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The Effect of the Presidential Candidates' Tax Plans on Flow-Through Businesses

By Robert Carroll

The Presidential candidates' tax plans would take the country in two very different directions. One aspect of their plans is how they would affect the entrepreneurial sector. This sector, which tends to be comprised of small businesses, is particularly important to the U.S. economy. It is an important source of innovation and risk-taking, it creates between 60 and 80 percent of net new jobs, it employs over half the labor force, and it generates more than one half of the nation's gross domestic product (GDP).

Entrepreneurs and small business invent new products, try out new technologies and experiment with new internal forms of organization. Others often follow their example, leading to increases in productivity, or learn from their mistakes and failures. By one count, patents by small firms were cited in subsequent patent applications 28 percent more frequently than those held by larger firms.

The entrepreneurial sector in the United States is proportionately larger than in the private sector economies of its major trading partners. This advantage allows new ideas in the U.S. to be developed and tested more rapidly in the marketplace and adds to the innovation and the dynamism of the U.S. economy.

An often underappreciated feature of the U.S. tax system is that most small businesses are not required to pay the corporate income tax. Instead, small business income "flows through" to the owners who report it on their individual income tax returns and pay taxes due. Indeed, about 35 percent of business taxes are paid in this manner by the owners of "flow-through" businesses—sole proprietorships, partnerships and S corporations.

The top individual tax rates are particularly important because a disproportionate share of the flow-through income reported by small business owners is taxed at those rates. Among the small share of tax returns that are subject to the top two tax rates, most receive small business income.

Consider the fraction of taxpayers with small business income. Roughly 25 percent of all taxpayers report small business income, but as shown in Table 1, this percentage rises steadily with income. When adjusted gross income (AGI) reaches $200,000 or more, 67 percent of taxpayers report small business income. Indeed, high-income taxpayers are over two and one-half times more likely to have small business income than the average taxpayer (i.e., 67 percent for those with incomes at $200,000 or over versus roughly 25 percent for all taxpayers).

Table 1
Tax Returns with "Small Business Income"
By AGI Class and as a Percent of all Tax Returns at Each AGI Class, 2006 (a)

Adjusted Gross Income	**All Tax Returns (millions)**	**Tax Returns with "Small Business Income"**		
		Millions	Distribution by Income Class (AGI)	Percentage with Small Business Income at Each AGI Class
Under $0	1.3	0.9	3%	71%
$0 - $15,000	33.4	5.6	16%	17%
$15,000 - $30,000	29.4	5.4	16%	18%
$30,000 - $50,000	24.9	5.2	15%	21%
$50,000 - $75,000	19.0	5.2	15%	27%
$75,000 - $100,000	11.5	3.8	11%	33%
$100,000 - $200,000	12.2	5.1	15%	42%
$200,000 or more	4.1	2.7	8%	67%
Total	135.9	33.9	100%	25%

(a) Small business income is defined as income or loss from sole proprietorships, farm proprietorships, partnerships, S corporations and rental activities.

Source: Tax Foundation Individual Tax Microsimulation Model.

According to the U.S. Department of the Treasury, taxpayers in the highest two tax brackets made up 8 percent of all taxpayers receiving small business income, but they received over 70 percent of such income and paid over 80 percent of the taxes on this income.[1] Also, roughly 50 percent of the revenue raised from rolling back the reduction in the top two tax rates enacted in 2001 and 2003 can be attributed directly to flow-through income.

Also, there is abundant research showing that high tax rates can affect flow-through businesses and entrepreneurs in a number of damaging ways. Taxes have been found to affect the attractiveness of entrepreneurship as compared to working for someone else.[2] A trio of papers by Carroll et al. (1999, 2000 and 2001) found taxes to slow the rate at which entrepreneurs expand operations and to discourage hiring and investment.[3]

In particular, this research found that reducing the tax rate from 39.6 percent to 33.2 percent[4] increased the likelihood of hiring increases by 12 percent, and for those employees, increased median wages 3.2 percent. The research also found that high-income tax rates reduce the investment spending of entrepreneurs and the likelihood that they invest at all. Raising the marginal tax rate by five percentage points was found to reduce the percentage of entrepreneurs who invested by 10.4 percent and lowered their average investment by 9.9 percent. Finally, higher tax rates were found to discourage the growth or expansion of small businesses. A 10-percent increase in the net-of-tax share, defined as one minus a taxpayer's tax rate, was found to increase business receipts by 8.4 percent.

Effect of Using Alternative Definitions for "Small Businesses"

One of the difficulties in evaluating the effect of changes in the top tax rates on flow-through entities is in characterizing these entities as businesses that have the so-called "entrepreneurial spirit." At least some, and maybe many, of these flow-through entities are owned by people who have a passive interest in the firm and whose creative energy is focused elsewhere. The limited individual tax data typically used to gauge the effects of tax changes on this sector make it difficult to distinguish these passive entities from businesses that are a source of innovation and risk-taking and that add to the productive capacity of the nation. Therefore, we consider several different definitions of "small business" in Table 2 in evaluating how the top two tax rates affect flow-through businesses.

In the broadest, most inclusive definition, nearly 80 percent of taxpayers affected by the top two tax rates report at least some income or loss from a flow-through entity. Here, flow-through income is defined as any income or loss from a sole proprietorship (Schedule C), a farm proprietorship (Schedule F), a partnership, S corporation, or rental activity. Using this definition for a "small business," about 50 percent of the tax increase from rolling back the top two tax rates would fall on the business income reported by owners of flow-through businesses.

The other definitions listed in Table 2 make various attempts to exclude tax returns where the business income may not be characterized by entrepreneurial spirit. For example, comparisons are made to the wages and total income taxpayers reported on their tax returns to gauge the extent to which their income comes from their business activities or from their role as wage earners. In the case of married couples filing jointly, these comparisons make no attempt to separately account for the business income or wages/total income reported by each earner on the return. Also, owners of S corporations are frequently required to pay themselves a "reasonable" wage, which would conflate the comparison.

Even under these alternative definitions, the fraction of taxpayers in the top two brackets with business income varies from 36 percent to 77 percent. However, roughly one-half of the $30.1 billion in higher taxes could be attributed to the business income regardless of the definition.

Table 2 Effect of Increasing the Top Two Tax Rates on "Flow Through" Business Owners 2006 (a)					
	Returns (millions)	**Percentage of Returns in Top Two Tax Rates**	**Tax Change ($billions)**	**Tax Increase on Business Income ($billions) (b)**	**Percentage of Tax Increase on Business Income**
Returns subject to top two tax rates	1.3	100%	$30.1		
Returns with:					
Any business income or loss	1.0	77%	$25.7	$15.4	51%
Positive business income	0.9	65%	$22.0	$16.4	55%
Business income exceeding 30% of their wage income	0.6	44%	$15.8	$15.1	50%
Business income exceeding 50% of their wage income	0.5	36%	$13.7	$13.4	45%
Business income exceeding 30% of their total income	0.7	49%	$17.5	$16.0	53%
Business income exceeding 50% of their total income	0.6	46%	$16.9	$15.6	52%
(a) Small business income is defined as income or loss from sole proprietorships, farm proprietorships, partnerships, S corporations and rental activities. Estimates assume the AMT patch is in place.					
(b) The tax on business income is estimated assuming that business income is earned last.					

Notes

1. U.S. Department of the Treasury, "Treasury Conference on Business Taxation and Global Competitiveness: Background Paper," July 26, 2007, pp. 20-21.

2. Donald Bruce, "Taxes and Entrepreneurial Endurance: Evidence from the Self-Employed," *National Tax Journal* Vol. 55(1), (March 2002).

3. Robert Carroll, Douglas Holtz-Eakin, Mark Rider and Harvey Rosen, "Income Taxes and Entrepreneurs' Use of Labor," *Journal of Labor Economics,* Vol. 18(2) (April 1999), pp. 324-351; Carroll et al., "Entrepreneurs, Income Taxes, and Investment," in *Does Atlas Shrug? The Economic Consequences of Taxing the Rich,* Joel Slemrod, ed., Harvard University Press,

NY, 2000, pp. 427-455 ; Carroll et al., "Personal Income Taxes and the Growth of Small Firms," *Tax Policy and the Economy*, MIT Press, Vol. 15, 2001, pp. 121-147.

4. This reduction in the tax rate is equivalent to a 10 percent reduction in a taxpayers "net-of-tax" rate defined as one minus their tax rate: 1 - 0.396 = 0.604 and 1 - 0.332 = 0.668. The resulting increase in the net-of-tax rate from 0.604 to 0.664 is what taxpayers get to keep after taxes.

Tax Foundation
2001 L Street NW, Suite 1050
Washington, DC 20036
Ph: (202) 464-6200
Fax: (202) 464-6201
www.taxfoundation.org