TAX FOUNDATION

SPECIAL REPORT

October 1996, No. 61

A Half Century of Small Business Federal Income Tax Rates and Collections

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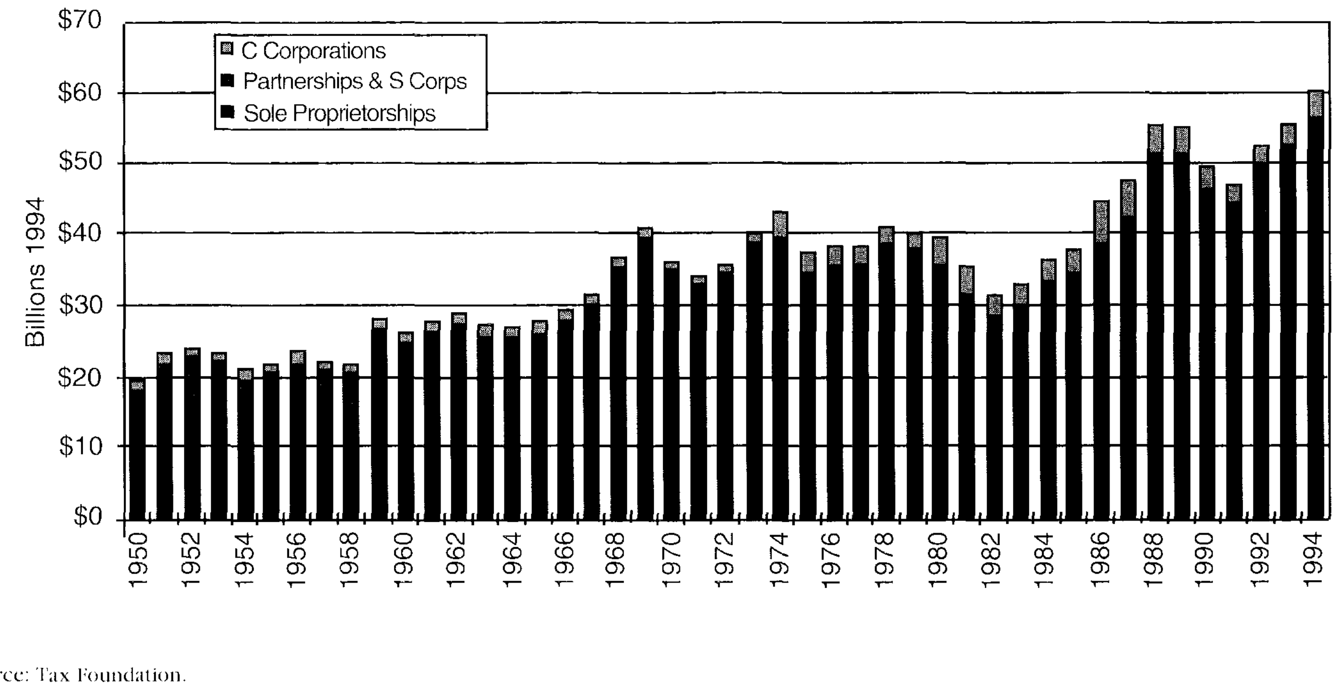
Since 1950, small businesses have, on an average annual basis, paid about nine percent of the income taxes imposed by the federal government. *Figure 1* shows the trend in these total tax payments. *Table 1* reports the totals and shares by type of business structure illustrated in *Figure 1*. On average over the past 45 years, "small" C corporations have paid 2.34 percent of all federal corporate income taxes; small businesses not structured as c corporations have paid 11.52 percent of all federal individual income taxes.

Small businesses are defined here to include sole proprietorships, farms, partnerships, S corporations, and corporations having assets of approximately $1 million or less in constant 1994 dollars. Over the course of forty-five tax years from 1950 to 1994 there has been a large amount of fluctuation in the average income tax paid by such businesses. These fluctuations have had three fundamental causes: changes in tax rates, changes in the definition of taxable income, and trend changes in the overall economy.

Figure 1
Total Small Business Federal Income Tax Collections by Type of Business, 1950-1994
(Billions of 1994 Dollars)



Source: Tax Foundation.

Table 1
Share of Federal Income Taxes Paid By Small Business, By Type
(Businesses with Net Income Only)

	Sole Proprietorships[1]	Partnerships & S Corps.[2]	C Corporations	Total Tax[3] ($Mils.)	Total Tax (1994 $Mils.)
1950	52.3%	41.8%	6.0%	$3,621.6	$19,123.3
1951	53.8	40.2	5.9	4,558.3	22,918.9
1952	55.3	39.3	5.4	4,869.0	24,096.9
1953	55.9	38.9	5.1	4,752.1	23,155.0
1954	55.3	39.4	5.3	4,325.5	20,755.9
1955	55.7	38.5	5.8	4,690.6	21,763.2
1956	59.1	34.8	6.0	5,186.3	23,292.3
1957	57.0	37.0	6.0	5,082.7	22,042.6
1958	57.9	36.4	5.7	5,148.0	21,874.8
1959	59.2	35.1	5.7	5,702.4	28,111.3
1960	60.1	34.4	5.5	5,375.1	26,089.7
1961	61.2	33.2	5.6	5,754.4	27,612.3
1962	62.2	32.4	5.3	6,084.9	28,546.8
1963	62.4	32.3	5.3	6,300.4	29,232.1
1964	62.7	32.1	5.2	6,257.2	28,507.8
1965	62.1	32.9	5.0	6,609.8	29,371.9
1966	63.9	31.4	4.7	7,322.7	31,432.7
1967	63.1	32.3	4.6	8,012.5	33,372.2
1968	59.7	36.1	4.2	9,832.7	39,021.7
1969	61.0	35.1	3.9	10,731.4	40,548.1
1970	61.3	35.0	3.7	10,052.8	36,041.4
1971	60.6	35.7	3.7	10,047.2	34,176.8
1972	61.0	35.3	3.8	10,958.4	35,643.1
1973	64.0	32.8	3.2	13,000.4	39,725.3
1974	59.5	32.0	8.5	15,218.9	42,775.7
1975	58.6	33.6	7.7	14,520.5	37,245.8
1976	59.8	33.3	6.9	15,837.5	38,215.8
1977	59.6	33.7	6.6	16,903.6	38,161.6
1978	59.6	34.6	5.7	19,448.7	40,703.7
1979	60.5	34.0	5.5	20,774.0	40,025.6
1980	57.0	32.5	10.5	22,470.1	39,549.9
1981	57.5	31.8	10.7	22,006.4	35,199.1
1982	54.4	35.5	10.1	20,920.6	31,505.8
1983	52.9	38.2	8.9	22,675.9	32,817.6
1984	51.1	40.2	8.8	26,124.9	36,230.3
1985	51.7	39.5	8.8	28,246.5	37,761.8
1986	50.3	36.4	13.2	34,082.3	44,387.9
1987	47.8	41.5	10.7	37,531.3	47,364.4
1988	46.5	46.4	7.1	45,495.5	55,260.2
1989	47.0	46.4	6.6	47,074.3	54,753.7
1990	42.8	50.9	6.3	44,482.1	49,590.5
1991	42.2	51.9	5.9	43,704.2	46,820.6
1992	39.6	55.3	5.1	49,951.0	52,444.4
1993	36.7	58.2	5.0	53,971.9	55,151.9
1994	34.1	59.2	6.7	60,124.2	60,124.2
Total	50.0%	43.0%	7.0%	$825,841.4	$1,602,546.7

[1] For years 1963 onward, individually owned farms are reported separately by the IRS, but are included here in sole proprietorships.
[2] S Corporations are listed separately by the IRS from 1969 to 1985, but are include here in partnerships.
[3] Average tax rates of sole proprietorships, partnerships, and S Corporations are used to calculate tax liabilities.
Source: Tax Foundation.

Marginal tax rates remained relatively stable throughout the late 1950s and the 1960s. In this policy environment, the number of small businesses, average small business taxable income, and total taxes collected from small business all grew at a relatively steady pace, generally tracking the average growth rate of the overall economy. The inflation of the 1970s broke this growth pattern. The rise of inflation drove many small business taxpayers into increasingly higher marginal tax brackets. Despite the inflation-driven "bracket creep" of the 1970s, there was a substantial dropoff in average income taxes paid by small businesses and a virtual standstill in the growth of their total tax payments. Major tax law changes in the 1980s, in large part a response to events of the 1970s, substantially reduced average small business taxes and preceded a surge in both the creation of new small businesses and total tax payments. This 1980s trend came to a virtual halt with the tax increase of 1990, and the retroactive tax rate increase of 1993 that increased the average tax liabilities of small businesses. However, the increased federal tax collections shown in *Figure* 1 have preceded a continuation of the slow rate of small business creation which began in 1990.

Figure 2 shows average small business income taxes for all business types combined. *Figure 3* shows average income taxes broken down by three categories of small business: sole proprietorships and farms, partnerships and Subchapter S corporations, and C corporations. As *Figure 3* shows, the fluctuations in average taxes have often varied among the different business types. The key factors that contributed to changes in average small business income taxes (and total small business tax payments) are illustrated in *Figures 4* through *6*. *Figure 4* reports weighted average marginal tax rates imposed on non-corporate small business incomes. *Figure 5* shows average taxable income by the three categories of small businesses. *Figure 6* shows the number of taxable returns filed by the three categories of small businesses.

To undertake this analysis, a few features of the existing data are noteworthy. First, only those small business returns with net income are included. Second, all partnerships with net income are included, despite the fact that some partnerships (like the major accounting firms) are known to be large enterprises. Third, small corporations are defined to be those with $1 million or less in assets in 1994 dollars. (Corporations with zero assets are excluded, because they tend to have reported income, on average, that substantially exceeds that of the sample of corporation with assets of more than zero and less than $1 million in 1994 dollars.) Since the Internal Revenue Service categorizes corporations into discrete asset sizes when it reports the data required for this study, approximations and adjustments had to be made to isolate over time those corporations with $1 million or less in assets. Between the years 1950 and 1973, corporations with $100,000 or less in assets constitute the sample; between 1974 and 1979, corporations with $250,000 or less are included; between 1980 and 1985, corporations with $500,000 or less are included; thereafter, corporations with $1 million or less are included.

Trends from 1950 to 1978

Three noteworthy episodes in the income taxation of small business occurred in the period between 1950 and 1978. The first was the enactment of the landmark Internal Revenue Act of 1954 and the Small Business Act of 1958. Next came the marginal tax rate cuts enacted in the Revenue Act of 1964. The third was the accelerating inflation of the 1970s.

The 1950s

Figure 2 shows that average small business income taxes fluctuated widely between 1950 and 1958. These fluctuations were primarily caused by the tax rate increases contained in the Revenue Acts of 1951 and 1952 and the subsequent tax reduction enacted with the Internal Revenue Act of 1954. The 1954 tax reduction combined with slowing economic growth in 1956 and 1957 and a recession in 1958 largely explain the decrease in average taxes between 1955 and 1958.

The substantial spike in average small business taxes reported in *Figure 2* for 1959 resulted primarily from the post-recession 5.5 percent growth in gross domestic product, which translated into a surge in taxable income (*Figure 5*). *Figure 3* reveals that the sudden 25.5 percent increase in real average taxes occurred for each type of small business. Each type experienced an average tax rise of at least 17 percent. While neither marginal rates nor the number of taxable returns varied significantly in this period, as shown in *Figures 4* and *6*, the surge is affected mainly by the 20.5 percent rise in real average taxable income, as shown in *Figure 5*.

The Small Business Act of 1958 was important because it created the Subchapter S corporation. This type of business organization has limited liability, a limited number of shareholders, and is treated similarly to partnerships in that business income is passed through to shareholders to be taxed at individual rates. This privilege eliminated double taxation of small corporations opting to take advantage of the law. However, marginal tax rates on individuals in excess of rates on corporations kept S corporations from becoming popular until the tax cuts of the mid 1980s. (The 1958 act also increased depreciation allowances and increased the amount of income which could be accumulated free of the "accumulated earnings tax," which was a surtax on the accumulation of income by corporations that encouraged the distribution of taxable dividends.)

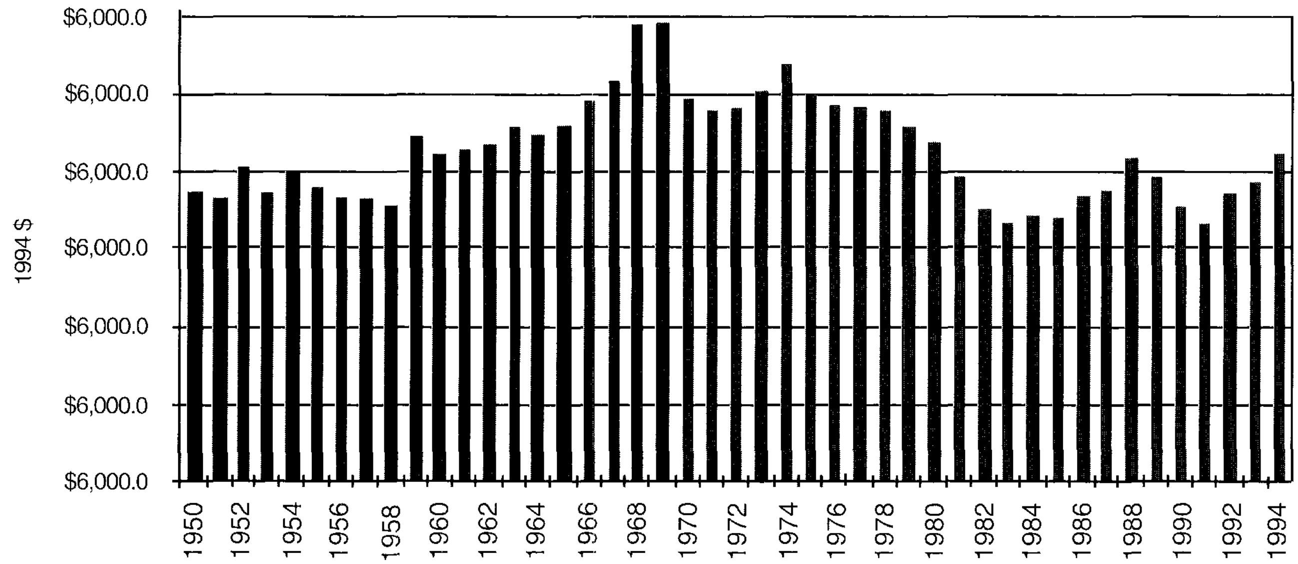
The 1960s

The Revenue Act of 1964 reduced the maximum individual tax rate from 91 percent to 70 percent and the maximum corporate tax rate from 52 percent to 48 percent. This tax rate cut followed the major reform of capital cost recovery rules and the 7 percent investment tax credit for new equipment purchases enacted in the Revenue Act of 1962.

The key outcome of this legislation with respect to small business taxation was the general increase in average tax burdens. This outcome foreshadowed a similar outcome of the major tax reform legislation of the 1980s. *Figure 2* shows that from 1964 to 1967 real average small business income taxes generally increased. *Figure 3* reveals that non-corporate businesses drove this trend. The striking aspect of this trend is that it occurred despite the noticeable drop in weighted average marginal tax rates reported in *Figure 4*. The explanation is depicted in *Figure 5*. The tax rate cuts preceded a major surge in taxable income. This surge coincided with average, inflation-adjusted economic growth rates in excess of 5.5 percent.

The sudden spike in average small business taxes in 1968 resulted from the imposition of a retroactive 10 percent surtax. This legislation marked the beginning of six different substantive legislative changes made in the tax code between 1968 and 1978. The Tax Reform Act of 1969, by introducing the alternative minimum tax, reversed many of the advantageous tax base reforms enacted in 1962 and the rate reductions enacted in 1964. As a result, none of the legislative changes substantially affected the overall direction of small business taxation, growth, or profitability.

Figure 2
Average Federal Income Taxes Paid by Small Businesses with Net Income, 1950-1994
(1994 Dollars)



Source: Tax Foundation.

The 1970s

Accelerating inflation tells the primary story of the 1970s. Inflation ran at an average annual rate of 6.8 percent between 1970 and 1978. Because tax brackets were not indexed for inflation, business owners were pushed into increasingly higher marginal tax brackets. This "bracket creep" increased weighted average marginal tax rates despite legislative reductions in statutory rates. *Figure 4* shows that weighted average marginal tax rates rose by 35.2 percent from 1970 to 1978.

Growth in total small business tax payments slowed markedly between 1970 and 1978. *Figure 1* and *Table 1* show total taxes rising at a real average annual growth rate of only 1.5 percent. Yet *Figure 4* shows rapidly rising marginal tax rates. The explanation for this trend is that this high- marginal-tax-rate, high-inflation period corresponded to a major decline in the real average taxable income of sole proprietorships and partnerships, as *Figure 5* reveals.

Burdens Since the Revenue Act of 1978

The Revenue Act of 1978 marked the first in a series of tax law changes that began a trend of tax rate reduction which lasted through the end of the 1980s. Several acts in the 1980s modified various provisions in the law, but ultimately only two of them had major effects on small business tax burdens: The Economic Recovery Tax Act of 1981 and the Tax Reform Act of 1986. These acts, along with strong economic growth during the 1980s, help to explain the trend in average small business tax burdens along with the relationship between average and total small business tax collections.

The Revenue Act of 1978 enacted four major categories of tax reduction for small business: (1) It reduced individual marginal tax rates on many filers by raising the income level at which successive rates take effect; (2) it reduced the amount of capital gains subject to tax; (3) it reduced corporate tax rates across the board; and (4) it made "permanent" the investment tax credit.

As *Figure 2* illustrates, 1978 marked the beginning of a downward trend in the income tax paid by the average small business. Small business average income taxes fell 18 percent between 1978 and 1981. *Figure 3*, which shows the average income taxes paid by each type of small business, reveals that partnerships and sole proprietorships were the business types most responsible for the declining average. The reasons for this decline can be discerned by analyzing and comparing *Figures 4-6*.

Figure 4 shows that while average taxes had fallen after the 1978 act, weighted average marginal tax rates had not declined substantially. The decline in average income tax, as revealed in *Figure* 5, corresponds to a drop in small business real average taxable income, which fell 20.2 percent between 1978 and 1981. This drop is consistent with both the provisions in the 1978 Act and the slowing economic growth that culminated in the recessions of 1980 and 1982.

Economic Recovery Act of 1981

The evidence shows that the 1981 Act started an explosion of small business creation and small business profitability. New small business creation, reflected in the increase in taxable returns shown in *Figure 6*, averaged six percent per year between 1981 and 1986. Despite the falling marginal tax rates shown in *Figure 4*, average small business income taxes began to rise after the 1982 recession. Because of increased profitability, average real taxes rose at an average annual rate of 3.2 percent between 1983 and 1986, as *Figure* 2 illustrates.

The explosion of business activity led to a substantial increase in the amount of income tax paid by small businesses, as shown in *Figure 1* and *Table 1*. The total taxes paid data show an average annual increase of 10.6 percent (adjusted for inflation) between 1983 and 1986. Total income taxes paid by small business rose at a pace over three times as fast as the average income taxes paid by small businesses from 1983 to 1986. Despite the reversals of 1982 and 1986, the 1981 Act marked a major turning point in the taxation and growth of small business.

The Economic Recovery Tax Act of 1981 (ERTA) phased in an across-the-board 23 percent individual tax rate reduction. This rate reduction, combined with the 60 percent capital gains exclusion enacted in 1978, ultimately provided the most generous treatment of capital gains since the earliest years of the income tax. ERTA also, for the first time, indexed tax brackets for inflation. Indexing went into effect in 1985 and assured that inflation alone would not cause taxpayers to shift into higher marginal tax brackets. It also reduced small business' tax liabilities by (1) increasing the investment tax credit and (2) reducing taxable income by authorizing accelerated depreciation methods that allowed them to deduct the cost of capital equipment more quickly. Both of these provisions encourage investment by reducing its cost.

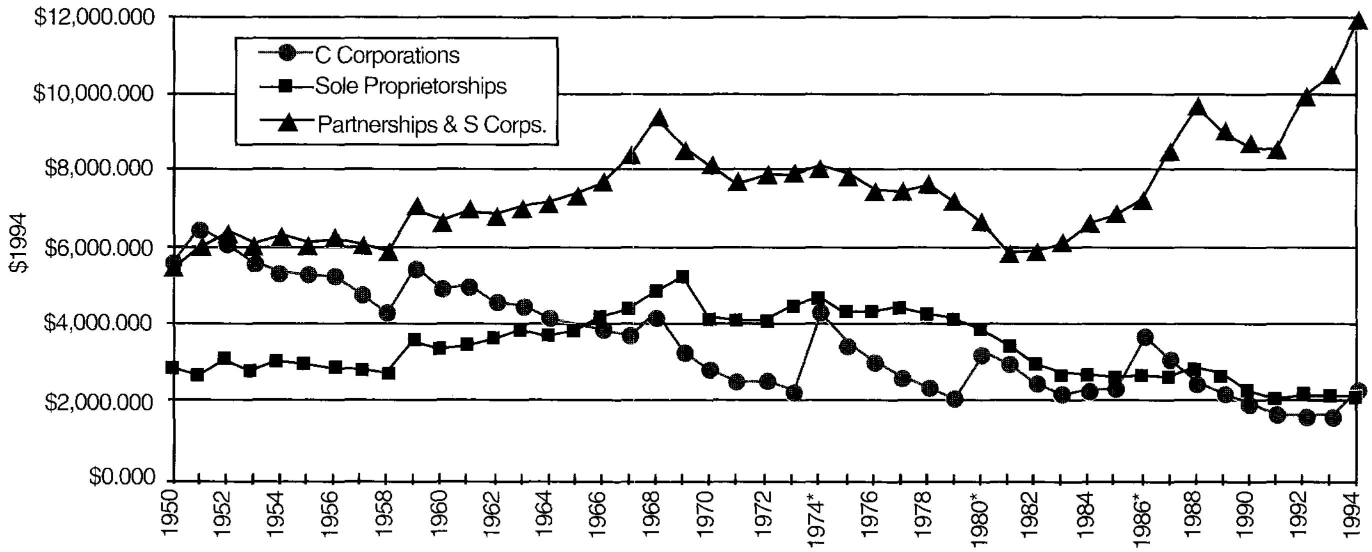
The 1981 Act was revised somewhat by two ensuing pieces of legislation seeking greater revenue: the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), and the Tax Reform Act of 1986 (TRA 86). Neither piece of legislation marked a substantial shift in overall tax policy away from the rate cutting philosophy of the 1981 act. Nevertheless, they limited some of the favorable tax provisions enacted in the 1981 law. TEFRA modified the favorable accelerated depreciation rules included in ERTA. It also reduced the investment credit. TRA 86 froze the expansion of some tax benefits provided for under the 1981 Act and further reduced the benefits of the investment tax credit beyond the reductions put in place in 1982. However, TRA 86 provided slightly more favorable capital gains treatment, reducing from one year to six months the amount of time an asset had to be held in order to qualify for exclusion, thereby reducing the taxation of capital mobility.

Table 1 also shows that all business types were contributing to the increase in total tax collections. However, not all businesses were contributing to the rise in average income taxes. Each business type, as *Figure 3* shows, displayed different trends. The trend in partnerships and sole proprietorships are most noteworthy.

Partnerships

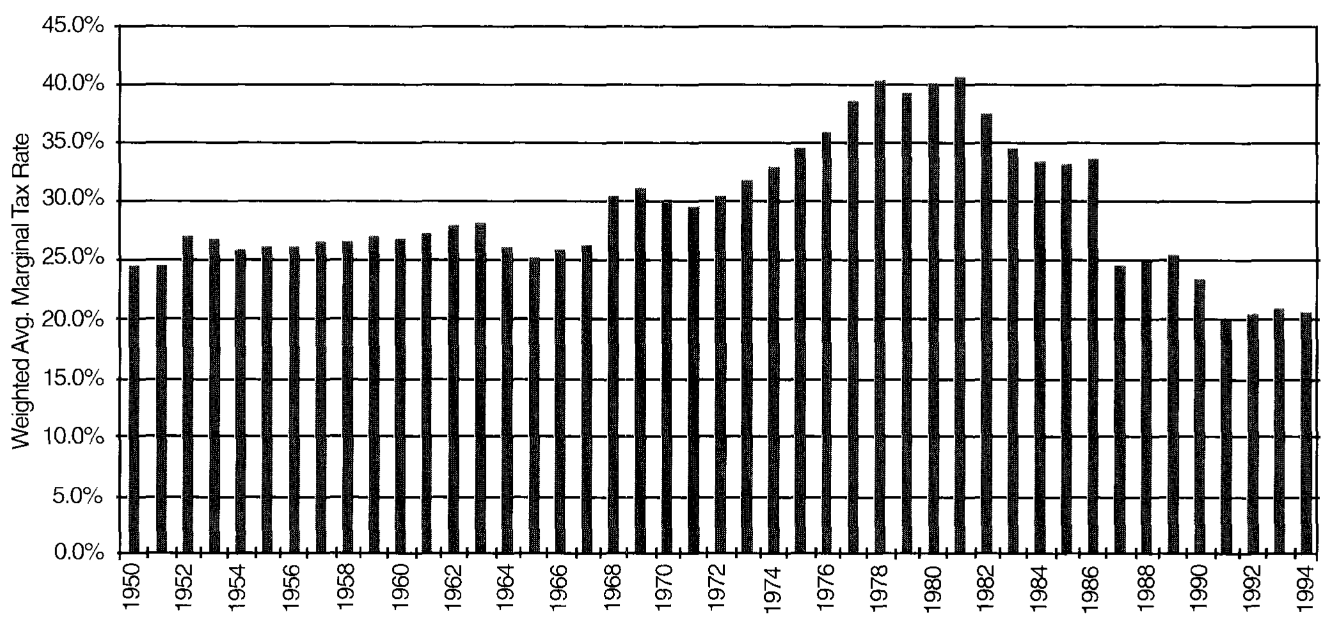
Despite the recessions of 1980 and 1982, *Figure* 5 shows a large increase in the taxable income of partnerships, rising 8.8 percent in the two years after the 1981 tax act. The taxable income of partnerships was rising as marginal tax rates fell and partnerships began to use incentives in the tax laws that encourage investment. The 1981 Act provided generous allowances for "passive losses," which simply put are losses generated by a business in which the partner does not "materially participate." Under the 1981 act, taxpayers could reduce their tax burden by using these losses to offset income from other sources. This made partnerships attractive because they provide investors a way to earn profits while minimizing their taxable income.

Figure 3
Average Federal Income Taxes Paid by Small Businesses with Net Income, 1950-1994
(By Type of Business, 1994 Dollars)



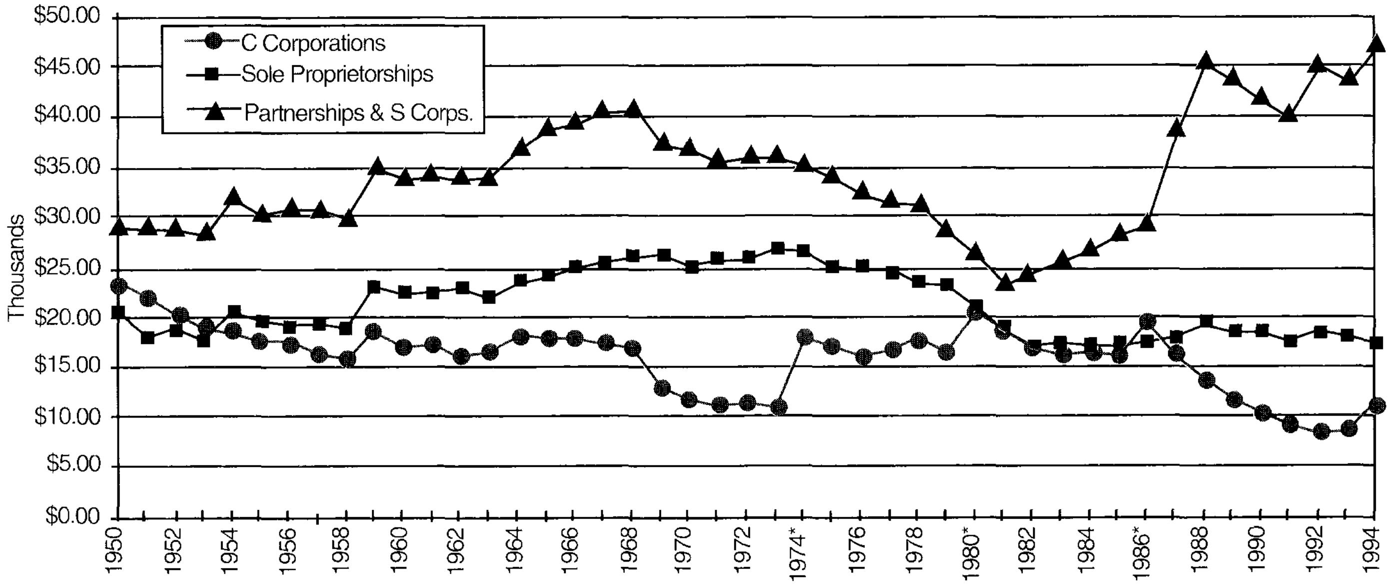
* For corporations, 1974, 1980, and 1986 represent first-year-of-data adjustments that enlarge the pool of corporations represented.
Source: Tax Foundation.

Figure 4
Weighted Average Marginal Federal Income Tax Rates for Small Business with Net Income, 1950-1994
(Individual Rates—Sole Proprietorships and Partnerships/S Corporations)



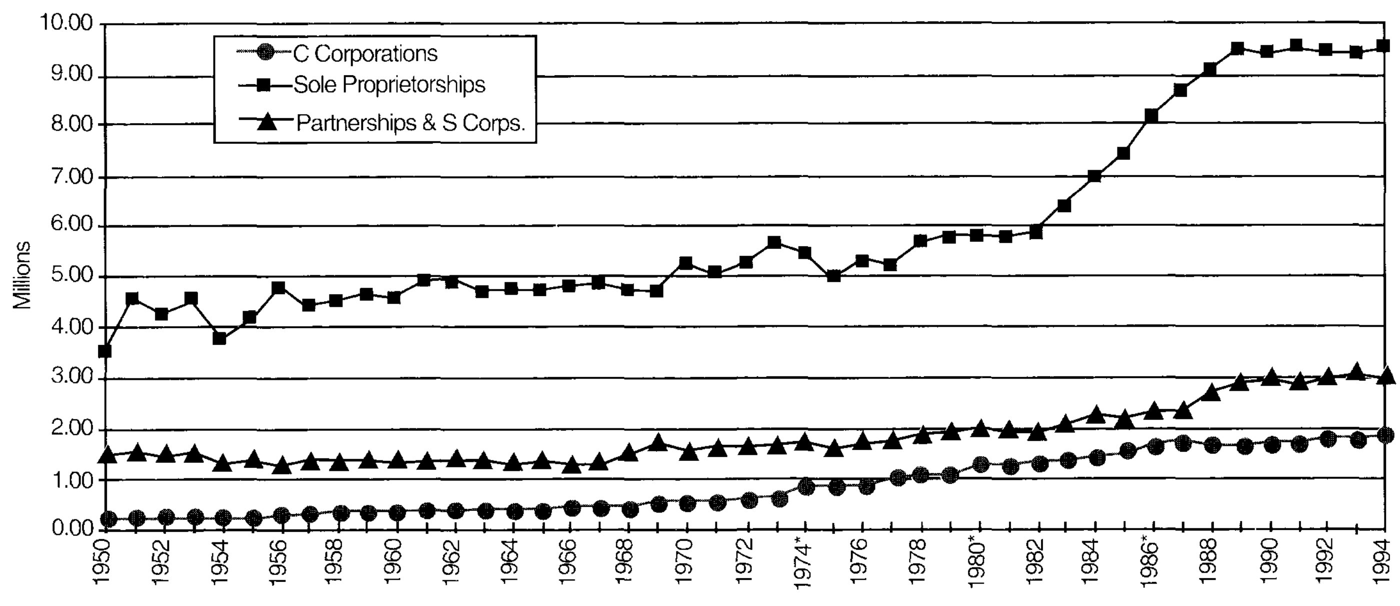
Source: Tax Foundation.

Figure 5
Real Average Taxable Income for Small Businesses with Net Income, 1950–1994
(By Type of Small Business, 1994 Dollars)



* For corporations, 1974, 1980, and 1986 represent first-year-of-data adjustments that enlarge the pool of corporations represented.
Source: Tax Foundation.

Figure 6
Number of Small Business Federal Income Tax Returns with Net Income, 1950-1994
(By Type of Small Business, 1994 Dollars)



* For corporations, 1974, 1980, and 1986 represent first-year-of-data adjustments that enlarge the pool of corporations represented.
Source: Tax Foundation.

Table 2
Share of Returns Filed By Type of Small Business (Businesses with Net Income Only)

	Sole Proprietorships	Partnerships & S Corps.	Corporations[1]	Total Returns
1950	67.7%	28.4%	3.9%	5,142,597
1951	72.3	24.4	3.3	6,273,422
1952	71.5	24.9	3.6	5,960,809
1953	72.6	24.0	3.4	6,239,724
1954	71.4	24.6	4.0	5,257,141
1955	71.6	24.2	4.2	5,751,429
1956	75.1	20.6	4.2	6,326,469
1957	73.0	22.4	4.6	6,042,588
1958	73.4	21.8	4.8	6,145,506
1959	73.2	22.1	4.7	6,291,956
1960	73.7	21.6	4.7	6,236,542
1961	74.9	20.3	4.8	6,477,067
1962	74.3	20.7	5.0	6,583,875
1963	73.4	21.2	5.4	6,369,587
1964	74.2	20.1	5.7	6,346,403
1965	73.6	20.5	5.9	6,414,008
1966	74.0	20.0	6.0	6,431,576
1967	73.7	20.0	6.3	6,484,675
1968	71.4	22.7	5.8	6,605,787
1969	68.4	24.4	7.2	6,825,184
1970	72.1	21.3	6.6	7,293,770
1971	70.6	22.3	7.1	7,115,532
1972	71.0	21.7	7.3	7,408,626
1973	71.8	21.0	7.2	7,886,378
1974	68.2	21.3	10.5	7,979,487
1975	67.2	21.5	11.4	7,444,819
1976	67.2	21.7	11.1	7,840,585
1977	65.8	21.9	12.3	7,889,256
1978	66.3	21.8	11.9	8,520,916
1979	66.3	21.7	12.0	8,728,493
1980	64.4	21.5	14.1	8,982,037
1981	64.5	21.4	14.1	8,981,329
1982	64.7	21.1	14.2	8,982,014
1983	65.5	21.1	13.4	9,789,305
1984	65.8	21.1	13.2	10,539,124
1985	67.3	19.8	12.9	10,997,637
1986	67.8	18.7	13.5	12,037,462
1987	68.6	18.3	13.1	12,654,776
1988	67.9	20.1	12.0	13,319,626
1989	68.0	20.4	11.6	13,933,399
1990	67.4	20.9	11.6	13,979,597
1991	67.8	20.4	11.8	14,005,435
1992	66.8	20.8	12.4	14,097,334
1993	66.2	21.5	12.3	14,259,865
1994	66.4	21.0	12.6	14,270,688
Totals	69.1%	21.3%	9.6%	383,143,836

[1]Corporations chosen for inclusion had average assets in 1994 dollars of $1 million or less. Constraints in the manner in which data is reported necessitated including firms from 1950-1973 with assets of $100,000 or less, from 1974-1979 at $250,000 or less, and from 1980-1985 assets of $500,000 or less.
Source: Tax Foundation.

Coinciding with the decline in marginal tax rates in the 1981 Act, partnership average taxes rose while the number of new partnerships also expanded. Partnership average taxes rose 6.1 percent per year (shown in *Figure 3*), because, as *Figure 5* makes clear, partnership average taxable income rose 4.5 percent per year between 1983 and 1986. The number of partnerships filing returns rose 3 percent annually between 1983 and 1986 (illustrated in *Figure 6*).

The number of partnerships did not increase as fast as sole proprietorships between 1983 and 1986. However, according to the IRS' *Statistics of Income Bulletin* for the Summer of 1992, the number of partners per partnership filing taxable returns increased from 6.9 in 1983 to 9.1 in 1986. Thus, as the number of sole proprietorships were growing, so too were the number of people involved in partnerships.

Sole Proprietorships

Sole proprietorships exhibited a different pattern than partnerships in the 1980s. With declining tax rates, inflation-adjusted average taxes fell 7.3 percent from 1982 to 1986. However, this period saw an explosive rate of new sole proprietorship creation. *Figure 6* demonstrates that between 1982 and 1986, the number of sole proprietors grew by nearly 2.4 million, or 8.9 percent annually, on average.

C Corporations

Between 1982 and 1986, C corporations provided more revenue as a result of both an increase in their number and their average taxes paid. Corporation real average taxable income increased at an annual rate of 3.4 percent between 1982 and 1986.

Over the same time period, small corporations filing taxable returns also increased at a 6.2 percent average annual rate. As a result, corporate average taxes rose at an average annual rate of 9.8 percent.

The Tax Reform Act of 1986

In 1986, Congress passed another major overhaul of the tax system. The Tax Reform Act of 1986 reduced marginal tax rates on individuals and corporations across the board, but it also broadened the base of taxable income. The maximum corporate tax rate was reduced from 46 percent to 34 percent. However, the top capital gains rate was increased from 20 percent to 28 percent on individuals and from 28 percent to 34 percent on corporations. The investment tax credit was also repealed as part of the tax overhaul.

Figure 4 shows the substantial decline in marginal tax rates resulting from the implementation of the 1986 Act. Yet *Figure 1* and *Table 1* show a 19.2 percent (or 9.2 billion dollar) jump in total taxes paid by small businesses between 1986 and 1989. The increased tax collections from small business can be explained by two main factors: the continued growth in new sole proprietorships and the surge in partnership taxable income — a direct consequence of the 1986 legislation. C corporations, whose number filing taxable returns shrank by 0.01 percent annually between 1986 and 1989 and whose real average taxable income declined at an average of 14.9 percent per year, did not play a substantial role in the growth of total income taxes paid by small business.

Partnerships

The partnership category also includes Subchapter S corporations. The rate reductions of TRA 86 created a favorable differential between individual tax rates and corporate tax rates. That made it advantageous for qualifying small corporations to elect to become Subchapter S corporations, which are limited liability companies taxed at individual marginal rates. The rapid growth in S corporations (reported by the IRS to have increased by 37.5 percent or 300,000 in the year following the 1986 act), contributed in part to both greater "partnership" average taxable income and an 8.7 percent annual rate of growth in the number of "partnerships" filing taxable returns, as shown in *Figure 6*. From 1986 to 1989, *Figure 5* illustrates that the combined taxable income of partnerships and S corporations grew at an average annual rate of 27.9 percent.

Aside from the inclusion of S corporations, the jump in the taxable income of partnerships is influenced by several elements contained in TRA 86. First, TRA 86 raised the effective marginal tax rate on capital gains. Capital gains were essentially treated as ordinary income, even though the deduction of capital losses was still limited. Second, TRA 86 changed passive loss rules, which allow a taxpayer to deduct losses from limited partnerships in which they do not play an active role. Under the 1981 Act, passive losses could be used to offset other forms of income. This was changed in 1986 to permit deducting losses only against income derived from similar passive activities. Third, the Omnibus Budget Reconciliation Act of 1987 (OBRA 87) subjected some partnerships to double taxation, taxing the partnership itself as a corporation and then taxing the income of individual partners. These tax law changes subjected a greater portion of the revenues of partnerships to taxation.

Sole Proprietorships

While marginal rates fell precipitously following TRA 86, *Figure 4* shows that average income taxes paid by sole proprietorships did not follow suit. In fact, following a 2.8 percent drop in 1987, average taxes rose again in 1988, despite the lower rates. *Figure 5* shows that, in 1987 and 1988, each sole proprietorship was paying a smaller rate of tax on a larger taxable income. Along with further rate reductions contained in TRA 86, came a continuation of the explosive growth in sole proprietorships during the latter portion of the 1980s. As *Figure 6* shows, sole proprietorships continued to rise at an average annual rate of 5.3 percent in the three years following TRA 86.

The Omnibus Budget Reconciliation Acts of 1990 and 1993

Legislative changes to the tax code occurred in 1990 and 1993. These changes marked a shift away from the tax-rate-cutting philosophy that began in 1978 and was dominant throughout the 1980s. This change in philosophy coincided with a complete stop in the eight year explosion of new sole proprietorships. It also preceded the beginning of a recession that caused the growth of per-firm taxable income to moderate or decrease.

After the recession ended in early 1991, *Figures 1 and 2* show both total and average income tax payments rising. Even with the economy experiencing economic growth between 1992 and 1994, however, the number of returns being filed by all small businesses remained relatively flat. Indeed, according to *Table 2*, the number of small businesses grew by only 1.2 percent between 1992 and 1994. The growth in total taxes was, therefore, concentrated on existing businesses, despite the overall decline in real average taxable income of 6.4 percent between 1992 and 1994. Hence, a greater proportion of each small business's taxable income was being taken in taxes.

The 1990 and 1993 Acts increased both the base of taxable income and the top rates at which that income was taxed. The Omnibus Budget Reconciliation Act of 1990 (OBRA 1990) increased the top individual tax rate from 28 to 31 percent, phased out personal exemptions for upper-income taxpayers, and reduced itemized deductions by 3 percent on income over $100,000 (indexed for inflation).

The Omnibus Budget Reconciliation Act of 1993 (OBRA 1993) added new 36 percent and 39.6 percent tax brackets. It also expanded the number of corporate tax brackets from 4 to 8, increasing the top bracket rate to 35 percent, and included intermediary rates as high as 39 percent. The 1993 Act imposed these tax rate increases retroactively, meaning that OBRA 1993, which became law in August of 1993, applied to economic activity which took place from January 1, 1993 onward. However, the 1993 legislation provided that this increase could be amortized in equal installments over the course of three years. The first third had to be paid in the tax year 1993. This amortization served to reduce the reported effect of the tax increase in 1993, but boost the reported effect of the increase for 1994 by one-third of the 1993 liability.

Average taxes for small businesses as a whole rose 18.8 percent in real terms during the 1990 to 1994 period of higher taxes. However, the components of this increase are not spread evenly among all forms of small business. Furthermore, the rate of growth in average income taxes outpaced the rate of growth in average taxable income for each type of business.

Partnerships

Between 1990 and 1994, the overall increase in average income taxes paid by small business is concentrated most heavily in partnerships (and S corporations). The rate of growth in average income taxes far outpaced the growth in taxable income partnerships experienced between 1990 and 1994. *Figure 5* illustrates that partnership real average taxable income grew 11.6 percent, or only 2.9 percent per year. Yet partnerships' income taxes rise an average of 9.5 percent per year in this time period. In addition, the number of partnerships fell slightly. Hence, each existing partnership was paying more tax as a result of the legislated tax increases.

With the OBRA 1990 law in effect and the economy coming out of recession, 1992 saw a single year increase of 15.8 percent in average partnership income taxes. With one-third of 1993's increased income tax liability due in 1994 in addition to the taxes otherwise due, partnerships paid 20.3 percent higher average income tax in 1994 than in 1992.

Sole Proprietorships

Driven by higher marginal tax rates, the tax burden on sole proprietorships grew during the 1990s even as their average taxable income fell. Sole proprietorship average taxes, shown in *Figure 3*, rose by 4.7 percent between 1990 and 1992, and another 6.4 percent between 1992 and 1994. *Figure 5* illustrates that sole proprietor real average taxable income fell after OBRA 1990 and after OBRA 1993. After declining by eight percent between 1990 and 1994, average taxable income reached its lowest level since 1985.

The strong growth of profitable sole proprietorships during the 1980s came to a virtual halt in 1990. According to *Table 1*, the number of sole proprietors filing taxable returns was six thousand fewer in 1992 than in 1990, and only about 65 thousand greater in 1994 than in 1992. The annualized average growth in the number of sole proprietors with net income was 0.15 percent between 1990 and 1994. (If the recession year of 1990 is *excluded*, the average annual growth rate is -0.03 percent.) That rate is compared with an annual average growth rate of nine percent between 1982 and 1989.

Conclusion

Small businesses have historically paid about one-tenth of the income taxes imposed by the federal government. This share has remained relatively stable over time despite the constant fluctuations in both the body of tax law and the trends of the overall economy.

With regard to small business and tax policy, the two most interesting episodes since 1950 were the tax law changes of the 1960s and the 1980s. In each of these decades, tax rate reductions corresponded to an increase in both the average and total taxes paid by small businesses, particularly non-corporate small businesses.

The 1962 reform of the rules for calculating depreciation and the 1964 tax rate cuts preceded a surge in economic growth that substantially increased the taxable income of the average, non-corporate small business. Similarly, the 1981 tax rate cuts and a new round of reforms for calculating depreciation rules preceded a surge in economic expansion that (1) increased the average taxable income of parnerships and S corporations and (2) generated an explosion in the number of new (and profitable) sole proprietorships.

Also interesting — and perhaps telling — is that the abrupt halt of these positive trends of the 1960s and 1980s coincided with tax laws that both raised tax rates and reversed, at least in part, the favorable depreciation rules.

SPECIAL REPORT (ISSN 1068-0306) is published at least 10 times yearly by the Tax Foundation, an independent 501(c)(3) organization chartered in the District of Columbia.

4-12 pp.
Annual subscription: $25.00
Individual issues $5.

The Tax Foundation, a nonprofit, nonpartisan research and public education organization, has monitored tax and fiscal activities at all levels of government since 1937.

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