small business stock; (5) the amortization of business start-up costs; (6) the tax credit for new retirement plan expenses of small firms; and (7) the ordinary income treatment of losses on the sale of small business corporation stock. See U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2005-2009* (Washington: GPO, 2005), table 1; and Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2006* (Washington: U.S. Govt. Print. Off., 2005), table 19-2.

<sup>6</sup> For more details on the taxation of non-corporate businesses, see CRS Report RL31538, *Passthrough Entities Not Taxed As Corporations*, by Jack H. Taylor.

<sup>7</sup> Internal Revenue Service, *Statistics of Income Bulletin: Winter 2004-2005* (Washington: 2005), pp. 128-131.

<sup>8</sup> Internal Revenue Service, *Statistics of Income Bulletin: Spring 2004* (Washington: 2004), pp. 50, 228, and 231.

Whether a business owner would be better off operating as a C corporation or as a passthrough entity is often a complicated decision involving a host of tax and non-tax considerations. Key non-tax considerations include the legal liability of shareholders, access to capital markets, and degree of shareholder control of management. Among the tax considerations, four are paramount: (1) the relative tax rates for corporate income, individual ordinary income, and long-term capital gains; (2) the investment horizon of investors; (3) the holding period for corporate stock; and (4) the rate at which corporate profits are paid out as dividends.

If one ignores non-tax considerations for the moment, then it becomes clear that the current mix of individual and corporate tax rates favors passthrough entities by a small margin for investors in the highest income tax bracket. Such a group offers an appropriate focus for this analysis because many small business owners are subject to the highest marginal income tax rate. A few simple calculations can prove this point. In 2005, the top personal tax rate is 35%; most corporate profits are taxed at 35%; and the top tax rate on long-term capital gains is 15%.<sup>9</sup> Assuming an investment horizon of one year — after which the firm's assets are liquidated — tax considerations alone would dictate that these investors would be better off owning a business enterprise operated as a partnership rather than a corporation. Under such a scenario, after-tax returns to a partnership would be \$.65 for every dollar invested, whereas they would be \$.55 for every dollar invested by a corporation.<sup>10</sup> Extending the investment horizon to five years would not alter the outcome. If one assumes that all after-tax income earned during that period is reinvested in the business, the firm's assets are liquidated after five years, and individuals in the top tax bracket can earn a pre-tax rate of return of 20% whether the investment is made as a partnership or a corporation, partnerships would earn a higher after-tax rate of return than corporations: 13.0% versus 11.3%.<sup>11</sup>

Nonetheless, the taxation of passthrough entities should not be viewed as a small business tax benefit. This is because firm size is no obstacle to operating as a passthrough entity: firms that are relatively large in employment, revenue, or asset size are organized as S corporations or LLCs, and firms that are relatively small

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<sup>9</sup> Under the recently enacted Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA, P.L. 108-27), in 2003, the top individual income tax rate is 35% and is scheduled to remain at that level through 2010, and the maximum rate on long-term capital gains is 15% for assets sold after May 6, 2003 and before January 1, 2009.

<sup>10</sup> These tax rates are derived from the following formula:  $(1-tp)$  is less than or equal to  $(1-tc) \times (1-tcg)$ , where  $tp$  is the highest personal tax rate,  $tc$  is the highest corporate tax rate, and  $tcg$  is the maximum tax rate on long-term capital gains. See Myron S. Scholes, et. al., *Taxes and Business Strategy: A Planning Approach*, 2<sup>nd</sup> edition (Upper Saddle River, NJ: Prentice-Hall, Inc., 2001), p. 67.

<sup>11</sup> The after-tax rate of return for a partnership is derived from the following formula:  $\$1[1 + R \times (1-tp)]^n$ , where  $R$  is the expected pre-tax rate of return,  $tp$  is the highest personal tax rate, and  $n$  is the investment horizon. And the after-tax rate of return for a corporation is derived from the following formula:  $\$1[1 + R \times (1-tc)]^n (1-tcg) + (tcg \times \$1)$ , where  $R$  and  $n$  are the same as the previous formula,  $tc$  is the highest corporate tax rate, and  $tcg$  is the maximum tax rate on long-term capital gains. See Scholes, *Taxes and Business Strategy*, pp. 66-67.



operate as C corporations. In addition, any tax advantage presently held by small passthrough entities could prove ephemeral, as it has in the recent past. For instance, their present advantage would shift to corporations if legislation were enacted that sharply reduced the top corporate and long-term capital gains tax rates relative to the maximum individual income tax rate.

## **Graduated Corporate Income Tax Rates**

Corporations with less than \$10 million in taxable income are subject to graduated federal income tax rates. The rate is 15% on the first \$50,000 of income, 25% on the next \$25,000, and 34% on selected amounts up to \$10 million. Corporations with taxable incomes ranging from above \$10 million to \$15 million pay a marginal rate of 35%. What is more, in two income ranges, corporations face marginal tax rates greater than 35%. A corporation with taxable income between \$100,000 and \$335,000 pays a marginal rate of 39%, which is five percentage points greater than the marginal rate on taxable incomes just above and below that range. And a corporation with taxable income of more than \$15 million up to \$18.3 million pays a marginal rate of 38%. These higher marginal rates are intended to offset the tax savings firms realize from the lower tax rates they paid when their taxable incomes were smaller. All corporate taxable income above \$18.3 million is taxed at a rate of 35%. As a result, the benefits of the graduated rates from 15% to 34% are limited to corporations with taxable incomes under \$335,000.

This graduated rate structure mainly benefits corporations that are relatively small in employment or asset size, because their taxable incomes are likely to remain below the \$335,000 threshold. It also gives owners of closely held small firms an incentive to incorporate in order to shield profits from higher individual tax rates. Not all small corporations, however, are allowed to take advantage of the reduced rates. Specifically, the taxable income of corporations providing services in the fields of health care, law, engineering, architecture, accounting, actuarial science, the performing arts, and consulting is taxed at a fixed rate of 35%, regardless of the amount. The graduated rate structure is not without drawbacks. Specifically, it gives smaller corporations a disincentive to grow beyond a certain size. In this sense, the higher rates serve as a tax on growth.

The revenue loss arising from the reduced rates on the first \$10 million of corporate taxable income is expected to total an estimated \$3.6 billion in FY2005.<sup>12</sup>

## **Expensing Allowance for Certain Depreciable Business Assets**

Expensing is the most accelerated form of depreciation for tax purposes. It entails treating the cost of a depreciable asset as an ordinary and necessary expense rather than as a capital expenditure. Ordinary and necessary costs are deducted in the year in which they are incurred, whereas capital costs typically are recovered over

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<sup>12</sup> U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2005-2009* (Washington: GPO, 2005), p. 34.

longer periods according to the depreciation methods and schedules allowed in the federal tax code.

Under section 179 of the Internal Revenue Code (IRC), firms were able to expense (or deduct) up to \$100,000 of the cost of qualified business property — mainly machinery and equipment and computer software — placed into service in the 2003 tax year and write off the remaining basis (if any) under current cost recovery rules.<sup>13</sup> The maximum allowance went up to \$102,000 in 2004. It is indexed for inflation in 2005, 2006, and 2007. Starting in 2008 and thereafter, however, the maximum allowance will drop to \$25,000 and remain there.

Because of a phase-out rule, not all firms are able to take advantage of this allowance. It is phased out, dollar for dollar, once spending on qualified property exceeds a certain threshold. In 2003, the threshold was \$400,000; it rose to \$410,000 in 2004. The threshold is indexed for inflation in 2005, 2006, and 2007. But beginning in 2008 and thereafter, it will decline to \$200,000 and remain at that level. As a result, no portion of an investment in qualified property that was placed into service in 2004 could be expensed if a business taxpayer's total expenditure for such property that year amounted to \$512,000 or more. One implication of the phase-out threshold is that most of the firms able to take advantage of the allowance are relatively small in revenue, asset, or employment size.

The allowance serves as a robust tax subsidy for business investment. In effect, the allowance defers the income tax on part or all of the first-year returns to investment in qualified assets. This deferral translates into a zero marginal effective tax rate through the standard economic model for the determination of the user cost of capital.<sup>14</sup>

In FY2005, the allowance is expected to result in an estimated revenue loss of \$0.5 billion.<sup>15</sup> The revenue effects of the expensing allowance in a particular year hinge on the behavior of business investment in that year. In periods of rising business investment, the allowance typically produces a revenue loss. But when a slump in business investment follows a period of sustained expansion, the allowance can actually yield a net revenue gain. This shift from loss to gain simply reflects the timing of depreciation deductions under expensing. In some cases, the entire cost of an asset is written off in its first year of use under the expensing allowance, leaving no depreciation deductions to offset income earned by the asset in future years.

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<sup>13</sup> For more details on the design of the expensing allowance and its economic effects, see CRS Report RL31852, *Small Business Expensing Allowance Under the Jobs and Growth Tax Relief Reconciliation Act of 2003: Changes and Likely Economic Effects*, by Gary Guenther.

<sup>14</sup> See Jane G. Gravelle, "Effects of the 1981 Depreciation Revisions on the Taxation of Income From Business Capital," *National Tax Journal*, vol. 35, no. 1, March 1982, pp. 2-6.

<sup>15</sup> Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2005-2009*, p. 33.

## Exemption of Certain Small Corporations From the Corporate Alternative Minimum Tax

Under current federal tax law, many corporations must compute their income tax liability under both the regular tax and the alternative minimum tax (AMT) and pay whichever is greater. Each tax has its own rates, allowable deductions, and rules for the measurement of taxable income. In general, the AMT applies a lower marginal rate to a broader tax base. It expands the corporate tax base by including a number of tax preferences under the regular corporate income tax in the computation of taxable income under the AMT. In addition, most tax credits allowed under the regular corporate income tax cannot be used to reduce AMT liability. The current AMT originated with the Tax Reform Act of 1986 and is mainly intended to insure that all profitable corporations pay at least some federal income tax.

Under the Taxpayer Relief Act of 1997 (P.L. 105-34), certain small corporations have been exempt from the AMT since 1998. Eligibility is determined by a corporation's average annual gross receipts in the previous three tax years. All corporations formed after 1998 are exempt from the AMT in their first tax year, regardless of the size of their gross receipts. They remain exempt as long as their average annual gross receipts do not exceed \$5 million in their first three tax years, and as long as their average annual gross receipts do not exceed \$7.5 million in each succeeding three-year period (e.g., 1999-2001, 2000-2002, etc.). If a corporation loses its eligibility, it becomes subject to the AMT in the first tax year when it no longer qualifies and in every tax year thereafter, irrespective of the amount of its gross receipts.

There is some evidence that this exemption may give some eligible small corporations a slight competitive advantage over comparable firms paying the AMT. A 1997 study found that firms investing heavily in machinery and equipment and intangible assets like research and development (R&D), financing the bulk of their investments through debt, and paying the AMT for five or more successive years had a higher cost of capital than comparable firms paying only the regular income tax in the same period.<sup>16</sup> In addition, the exemption gives owners of small firms an incentive to incorporate, since the taxable income of owners of passthrough entities is subject to the individual AMT as well as the regular income tax.

A 2000 report by the Treasury Department's Inspector General for Tax Administration (TIGTA) suggested that the implementation of the exemption from the AMT for certain small firms ran into some unexpected problems in its first year or two. According to the report, more than 2,300 small corporations paid the AMT in 1998 when an examination of their federal income tax returns indicated they qualified for the exemption; their overpayments of the tax may have totaled more than \$25 million.<sup>17</sup> The report attributed the erroneous payments to the many complex changes made by the Taxpayer Relief Act of 1997 and the "short time"

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<sup>16</sup> Andrew B. Lyon, *Cracking the Code: Making Sense of the Corporate Alternative Minimum Tax* (Washington: Brookings Institution Press, 1997), pp. 77-97.

<sup>17</sup> Treasury Department, Inspector General for Tax Administration, *More Small Corporate Taxpayers Can Benefit from the Alternative Minimum Tax Exemption Provision*, no. 2001-30-019 (Washington: Nov. 2000), p. 4.

available to taxpayers and tax professionals to understand the changes and take them into consideration in filing 1998 tax returns. It recommended that the IRS take a variety of steps to increase taxpayer awareness of the exemption, explain how it is intended to work, and identify and contact taxpayers who erroneously paid the AMT. In a recent follow-up report, TIGTA found that the IRS had taken many of these steps, but that it had failed to notify more than 3,600 taxpayers who may have mistakenly paid the AMT and fallen short of its commitment to “inform and educate tax practitioners on what they need to do on their clients’ behalf.”<sup>18</sup>

It is not known whether there is a revenue gain or loss from exempting small corporations from the AMT. Exempt firms do not compute their AMT liability, but they could end up paying the regular corporate income tax.

## **Amortization of Business Start-Up Costs**

One of the basic principles underlying the federal income tax is that taxable income should exclude all costs incurred in earning it. This implies that all ordinary and necessary costs incurred in conducting a trade or business should be deducted from a firm’s current taxable income. The principle also suggests that ordinary and necessary costs paid or incurred before the start of a trade or business should not be deducted from current income. Rather, because the expenses paid or incurred in connection with starting up or organizing a business represent a serious attempt to create an asset with a useful life extending beyond one tax year, they probably should be capitalized and added to the taxpayer’s basis in the business and recovered when the business is sold or ceases to exist.

Under IRC section 195, however, business taxpayers who incurred or paid business start-up and organizational costs and then entered the trade or business no later than October 22, 2004 may amortize (or deduct in equal annual amounts) those expenditures over a period of not less than 60 months beginning in the month when the new trade or business commenced. As a result of the American Jobs Creation Act of 2004 (P.L. 108-357), business taxpayers who incur or pay business start-up and organizational costs after October 22, 2004 may deduct up to \$5,000 of those expenditures in the year when the new trade or business begins. The maximum deduction of \$5,000 must be reduced (but not below zero) by the amount by which the eligible expenditures exceed \$50,000. Any expenditures that cannot be deducted may be amortized over a period of 180 months beginning with the month when the new trade or business commences. In order to claim either allowance, a taxpayer must have an equity interest in the new trade or business and actively participate in its management.

To qualify for amortization or the deduction, the start-up and organizational costs must meet two criteria. First, they must be paid or incurred as part of an investigation into creating or acquiring an active trade or business or starting a new trade or business, or as part of any activity done to produce income or profit before

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<sup>18</sup>Treasury Department, Inspector General for Tax Administration, *Significant Actions were Taken to Address Small Corporations Erroneously Paying the Alternative Minimum Tax, but Additional Actions Are Still Needed*, no. 2003-30-114 (Washington: May 2003), pp. 4-5.

starting a trade or business with the intention of making such activity into an active trade or business. Second, the costs must be costs that would be deductible if they were paid or incurred in connection with the expansion of an existing active trade or business in the same industry entered by the taxpayer.

The option to deduct business start-up and organizational costs clearly benefits fledgling firms with relatively small such costs. It permits them to deduct expenses that otherwise would not be recovered until the taxpayer sold his or her interest in the business. In effect, the option accelerates the recovery of certain essential up-front costs for these firms, and this acceleration can foster their formation and growth by reducing their cost of capital and increasing their cash flow at a time when their access to capital may be severely restricted.

According to an estimate by the Joint Tax Committee, the amortization or deduction of qualified business start-up and organizational costs may produce a revenue loss of \$0.6 billion in FY2005.<sup>19</sup>

## Cash Basis Accounting

Under IRC section 446, firms must compute their taxable income under the method of accounting they regularly use in keeping their books. Two methods of financial accounting are widely used in the private sector: cash-basis and accrual-basis. Under cash-basis accounting, which is the preferred method for self-employed individuals, income generally is recorded when it is received in the form of cash or its equivalent, and expenses generally are recorded when they are paid, regardless of when the income is actually earned and the expenses actually incurred. Under accrual-basis accounting, by contrast, income and expenses generally are recorded when the transactions giving rise to them are completed or nearly completed, regardless of when cash or its equivalent is received or paid. More specifically, a firm using accrual-basis accounting records income when its right to receive it is established, and expenses when the amounts are fixed and its liability for the expenses is established. Each accounting method has its advantages: in general, cash-basis accounting is much simpler to administer, but accrual-basis accounting often yields a more accurate measure of a firm's economic income because it matches income with expenses with greater precision and rigor. An important requirement in selecting an accounting method for tax purposes is that it clearly reflect a business taxpayer's income.

Under current federal tax law, firms that are required to maintain inventories must use the accrual method in computing taxable income. In addition, the following entities generally must use the accrual method of accounting for tax purposes: C corporations, partnerships with C corporations as partners, trusts that earn unrelated business income, and authorized tax shelters.

Nonetheless, the cash method may be used by these entities provided they are not considered a tax shelter and meet at least one of the following three criteria: (1)

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<sup>19</sup> Joint Tax Committee, *Estimates of Federal Tax Expenditures for Fiscal Years 2005-2009*, p. 33.

is engaged in farm or tree raising, (2) is a qualified personal service corporation, or (3) is a firm (including C corporations) with \$5 million or less in average annual gross receipts during the previous three tax years. Moreover, under recent rulings by the IRS, the cash method of accounting may be used by most sole proprietorships, S corporations, and partnerships with average annual gross receipts of \$1 million or less in the three previous tax years (IRS Rev. Proc. 2001-10), and by firms with average annual gross receipts of \$10 million or less whose main business activity is providing services or fabricating products according to customer designs or specifications (IRS Rev. Proc. 2002-28).

As these rules suggest, many of the firms permitted to use the cash method for tax purposes are likely to be small in receipt, asset, or employment size. Cash-basis accounting can confer the same tax benefit on small firms as the expensing allowance under IRC section 179: the deferral of income tax payments. In principle, a firm earns income when the legal right to be paid comes into existence. Under the cash method of accounting, however, a firm may delay the recognition of income until cash payments are received, thereby postponing the payment of tax on that income.

Although many small firms may be eligible to use cash-basis accounting for tax purposes, it may not always be practical or advisable for these firms to use it. The reason lies in the requirements of the income statements and balance sheets used in external financial reports.<sup>20</sup> Cash-basis accounting can distort a firm's financial position in at least two ways. First, it records only transactions involving cash or its equivalent, thereby leaving out transactions involving exchanges of assets or liabilities. Second, the determination of net income under cash-basis accounting can be manipulated by recording revenues or expenses long before or after goods and services are produced or sold. Thus, small firms with a need to release reliable and accurate external financial reports may be better off eschewing cash-basis accounting.

The Joint Committee on Taxation estimates that the use of cash accounting outside agriculture may cause a revenue loss of \$0.7 billion in FY2005.<sup>21</sup>

## **Tax Incentives for Private Equity Investment in Small firms**

The federal tax code also contains several provisions intended to encourage the flow of private equity capital into certain start-up small firms that might otherwise experience considerable difficulty raising funds to finance current operations and new investment. These provisions, which are described below, do so largely by increasing potential after-tax returns or reducing potential after-tax losses on equity investment in such firms. The same tax benefits are not available to investors who acquire equity holdings in larger established firms.

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<sup>20</sup> See Robert Libby, Patricia A. Libby, and Daniel G. Short, *Financial Accounting* (Chicago: Irwin, 1996), p. 111.

<sup>21</sup> Joint Tax Committee, *Estimates of Federal Tax Expenditures for Fiscal Years 2005-2009*, p. 34.

### **Partial Exclusion of Capital Gains on Certain Small Business Stock.**

Two important considerations in determining an individual's income tax liability are the recognition of income as ordinary or capital and the distinction between long-term and short-term capital gains or losses. A capital gain or loss arises when an asset such as a stock or bond is sold or exchanged. If the selling price is greater than the acquisition or purchase price, then the transaction produces a capital gain. Conversely, a capital loss results when the selling price is less than the purchase price. Capital assets held longer than 12 months and then sold or exchanged give rise to long-term capital gains or losses, whereas sales or exchanges of capital assets held one year or less produce short-term capital gains or losses. Short-term capital gains are considered ordinary income and thus are taxed at regular income tax rates. By contrast, long-term capital gains are considered capital income and taxed at rates of 15% for individual taxpayers in income tax brackets above 15% and 5% for individual taxpayers in the 10% and 15% income tax brackets.<sup>22</sup>

Under IRC section 1202, non-corporate taxpayers (including partnerships, LLCs, and S corporations) may exclude 50% of any gain from the sale or exchange of qualified small business stock (QSBS) that has been held for more than five years. The exclusion rises to 60% if the QSBS has been issued by a corporation based in an empowerment zone. There is a cumulative limit on the gain from stock issued by a single qualified corporation that may be excluded: in a given tax year, the gain is limited to the greater of 10 times the taxpayer's adjusted basis of all QSBS issued by the firm and disposed of during the year, or \$10 million — reduced by any gains excluded by the taxpayer in previous years. The remaining gain is taxed at a fixed rate of 28%. As a result, the marginal effective tax rate on capital gains from the sale or exchange of QSBS held for over five years is 14%. For individuals subject to the AMT, a portion of the excluded gain is treated as an individual AMT preference item, which means that it must be included in the calculation of AMT taxable income. The portion is 42% for QSBS acquired on or before December 31, 2000 and disposed of by May 6, 2003, 28% for QSBS acquired after December 31, 2000 and no later than May 6, 2003, and 7% for QSBS acquired after May 6, 2003 and by December 31, 2008.<sup>23</sup>

To qualify for the partial exclusion, small business stock must satisfy certain requirements. First, it must be issued after August 10, 1993 and must be acquired by the taxpayer at its original issue, either directly or through an underwriter, in exchange for money, property, or as compensation for services rendered to the issuer. Second, the stock must be issued by a domestic C corporation whose gross assets do not exceed \$50 million before and immediately after the stock is issued. Third, at

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<sup>22</sup> Under the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA, P.L. 108-27), the 15% rate applies to assets sold or exchanged after May 6, 2003 and before January 1, 2009; and the 5% rate to assets sold or exchanged after May 6, 2003 and before January 1, 2008. In 2008, long-term capital gains received by taxpayers in the 10% and 15% income tax brackets are exempt from taxation, making the rate 0%. Assuming no change in current tax law, beginning in 2009 and thereafter, the maximum long-term capital gains tax rates will rise to 20% for taxpayers in income tax brackets above 15% and 10% for taxpayers subject to marginal rates of 10% and 15%.

<sup>23</sup> The 7% rate stems from a provision in JGTRRA.

least 80% of the corporation's assets must be tied to the active conduct of one or more qualified trades or businesses during "substantially all" of the five-year holding period. Assets linked to working capital, start-up activities, or research and development meet the active business test even though they are devoted largely to the development of future assets or lines of business. Specialized small business investment companies licensed under the Small Business Investment Act of 1958 also are deemed to meet the active business test, making their stock eligible for the partial exclusion.

Some small firms cannot benefit from the partial exclusion. Specifically, stock issued by small C corporations primarily engaged in one of the following commercial activities does not qualify for the partial gains exclusion: health care, law, engineering, architecture, hospitality, farming, insurance, finance, and mineral extraction. And stock issued by the following domestic C corporations is not eligible for the partial exclusion: current or former domestic international sales corporations (DISCs), regulated investment companies (RICs), real estate investment trusts (REITs), real estate mortgage investment conduits (REMICs), financial asset securitization investment trusts (FASITs), cooperatives, or C corporations that have claimed the possessions tax credit under IRC section 936.

The partial exclusion for QSBS is intended to make it easier for small start-up firms in a variety of industries to raise equity capital despite considerable uncertainty or skepticism among investors about their growth potential and future prospects for commercial success. It does this by increasing the potential after-tax returns an investor can earn on sales or exchanges of QSBS relative to potential after-tax returns on other investment opportunities over a five-year period. Because of JGTRRA, however, the investment incentive provided by the partial exclusion is much weaker than it once was. Before the act, the maximum tax rates on long-term capital gains were 20% on assets held for at least one year and 18% for assets acquired after December 31, 2000 and held for more than five years, while the effective tax rate on capital gains realized on sales or exchanges of QSBS was 14%. JGTRRA unified and lowered the maximum tax rate on long-term capital gains to 15% but made no compensatory change in the taxation of capital gains on QSBS.

An estimated \$210 million in revenue may not be collected in FY2005 because of the exclusion.<sup>24</sup>

**Losses on Small Business Investment Company Stock Treated as Ordinary Losses without Limitation.** Generally, losses on stock investments are treated as capital losses. These losses may be used to offset any capital gains in the same tax year, but individuals may use capital losses to offset no more than \$3,000 of ordinary income in a single tax year.

Under IRC section 1242, however, individuals who invest in small business investment companies (SBICs) are permitted to deduct from ordinary income in a single tax year all losses from the sale or exchange or worthlessness of stock in these

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<sup>24</sup> U.S. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2006: Analytical Perspectives* (Washington: GPO, 2005), table 19-1, p. 317.



companies. This provision encourages private investment in these companies by lowering the potential after-tax loss on an investment in a SBIC relative to potential after-tax losses on alternative investments. SBICs are private regulated investment corporations licensed under the Small Business Investment Act of 1958 to provide equity capital, long-term loans, and managerial guidance to firms with less than \$18 million in assets and less than \$6 million in net income in the previous two years. They use their own capital and funds borrowed with a SBA guarantee to make equity and debt investments in qualified firms. For tax purposes, most SBICs are treated as C corporations. In FY2002, SBICs provided \$2.5 billion in financing for 2,610 firms.<sup>25</sup>

**Rollover of Gains into Specialized Small Business Investment Companies.** In general, gains or losses on the sale or exchange of stocks are recognized for tax purposes in the year when they are realized.

But under IRC section 1044, which was adopted as part of the Omnibus Budget Reconciliation Act of 1993, individual and corporate taxpayers who satisfy certain conditions are allowed to roll over without the payment of tax any capital gains on the sale of publicly traded securities. The proceeds from the sale must be used to purchase common stock or partnership interests in specialized small business investment companies (SSBICs) licensed under the Small Business Investment Act of 1958 within 60 days of the sale. SSBICs are similar to SBICs except that SSBICs are required to invest in small firms owned by individuals who are considered socially or economically disadvantaged — mainly members of minority groups. If the proceeds from the sale exceed the cost of the SSBIC stock or partnership interest, the excess is recognized as a capital gain and taxed accordingly. The taxpayer's basis in the SSBIC stock or partnership interest is reduced by the amount of any gain from the sale of securities that is rolled over. The maximum gain that an individual can roll over in a single tax year is the lesser of \$50,000 or \$500,000 less any gains previously rolled over under this provision. For corporations, the maximum deferral in a tax year is \$250,000 or \$1 million less any previously deferred gains.

**Ordinary Income Treatment of Losses on Sales of Small Business Stock.** IRC section 1244 permits individuals to deduct any loss from the sale or exchange or worthlessness of small business stock as an ordinary rather than a capital loss. Stock that is eligible for this treatment must satisfy four conditions. First, it must be issued by a domestic corporation after November 6, 1978. Second, the stock must have been issued to an individual investor or his or her partnership in exchange for money or other property but not stock or securities. Third, the stock must be issued by a small business corporation, which is defined as one whose total amount of money and property received by the firm as a contribution to capital and paid-in surplus does not exceed \$1 million when it issues the stock. Finally, during the five tax years preceding the year in which the loss on the stock is realized, the firm must have derived more than 50% of its gross receipts from sources other than royalties, rents, dividends, interest, annuities, and stock or security transactions. The maximum

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<sup>25</sup> See the website for the U.S. Small Business Administration's SBIC program: [<http://www.sba.gov/INV/>].

amount that may be deducted as an ordinary loss in a tax year is \$50,000 (\$100,000 for a couple filing jointly).

This special treatment could produce an estimated revenue loss of \$50 million in FY2005.<sup>26</sup>

## **Uniform Capitalization of Inventory Costs**

Firms deriving income from the production, purchase, or sale of merchandise must maintain inventories in order to determine the cost of goods sold during a tax year. This cost is then subtracted from gross receipts in the computation of their taxable income. The cost of goods sold generally is calculated by adding the value of a firm's inventory at the beginning of the year to purchases of inventory items made during the year and subtracting from that sum the value of the firm's inventory at the end of the year.

IRC section 263A requires business taxpayers engaged in the production of real or tangible property or in the purchase of real or tangible and intangible property for resale to "capitalize" or include in the estimated value of their inventories both the direct costs of the property included in inventory and the indirect costs that can be allocated to it. This requirement, known as the uniform capitalization rule, was added to the tax code by the Tax Reform Act of 1986. In general, direct costs are the material and labor costs associated with the production or acquisition of goods, and indirect costs are all other costs associated with the production or acquisition of goods (e.g., repair and maintenance of equipment and facilities, utilities, insurance, rental of equipment, land, or facilities, and certain administrative costs). Taxpayers have some discretion in allocating indirect costs to production or resale activities, provided the methods used in the allocation produce reasonable and defensible results for their trade or business.

Some small firms are exempt from the uniform capitalization rule. Specifically, it does not apply to tangible or intangible property acquired for resale by a taxpayer with average annual gross receipts of \$10 million or less in the previous three tax years. This exemption is advantageous in that eligible firms face lower administrative costs and less complexity in complying with income tax laws and have more control over the timing of business expense deductions, creating opportunities for the deferral of income tax liabilities.<sup>27</sup>

## **Simplified Dollar-Value LIFO Accounting Method for Small Firms**

Business taxpayers that maintain inventories in order to determine the cost of goods sold in a tax year must measure the value of their inventories at the beginning

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<sup>26</sup> Office of Management and Budget, *Budget of the U.S. Government in Fiscal Year 2006: Analytical Perspectives*, table 19-1, p. 318.

<sup>27</sup> See Paul G. Schloemer, "Simplifying the Uniform Inventory Capitalization Rules," *Tax Notes*, vol. 53, no. 9, Dec. 2, 1991, pp. 1065-1069.

and end of each tax year. Because it is time-consuming and costly to do this item by item, many taxpayers use methods that assume certain item or cost flows.

One such method is known as “last-in-first-out”(or LIFO). LIFO assumes that the most recently acquired goods are sold first. Consequently, LIFO allocates the newest unit costs to the cost of goods sold and the oldest unit costs to the ending inventory. The method can be advantageous to use when the unit costs of many inventory items are rising because LIFO yields a lower taxable income and lower inventory valuation than other methods. There are various ways to apply LIFO. A widely used application is known as the dollar-value method. Under this method, a taxpayer accounts for its inventories on the basis of a pool of dollars rather than item by item. Each pool of dollars includes the value of a number of different inventory items and is measured in terms of the equivalent dollar value of the inventory items at the time they were first added to the inventory account, or the base year. Using the dollar-value method is complicated and costly for most taxpayers.<sup>28</sup>

But under IRC section 474, which was established by the Tax Reform Act of 1986, some small firms may use a simplified dollar-value LIFO method. It differs from the regular dollar-value method in the manner in which inventory items are pooled and the technique for estimating the base-year value of the pools. A firm is eligible to use the simplified method if its average annual gross receipts were \$5 million or less in the three previous tax years.

## **Tax Credit for Pension Plan Start-Up Costs of Small Firms**

Under IRC section 45E, certain small firms may claim a non-refundable tax credit for a portion of the start-up costs involved in setting up new retirement plans for employees. The credit, which was enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001, began in 2002 and is scheduled to disappear (or “sunset”) after 2010. It is part of the general business credit and thus subject to its limitations and rules for carryover.

The credit is equal to 50% of the first \$1,000 in eligible costs incurred in each of the first three years of a qualified pension plan’s existence. Eligible costs are defined as ordinary and necessary expenses incurred in connection with the administration of the plan and the education of employees about the plan’s benefits and requirements. Qualified plans include new defined benefit plans, defined contribution plans, savings incentive match plans for employees, and simplified employee pension plans. Firms with fewer than 100 employees who received at least \$5,000 in compensation in the previous year are eligible to claim the credit. They can do so only if at least one highly compensated employee participates in the plan.

The credit is intended to give owners of small firms that never have offered retirement benefits a robust incentive to establish pension plans for employees by reducing the after-tax cost of setting up and administering these plans in their early

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<sup>28</sup> For more details on this method, see U.S. Congress, Joint Committee on Taxation, *Impact on Small Business of Replacing the Federal Income Tax*, JCS-3-96 (Washington, April 23, 1996), pp. 18-19.

years. Recent surveys have suggested that these costs often constitute a formidable barrier to the creation of pension plans among small employers. An estimated \$100 million in revenues may not be collected in FY2005 because of the credit.<sup>29</sup>

## Magnitude of Small Business Tax Benefits

By now it should be clear that the federal tax code encourages the formation of small firms and fosters their growth in a variety of ways. What is not clear is the extent to which the tax code generally favors smaller firms over larger ones. Addressing this question raises difficult analytical issues that extend beyond the scope of this report. Nonetheless, it is possible to illustrate the potential magnitude of specific small business tax preferences.

Consider the expensing allowance under IRC section 179. In the minds of many, the allowance is the quintessential small business tax subsidy, even though its revenue cost can be much lower than that of some other small business tax preferences and many firms outside manufacturing derive little or no benefit from it. In a 1995 study, Douglas Holtz-Eakin, presently the director of the Congressional Budget Office, analyzed the effect of the expensing allowance on a firm's user cost of capital. As was discussed earlier, expensing stimulates business investment by reducing the contribution of income taxes to the user cost of capital. **Table 1** summarizes his findings.<sup>30</sup> The first column gives the assumed corporate tax rate; the second shows the required pre-tax rate of return if the entire cost of the investment were expensed; the third provides the required pre-tax rate of return if the entire cost were recovered through the depreciation allowances allowed under federal tax law in the early 1990s; and the final column displays the effective tax subsidy from expensing, which is expressed as the difference (in percentage points) between the required rates of return shown in columns three and two.

At least two inferences can be drawn from the results. First, expensing produced a significant investment subsidy, and the extent of the subsidy rose with a firm's marginal tax rate. For example, at a tax rate of 15%, expensing lowered the user cost of capital by about 11%; but at a rate of 35%, expensing lowered the user cost of capital by 28%. Second, the user cost of capital under expensing fell as the tax rate increased because tax deductions became increasingly valuable at higher tax rates.

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<sup>29</sup> Office of Management and Budget, *Budget of the U.S. Government in Fiscal Year 2006: Analytical Perspectives*, table 19-1, p. 319.

<sup>30</sup> Douglas Holtz-Eakin, "Should Small Businesses Be Tax-Favored?," *Tax Notes*, vol. 48, No. 3, Sept. 1995, p. 389. (In 2003, Dr. Holtz-Eakin was named the Director of the Congressional Budget Office.)

**Table 1. Estimated User Cost of Capital Under-Expensing**  
(%)

Corporate Tax Rate	Expensing	Regular Depreciation	Size of Subsidy
15	17.95	20.23	2.28
25	17.05	21.13	4.08
35	16.15	22.40	6.25

**Source:** Douglas Holtz-Eakin, "Should Small Business Be Tax-Favored?," *National Tax Journal*, Sept. 1995.

**Note:** The calculations assume an interest rate of 9%, an inflation rate of 3%, and a rate of economic depreciation of 13.3%. The following formula is used to compute the user cost of capital:

$$c/q = (p - \pi + d/1 - t) \times (1 - tz),$$

where  $c$  is the annual value of revenue from the investment,  $q$  is the purchase price of the capital good,  $p$  is the after-tax financial cost of capital,  $\pi$  is the rate of inflation,  $d$  is the rate of geometric depreciation,  $t$  is the marginal tax rate, and  $z$  is the present value of depreciation allowances per dollar of investment. In the case of expensing,  $z = 1.0$ ; and in the case of regular depreciation,  $z = 0.2814$ .

## Economic Role of Small Firms

Available data indicate that small firms make significant contributions to the performance of the U.S. economy.<sup>31</sup> The vast majority of employers are small firms, which are defined as independent business enterprises with fewer than 500 employees. They account for more than 50% of employment and over 44% of the payroll in the domestic private sector. In addition, throughout the 1990s, small firms were responsible for 60% to 80% of annual net new job creation and generated over 50% of non-farm private gross domestic product. Most firms start out small in employment size, but their chances of eventually growing into large, competitive, established firms are less than overwhelming. About one in every two new firms survives at least four years.<sup>32</sup> Each year, hundreds of thousands of new firms come into existence, and hundreds of thousands existing firms cease to exist. This constant churning is reflected in the shifting contributions of small firms to annual net job creation.

Small firms also appear to play important roles in industries where technological innovation is a main driving force for growth and structural change. They employ

<sup>31</sup> The primary source for source data is the Small Business Administration (SBA). A useful publication is *Small Business by the Numbers*, which is issued by the SBA's Office of Advocacy. It was last updated in December 2004 and is available from the SBA website at [<http://www.sba.gov/advo/stats/sbfaq.html>].

<sup>32</sup> Small Business Administration, *Small Business by the Numbers*.

nearly four out of every 10 scientists, engineers, and computer specialists working in the private sector, and small firms that file applications for patents produce 13 times as many patents per employee as large firms that do likewise.

## **Economic Arguments For and Against Small Business Tax Preferences**

Existing small business tax subsidies and proposals to expand them raise some intriguing and important policy issues. For some, a key issue is whether or not such subsidies can be justified on economic grounds. More specifically, can a sound argument based mainly on the principles of economic equity or efficiency be made in favor of small business tax subsidies? The answer has implications for social welfare, since more than \$8 billion in tax benefits are likely to be distributed to small firms in FY2005, in addition to a variety of federal programs designed to lend financial support to small business. If a careful examination of the economic rationale for these tax subsidies were to suggest that it is weak or untenable, then one might be justified in arguing that plowing these resources into other applications (e.g., reducing the federal budget deficit or raising federal spending on public education or basic research) may yield superior economic outcomes. At the same time, it should be recognized that persuasive non-economic arguments can be made in favor of small business tax subsidies, and that these arguments can outweigh purely economic considerations in the minds of some lawmakers considering proposals to create new such subsidies.

Nevertheless, the central focus of this section is the economic arguments for and against such proposals and their merits. These arguments are explored below.

### **Chief Economic Arguments in Favor of the Preferences**

In general, proponents of small business tax subsidies cite four economic justifications for them: (1) the special economic role played by small firms; (2) the formidable barriers to their formation and growth in financial markets; (3) the impact of marginal tax rates on the formation of small firms, and (4) the valuable opportunities for individual economic advancement offered by small business ownership. Each is examined in some detail here.

**Special Economic Role of Small Firms.** The direct economic contributions of small firms are often cited as reasons to increase federal support for small business. For example, in the 107<sup>th</sup> Congress, Senator Christopher Bond noted on the floor of the Senate that “small businesses represent more than 99% of all employers, employ 53% of the private work force, create about 75% of the new jobs in this country, ... contribute 47% of all sales in this country, and ... are responsible for 51% of private gross domestic product.”<sup>33</sup> Similarly, Senator Olympia Snowe stated on the floor of the Senate early in the first session of the 108<sup>th</sup> Congress that

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<sup>33</sup> Sen. Christopher Bond, remarks in the Senate, *Congressional Record*, daily edition, vol. 147, Jan. 25, 2001, p. S576.

“they (small businesses) represent 99% of all employers, employ 51% of the private-sector workforce, provide about 75% of the net new jobs, contribute 51% of the private-sector output, and represent 96% of all exporters of goods.”<sup>34</sup> A key message in both statements is that small firms generate the vast share of new domestic private-sector jobs.

But proponents of small business tax subsidies also point to the increases in economic efficiency produced by small firms and the dynamic structural changes and important technological innovations they introduce as justifications for the subsidies.

In defending small business tax subsidies, some point to evidence that small firms can supply certain goods and services more efficiently than large firms. As economist Bo Carlsson has noted, this advantage can be found in industries characterized by large production runs and falling unit costs such as computers, automobiles, and steel.<sup>35</sup> In such industries, small and large firms specialize in different products or services and often end up interacting more as close collaborators than as fierce competitors. In Carlsson’s view, the rise in outsourcing among large U.S. firms in the 1990s served to further solidify this division in labor between large and small firms. Among the reputed advantages of small firms in the vast chain of supply undergirding the U.S. economy is greater flexibility in responding to new market opportunities and competitive threats.

The belief that small firms can serve as powerful agents of dynamic economic change and growth is rooted in the critical roles played by small start-up firms in the growth of certain high-technology industries as far back as the 1950s. Two notable findings in the recent literature on firm size and technological innovation is that the contribution of small firms to innovation seems to vary by industry, and that their contributions are likely to be most significant in relatively young industries with relatively low levels of concentration.<sup>36</sup> The same literature offers fresh evidence that in certain industries small start-up firms are more adept than large established firms at identifying promising commercial applications for new technologies and exploiting these opportunities. During the 1980s and 1990s, several dramatic illustrations of this adept flexibility emerged in biotechnology, microelectronics, computer software, and electronic commerce.<sup>37</sup>

Experiences such as these have led some economists to conclude that small entrepreneurial firms serve as a vital and indispensable source of economic growth and renewal. They contend that economic growth is marked by the continuous creation and destruction of jobs and firms, and that small entrepreneurial firms inject

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<sup>34</sup> Sen. Olympia Snowe, remarks in the Senate, *Congressional Record*, daily edition, vol. 149, no. 6, Jan. 14, 2003, p. S299.

<sup>35</sup> Bo Carlsson, “Small Business, Entrepreneurship, and Industrial Dynamics,” in *Are Small Firms Important? Their Role and Impact*, Zoltan J. Acs, ed. (Boston: Kluwer Academic Publishers, 1999), p. 100.

<sup>36</sup> Joshua Lerner, “Small Business, Innovation, and Public Policy,” in *Are Small Firms Important? Their Role and Impact*, p. 160.

<sup>37</sup> *Ibid.*, p. 160.

needed innovation and competition into this process. Carlsson has claimed that without the “heterogeneity and volatility” provided by small start-up firms, “the economy eventually stagnates or even collapses.”<sup>38</sup>

**Opportunities for the Social and Economic Advancement of Immigrants, Women, and Members of Minority Groups.** Proponents of small business tax subsidies also cite the many benefits of small business ownership for women, minority groups, immigrants, and the communities where they reside as an important justification for the subsidies. They argue that owning and managing a small business gives them access to the social and economic mainstream in the United States. In addition, they claim that women-, minority-, and immigrant-owned small firms benefit their immediate communities and society at large in ways that go beyond direct economic effects. There is evidence that female small business owners in general encourage greater openness in workplace communication and decision-making and are more likely to hire a diverse workforce, put into place desirable child-care programs, and pay full benefits to employees than male small business owners, and that families with self-employed women who work out of their homes are more stable than the average family.<sup>39</sup> And in the case of minority and immigrant groups, small business ownership helps to build tight-knit social networks, providing job and skills training, and creating informal capital markets.<sup>40</sup>

**Imperfections in Capital Markets.** Yet another economic argument made in favor of small business tax subsidies is that they can ease or offset the barriers faced by many small business owners and aspiring entrepreneurs in raising funds to start or expand a business. If capital markets were truly efficient, then every small business investment opportunity offering a rate of return above the cost of capital would obtain funding, regardless of the creditworthiness of the owners. But proponents of government support for small business say that such is not the case. They argue that largely because of inadequate information on the part of investors, many potential and current entrepreneurs are unable to borrow or attract equity capital, forcing them to finance projects out of their own resources and those of friends and family members or to abandon them altogether. Small business owners facing severe liquidity constraints have an elevated risk of failure.

**Impact of Progressive Income Taxes.** Supporters of targeted tax relief for small firms also maintain that taxes have a significant effect on three key decisions made by small business owners: how fast to grow the firm; whether to expand capital investment, and if so, by how much; and whether to hire more employees, and if so, how many? They cite studies suggesting that as individual or corporate tax rates rise, small firms grow at a slower rate, invest less in new tangible and intangible

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<sup>38</sup> Bo Carlsson, “Small Business, Entrepreneurship, and Industrial Dynamics,” p. 109.

<sup>39</sup> See Candida Brush and Robert D. Hisrich, “Women-Owned Businesses: Why Do They Matter?,” in *Are Small Firms Important? Their Role and Impact*, pp. 111-127.

<sup>40</sup> See John Sibley Butler and Patricia Gene Greene, “Don’t Call Me Small: The Contribution of Ethnic Enterprises to the Economic and Social Well-Being of America,” in *Are Small Firms Important? Their Role and Impact* (Boston: Kluwer Academic Publishers, 1999), pp. 129-145.



assets, and become increasingly less likely to expand employment.<sup>41</sup> In their view, these effects, when paired with the economic contributions of small firms (especially those that can rightly be called entrepreneurial), constitute a persuasive argument in favor of offering tax breaks to these firms.

## Chief Economic Arguments Against the Subsidies

While acknowledging the significant economic role played by small firms, some maintain that this role should not be viewed as a cogent argument for targeting tax subsidies at small firms. Among public finance economists, a standard and irrefutable rationale for government intervention in the economy is the presence of some kind of market failure. In general, market failures can be thought of as conditions that prevent or retard the emergence of economically efficient outcomes. Foremost among these conditions are a lack of perfect competition, the presence of public goods, positive or negative external effects (or externalities), the existence of incomplete markets, and imperfect information on the part of consumers.<sup>42</sup> Critics of small business tax subsidies say there is no evidence that any market failure hinders the formation or growth of small firms. Moreover, in their view, such subsidies are likely to produce undesirable equity and efficiency effects.

**Equity Concerns.** Critics charge that the main equity effect of small business tax preferences is to undercut the progressivity of the federal individual income tax. Under a progressive income tax, a taxpayer's tax liability depends on his or her taxable income, and taxpayers with higher taxable incomes pay higher taxes than taxpayers with lower taxable incomes. But small business tax preferences weaken the link between tax burden and income by reducing the tax burden on small business owners. It is thought that individuals, and not firms, ultimately bear the burden of business income taxes. While all owners of capital stand to benefit ultimately from small business tax preferences, a large portion of those benefits probably end up in the hands of small business owners, whose income and wealth tend to be well above average for U.S. households.<sup>43</sup>

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<sup>41</sup> Douglas Holtz-Eakin and Harvey Rosen, *Economic Policy and the Start-up, Survival, and Growth of Entrepreneurial Ventures*, report submitted to the Small Business Administration, May 2001, pp. 43-44.

<sup>42</sup> For more information on market failures, see Joseph E. Stiglitz, *Economics of the Public Sector*, 3<sup>rd</sup> Edition (New York: W.W. Norton & Co., 2000), pp. 76-90.

<sup>43</sup> According to a 1990 study by Charles Brown, James Hamilton, and James Medoff, the average family owning a small business had an income that was 80% greater and wealth that was five times greater than the average family. (See Charles Brown, James Hamilton, and James Medoff, *Employers Large and Small* (Cambridge, MA: Harvard University Press, 1990), pp. 15-17.) More recently, in a study of the wealth and income of U.S. small business owners, George W. Haynes found that, in 1998, the mean income of households with small business owners was \$101,563, compared to \$43,999 for households with no business owners, and the mean wealth of households with small business owners was \$832,514, compared to \$171,904 for households with no business owners. (See George W. Haynes, *Wealth and Income: How Did Small Businesses Fare from 1989 to 1998?*, Small Business Administration (Washington: May 16, 2001), pp. 24 and 27.

**Efficiency Concerns.** Critics also criticize small business tax subsidies on efficiency grounds. In theory, income taxes reduce social welfare by distorting the behavior of consumers and firms. As a result, those taxes are likely to cause the least harm when the tax code does not prevent economic resources from migrating to their most productive uses. This doctrine of neutrality has certain important implications for tax policy. First, it implies that the returns to all investments should be taxed at uniform rates. Second, the doctrine implies that any tax on a factor of production or output that is not uniform across firms may cause social welfare to be less than optimal.<sup>44</sup> Finally, it implies that taxes should not distort a firm's choice of inputs or its investment or production decisions.

Critics of small business tax preferences contend that they violate each of these policy prescriptions. In their view, an efficient or desirable allocation of resources can be achieved only if the tax code does not favor small firms over large firms, or unincorporated firms over incorporated firms, or interfere with the natural growth and evolution of firms, or encourage firms to attain a particular asset, employment, or revenue size.<sup>45</sup>

Critics also deny that there is something uniquely desirable about the economic role of small firms that would warrant the use of tax subsidies (or other government support, for that matter) targeted at small firms. Backers of such preferences have argued that small firms consistently create more jobs and spawn more important technological innovations than large firms, and that these capabilities are as good a reason as any to extend tax preferences to small firms. But critics of the preferences challenge the belief that the direct economic contributions of small firms constitute a sound argument for government subsidies targeted at such firms.

Critics and proponents alike agree that small firms generally are a robust source of job creation. According to data from the Small Business Administration, small firms created between half and three-quarters of all new jobs from 1990 to 1997, depending on how the employment size of a small firm is specified.<sup>46</sup> But critics maintain that for a variety of reasons these data do not necessarily prove that small firms are endowed with a greater job-creating prowess than large firms. To begin with, they note that the data raise more questions than they answer. Among the key unanswered questions: What does it mean to be small? When should a firm's size be measured? Is gross or net job creation a better indicator of job-creating prowess? And how long should a job last before it is counted as a new job?

In addition, critics say there is an abundance of evidence that small firms are not demonstrably and consistently better at creating jobs than large firms. First, there appears to be considerable variation over time in the share of new jobs created by small firms. In a widely cited study, David Birch and James Medoff estimated that

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<sup>44</sup> Stiglitz, *Economics of the Public Sector*, pp. 567-569.

<sup>45</sup> Douglas Holtz-Eakin, "Should Small Businesses be Tax-Favored?," *National Tax Journal*, vol. 48, no. 3, Sept. 1995, p. 390.

<sup>46</sup> U.S. Small Business Administration, Office of Advocacy, *Small Business FAQ*, (Washington: Dec. 2000).

the share of total net new jobs generated by firms employing 100 or fewer workers varied from about 40% to 140%, depending on the stage of the business cycle.<sup>47</sup> Second, most jobs created by small firms are created by new firms, which typically start out small in employment or asset size; and many of these jobs do not last a long time because most new firms fail within their first few years.<sup>48</sup> Third, a few firms accounted for most small business job creation between the late 1980s and early 1990s — Birch and Medoff labeled these firms “gazelles” — and these firms went swiftly from small to large, and in some cases from large back to small, suggesting that their job-creating ability was unstable at best.<sup>49</sup> Finally, during the 1970s and 1980s, large firms and plants dominated job creation and destruction in the manufacturing sector, and there was no strong, systematic relationship between firm size and net job growth rates.<sup>50</sup>

Critics also contend that even if small firms were to create more jobs than large firms over time, there is no reason to think that government support for small business would lead to faster employment growth over time. Economic analysis indicates that the economy generates jobs through the natural processes of growth, decline, and structural change, regardless of the size distribution of firms. From this perspective, the level of national employment results from a mix of factors that would swamp the employment effects of any small business subsidies. The key factors are fiscal and monetary policy, overall consumption and investment, and the difference between U.S. exports and imports.

Research and development (R&D) is the lifeblood of technological innovation, which, in turn, serves as an engine of long-term economic growth. Economists generally agree that without government support, private investment in R&D would fall short of the socially optimal amount. Left to their own devices, firms are likely to invest too little in R&D for two reasons. One is that they cannot capture all the returns to R&D investment, mainly because other firms are able to exploit the results of research in spite of available intellectual property protection. A second reason is that some firms lack access to sufficient capital to invest in R&D because they are unwilling or unable to provide investors with the information they require to evaluate

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<sup>47</sup> See David Birch and James Medoff, “Gazelles,” in *Labor Markets, Employment Policy, and Job Creation*, Lewis C. Solomon and Alec R. Levenson, eds. (Boulder, CO: Westview Press, 1994), p. 162. The share of net new jobs created by firms with 100 or fewer workers can exceed 100% in a year if these firms create more jobs than they destroy, all other firms destroy more jobs than they create, and the net job gain arising from the former exceeds the net job loss arising from the latter. For example, if firms with 100 or fewer employees account for a net job gain of 100 and all other firms generate a net job loss of 25, then the economy as a whole would realize a net job gain of 75, and the share of that gain attributable to firms with 100 or fewer employees would be 133%.

<sup>48</sup> *Ibid.*, p. 8.

<sup>49</sup> Birch and Medoff, “Gazelles,” pp. 162-164.

<sup>50</sup> Steven J. Davis, John C. Haltiwanger, and Scott Schuh, *Job Creation and Destruction* (Cambridge, MA: MIT Press, 1996), pp. 169-170.

the potential returns on planned R&D investments.<sup>51</sup> This tendency to invest too little in R&D represents a market failure in that too few resources are allocated to R&D compared to its potential economic benefits. To remedy this failure, many economists recommend government support to encourage private-sector R&D investment.

But critics of small business tax subsidies maintain that it is far from clear that this support should be targeted at small firms. They point to a wealth of evidence suggesting that both small and large firms hatch the innovations that end up driving the processes of economic growth and structural change, and that it is impossible to disentangle the contributions of each group. According to data reported by the National Science Foundation (NSF), larger firms perform the vast share of business R&D: from 1992 to 1997, for example, companies with fewer than 500 employees accounted for 14% of total business R&D spending, whereas companies with 10,000 or more employees were responsible for 59% of this spending.<sup>52</sup> Nonetheless, small firms and large firms each appear to have distinctive advantages as agents of technological innovation.<sup>53</sup> In addition, numerous studies have been done of the effects of firm size and market structure on innovation.<sup>54</sup> On the whole, they suggest that no firm size has proven to be ideal for generating new and successful commercial technologies. Another finding was that in some industries, small firms were more innovative, but in other industries, large firms had the edge.

**Other Concerns.** Critics also raise questions about the suitability and effectiveness of some current or proposed small business tax subsidies.

One argument in favor of these subsidies is that the creation of new small firms is needed to prevent the development of monopoly power by large firms. But critics contend that it is far from clear that the best way to achieve such a policy goal is to offer government support for the formation and growth of small firms. They point out that only a tiny share of small start-up firms survive and grow to the point where they pose a serious competitive threat to large entrenched firms in the same market. In their view, antitrust law is likely to be a more effective tool than small business tax

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<sup>51</sup> Scott J. Wallsten, "Rethinking the Small Business Innovation Research Program," in *Investing in Innovation: Creating a Research and Innovation Policy That Works*, Lewis M. Branscomb and James H. Keller, eds. (Cambridge, MA: MIT Press, 1998), p. 197.

<sup>52</sup> National Science Board, *Science & Engineering Indicators — 2000*, Vol. 1 (Arlington, VA: 2000), appendix table 2-54, pp. A-97 and A-98.

<sup>53</sup> On the one hand, small firms may have a greater potential than large firms to create or dominate a new industry through R&D and may be more flexible than large firms in the pursuit of promising R&D projects. On the other hand, large firms can more easily cover the substantial sunken costs involved in conducting R&D and are more likely to capture a large share of the returns to R&D investments through marketing campaigns, the protection of intellectual property rights, and the creation of regional, national, and international distribution and service and repair networks. See Wallsten, "Rethinking the Small Business Innovation Research Program," p. 197.

<sup>54</sup> F. M. Scherer and David Ross, *Industrial Market Structure and Economic Performance*, 3<sup>rd</sup> edition (Boston: Houghton Mifflin Co., 1990), pp. 651-657.

subsidies for thwarting the rise of monopoly power and other anti-competitive business practices.

Critics also note that if the aim of public policy is to stimulate employment growth, then it makes little sense to offer small firms tax subsidies that lower the cost of capital, such as the current expensing allowance. Such subsidies have the effect of lowering the cost of capital relative to labor, thereby encouraging small firms to substitute machinery and equipment for labor. A possible result of a subsidy like the expensing allowance is lower levels of employment than would prevail in the absence of the allowance.

Furthermore, critics argue that small business tax preferences impose an implicit or a hidden tax on business growth. This tax has been described as the “notch problem,” and it is an unavoidable byproduct of the design of many tax preferences targeted at small firms. Under the typical small business tax subsidy, firms lose the tax benefit when their employment, assets, or receipts surpass a certain limit specified by law. Such a design can create a disincentive to grow beyond that limit. The expensing allowance under IRC section 179 illustrates this pitfall. As a firm raised its investment in assets that qualify for the allowance in 2003 beyond \$400,000, the amount that could be expensed was reduced dollar for dollar, ultimately to zero starting at \$500,000. In effect, this rule gave firms an incentive to invest no more than \$100,000 in qualified assets in a single tax year. For any investment, the cost of capital depends in part on the investor’s marginal tax rate. Jane Gravelle of CRS has estimated that the marginal effective tax rate on investment in equipment is 0% on the first \$100,000, 26% on amounts over \$100,000 to \$400,000, 43% on amounts over \$400,000 to \$500,000, and 26% on amounts above \$500,000.<sup>55</sup> Douglas Holtz-Eakin has pointed out that this phase-out rule effectively raises a firm’s cost of capital at a time when its growth is boosting its capital needs.<sup>56</sup>

## Conclusions

There is no question that small firms make important contributions to the performance and growth of the U.S. economy. Available evidence indicates that, depending on how small firms are defined, they account for a majority of private-sector jobs and private-sector output, generate numerous technological innovations, and serve as agents of revitalization and structural change in a variety of industries.

These contributions explain much of the widespread support inside and outside of Congress for government policies to assist small business. A concrete manifestation of this support is the preferential tax treatment received by many small firms. The combined revenue cost of current federal small business tax subsidies, excluding the tax treatment of passthrough entities, probably exceeds \$8 billion in

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<sup>55</sup> The estimate assumes a rate of inflation of 2% and a corporate tax rate of 35%. It is based on a simulation done by Gravelle with the aid of the CRS capital stock model on May 9, 2003.

<sup>56</sup> Holtz-Eakin, “Should Small Businesses Be Tax-Favored?,” p. 393.

FY2005. A variety of initiatives to expand these subsidies are attracting bipartisan support in the 109<sup>th</sup> Congress.

Mainstream economic analysis suggests that it is difficult to justify an expansion of small business tax subsidies on economic equity or efficiency grounds. Small business tax preferences reduce the tax burden on owners of small firms, diluting the progressivity of the federal individual income tax system in the process. In addition, under current market conditions, it appears that there would be no significant efficiency gains from further subsidizing small firms through the tax code. Economic theory holds that the efficiency losses caused by income taxes are minimized when taxes do not distort the production arrangements within firms and all returns to capital are taxed at the same rate. What is known about the economic contributions and performance of small firms does not appear to support the view that their formation and growth are severely constrained by market failures that would warrant targeted tax relief.

This is not to imply, however, that government support for small firms would never be justified on economic grounds. There is plenty of empirical evidence that small entrepreneurial firms play critical roles in production and economic growth and structural change. Measures aimed at simplifying tax accounting and compliance for small firms would have desirable efficiency effects. In addition, the emergence of a market failure that retards the formation and growth of small firms would create a plausible economic rationale for government intervention. A possibility would be capital market imperfections that systematically impede the entry of new small entrepreneurial firms or greatly diminish their chances of survival. Such a market failure could be remedied through policy measures that increase the flow of capital to small start-up firms without substantially distorting the allocation of capital in the economy at large. Tax subsidies might be one such measure, but to be effective, they would need to address the root causes of any capital market imperfections. A continuing challenge for policymakers is to identify market failures that disproportionately harm small firms and devise appropriate policy responses.

The discussion presented here also underscores the need for the development of a robust model of the formation of small firms and their contributions to the economy. As it now stands, considerable uncertainty surrounds debate on this issue. Holtz-Eakin has noted that the use of such a model would enable policymakers to determine whether any market failures are hampering the formation and growth of small firms, identify the factors underlying these failures, and develop policies intended to address these factors.<sup>57</sup>

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<sup>57</sup> *Ibid.*, p. 393.